Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Russia’s invasion of Ukraine is pushing inflation to very high levels and will act as a significant drag on global growth, combined with other headwinds such as rising interest rates

- Concerns that we could be entering a period of stagflation as CPI rates rise to 40 year highs. Inflation to stay elevated well into 2023, with economic growth slowing sharply at the same time

- Significant rate hikes on the cards in 2022-23 as central banks respond to deteriorating inflation outlook. Markets see EZ, UK & US rates rising to 1.4%, 2.4% and 3.15%, respectively, next year

- Fed the most committed to aggressive policy tightening. Weakening activity might see the more cautious BoE and ECB not deliver fully on market rate hike expectations

- Dollar soars to 20-year high on tough talk from Fed about need for significant rate hikes in US. Collapse in yen, while sterling under pressure on worsening outlook for UK economy

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Global Economic Outlook

Growth forecasts cut as inflation spikes even higher on Russian invasion of Ukraine

Growth forecasts are being scaled back everywhere as inflation surges even further on the back of the War in Ukraine. The IMF, in its latest Economic Outlook, says global growth is expected to slow significantly in 2022, largely as a consequence of the war. It notes the war has led to further increases in commodity prices and intensified supply chain disruptions. The OECD has also observed that the war will result in a substantial near-term drag on global growth and significantly stronger inflationary pressures. Meanwhile, restrictions on activity in parts of China to contain a new wave of COVID infections will add even further to the disruptions in supply chains.

The IMF is now forecasting that the world economy will grow by 3.6% this year compared to its projection of 4.9% made last autumn and growth of over 6% in 2021. Growth in advanced economies is expected to slow sharply from 5.2% last year to 3.3% in 2022 and 2.4% in 2023, according to the IMF, which has knocked 1.2p.p. of the 2022 forecast since last autumn. Meanwhile, CPI inflation in advanced economies is now forecast by the IMF to average 5.7% this year, up from the projection of 2.3% made in late 2021.

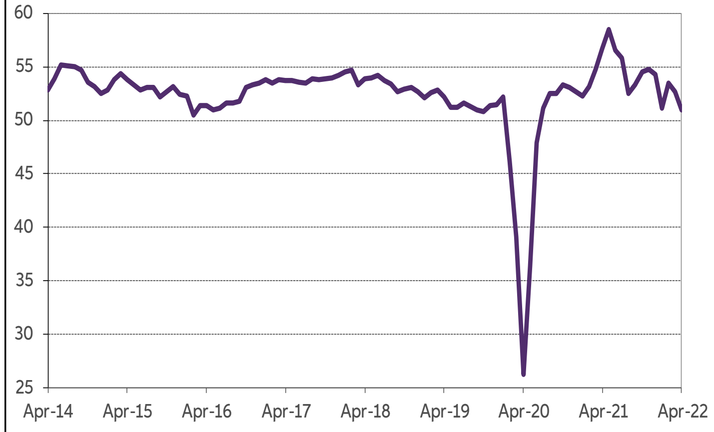
The impact of the war is not uniform across the world economy. Many commodity-producing economies will see higher output and earnings, with bigger output declines occurring in large commodity-importing countries. Russia and Ukraine are entering very deep recessions. Within advanced economies, the EU will be hardest hit given its closer business and energy linkages with Russia prior to the war. The OECD estimates that even with a fiscal response, Eurozone GDP will still take a hit of about 1 percentage point in the first year from the war, nearly three times the impact on the US economy.

There are other headwinds to global growth, apart from the rapid rise in inflation that is eroding real spending power. Uncertainty is very elevated at present, which will impact investment. Meanwhile, global interest rates have risen sharply this year, with central banks ending QE programmes and starting to hike official rates. Financial conditions have tightened considerably, with a sharp rise in bond yields, declines in stock markets and a widening of credit spreads, as well as increased volatility on forex markets.

Shortages of raw materials, key inputs and workers, as well as delays and capacity constraints in transportation, continue to negatively impact supplier delivery times and hold back output in some industries. This is being added to by the aforementioned, imposition of fresh restrictions in parts of China. Both the IMF and OECD highlight the considerable uncertainty around economic forecasts, which is well beyond the usual range. Inflation could turn out to be higher and growth weaker than projected. There is also a growing concern that central banks could make a policy mistake and tighten policy too aggressively in their attempt to dampen inflation, tipping economies into recession.

Inflation rose sharply last year. The war in Ukraine is causing inflation to surge even more this year. Food price inflation is also starting to pick up. Headline CPI rates have risen to 7.5% in the Eurozone and 8.5% in the US. The risk now is that this spills 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 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	-3.1	6.1	3.6	3.6
Advanced Economies	-4.5	5.2	3.3	2.4
US	-3.4	5.7	3.7	2.3
Eurozone	-6.4	5.3	2.8	2.3
UK	-9.4	7.4	3.7	1.2
Japan	-4.5	1.6	2.4	2.3
Emerging Economies	-2.0	6.8	3.8	4.4
China	2.3	8.1	4.4	5.1
India	-7.3	8.9	8.2	6.9
World Trade Growth (%)	-8.2	10.1	5.0	4.4
Inflation -CPI Advanced Economies (%)	0.7	3.1	5.7	2.5

Source: IMF World Economic Outlook, April 2022

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Interest Rate Outlook

Central banks move to tighten monetary policy 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 has 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 rates.

The war in Ukraine has added to inflationary pressures, with further very sharp increases in energy and other commodity prices. CPI rates have reached 8.5% in the US and 7.5% in the Eurozone and hit double-digit levels in some economies. The BoE is forecasting that inflation in the UK will rise above 10% in the final quarter of this year. Growth, though, is going to be weaker than expected in 2022-23, making central banks task more difficult as they don't want monetary tightening to push economies into recession.

The US Federal Reserve has been the most vocal of the central banks in delivering a clear message that a significant tightening of policy is on the cards over the coming year. It increased rates by 25bps in March and 50bps in May, bringing the funds rate up to a 0.75-1.0% range. This was the first 50bps hike in US rates since 2000. The Fed signalled that further 50bps hikes are on the cards at the next two meetings. It may revert to 25bps hikes after that, if inflation is on a clear downward path by the end of the summer. This would raise the funds rate to a 2.5-2.75% range by end year. Further rate hikes are expected in 2023. The markets see the funds rate rising to 2.7% by end 2022 and 3.15% next summer. Meanwhile, the Fed will embark on a passive quantitative tightening programme in June. The Fed says that it is absolutely essential to restore price stability. It argues that the economy is strong and therefore expects that it will be able to withstand the considerable monetary tightening.

The Bank of England wrapped up its QE bond purchase programme in December. It has hiked the Bank rate on four occasions since then, taking it from 0.1% up to 1%. Further rate increases are expected in 2022. Markets are now pricing in that UK rates could be raised to 2% by year end and 2.4% in summer 2023. The BoE, though, seems a lot less sure on this. Most MPC members at its May meeting were happy with guidance that some degree of further tightening in monetary policy may be still appropriate, but some others judged such guidance was not apt at this juncture given the risks around growth and inflation were now more evenly balanced. Growth in the UK economy is expected to slow sharply as a result of fiscal and monetary tightening and higher energy costs. Based on market rate projections, 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 the risks to economic activity and the cautious guidance from the BoE. Rates may top out at below 2%.

The ECB has been engaged in lowering the pace of its asset purchases since last autumn and is set to end QE in Q3 2022, possibly as early as the start of July. It has indicated that rate hikes could begin soon after. Markets now believe that the ECB will begin raising rates in July and are pricing in nearly 90bps of hikes by end year. They see a further 100bps of rate increases in 2023. This would take the deposit rate up from –0.5% to 1.4% by the end of next year. Thus, we are nearing the end of the negative interest rate regime that has been in place since 2014. Greater clarity will be provided by the ECB at its June policy meeting. With the EU economy quite exposed to Russia and facing considerable downside risks, rate hikes on the scale expected by the markets may not materialise. Nonetheless, a series of rate increases look to be in prospect over the second half of this year.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.875	1.40	2.59	2.85	2.90
June'22	1.375	1.90	2.90	3.10	3.15
Sept'22	2.125	2.40	3.20	3.30	3.30
Dec'22	2.625	2.90	3.40	3.50	3.40

** 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	-0.42	0.22	0.87	1.44
June'22	-0.50	-0.30	0.40	1.05	1.60
Sept'22	0.00	0.10	0.75	1.20	1.60
Dec'22	0.25	0.35	1.00	1.30	1.50

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	1.00	1.24	2.00	2.30	2.26
June'22	1.25	1.40	2.10	2.35	2.30
Sept'22	1.50	1.60	2.10	2.30	2.25
Dec'22	1.75	1.80	2.00	2.25	2.15

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar soars as hawkish Fed signals significant rate tightening in store

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 in late November, with the key support level of $1.16-1.17 giving way during the 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 ground against a broad range of currencies, with particularly large gains against the yen and sterling.

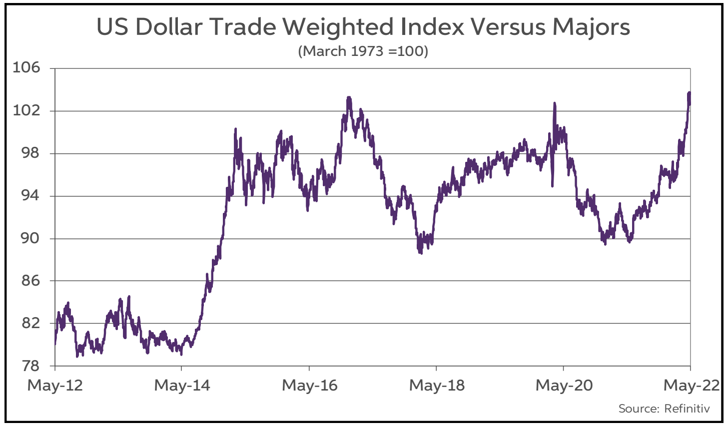
Not surprisingly, given the Eurozone's closer trade and financial ties with Russia and in particular its reliance on imports of gas from there, the euro came under pressure following the invasion of Ukraine and the imposition of sanctions on Russia. Support at the $1.10 level against the dollar was easily 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, the major support at $1.04, which is the lowest point hit by the euro in the past twenty years, reached at end 2016, has held in the past couple weeks. The euro has stabilised, with the EUR-USD pair trading around the $1.05 level over the past fortnight.

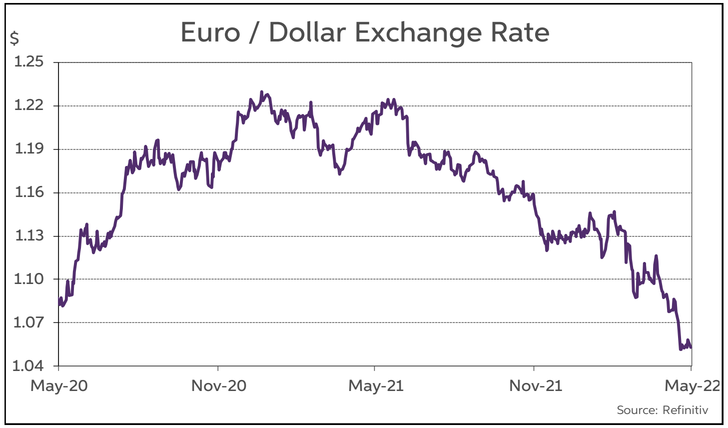
It is difficult to envisage a significant fall in the dollar over the balance of this year as it should be supported by a significant move upwards in US interest rates. The Fed has hiked rates by 75bps in total during the past two months and indicated that a further 100bps in rate increases are on the cards over the summer, with more hikes to come after that. Markets are pricing that US rates will have risen to above 3% by mid-2023.

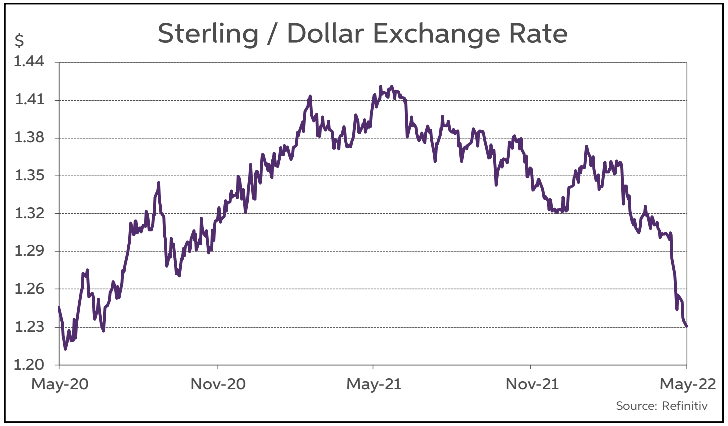
From a euro viewpoint, though, the fact that the ECB looks set to hike rates over the course of the second half of 2022 should prove supportive of the currency. However, ECB rate increases in H2 2022 will be relatively modest compared to the Fed. Meanwhile, the war in Ukraine is likely to continue to pose a risk for the euro, especially if there is a prolonged 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 could put 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 currency. 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.







Forex Market Outlook

Sterling on the slide 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.

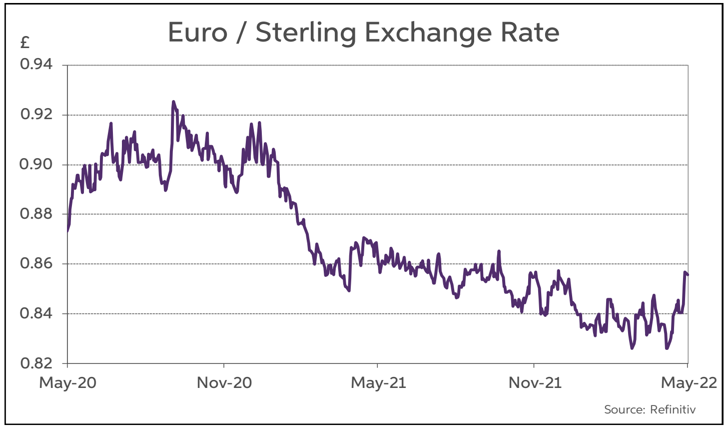
The BoE started to turn quite hawkish on monetary policy from October onwards. There was a 15bps rate hike in December, followed by three 25bps increases to date in 2022, bringing the Bank rate to 1%. Markets are pricing in that UK rates could rise by a further 100bps over the rest of the year. This would take the Bank rate up to 2%, with rates seen reaching 2.4% in mid-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 $1.36 in mid-February to $1.23 by May. Meanwhile, the euro has risen from below 83p in mid-April up towards the 86p level recently.

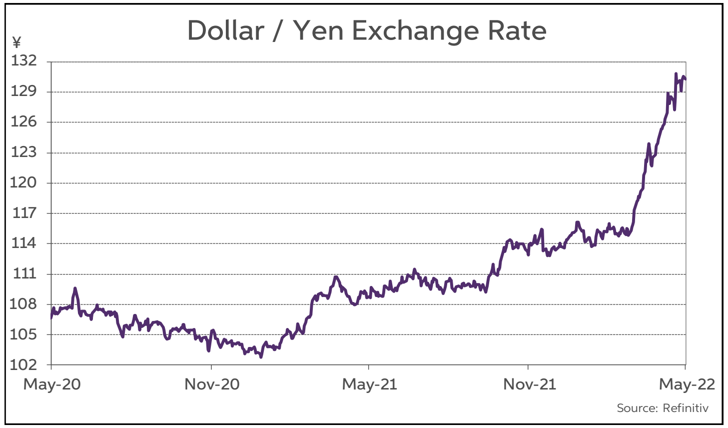
This weakness seems to be largely due to concerns about the economic outlook. While the UK is expected to record a good rise in GDP in 2022, this is largely due to carryover effects and strong Q1 growth. The economy is set to lose considerable momentum as the year progresses in the face of a tightening of fiscal and monetary policy as well as galloping inflation. The Bank of England is quite downbeat on the 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. The BoE sees the UK economy experiencing stagflation in 2023-24.

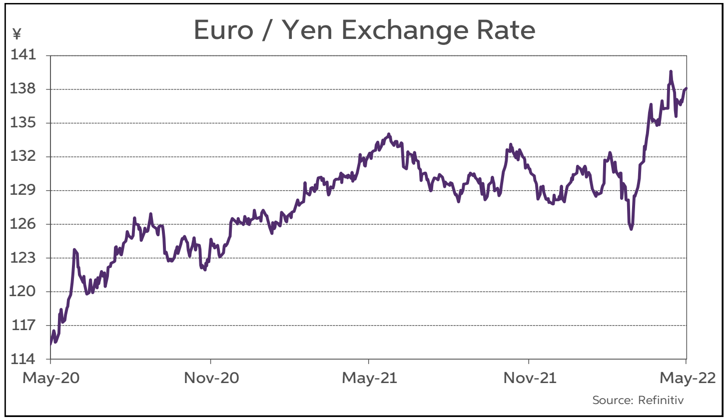
Thus, the BoE has turned more cautious recently on policy tightening. Most MPC members were in agreement at its May meeting that some degree of further tightening may be appropriate, but some others were not so sure given the headwinds facing the economy. There is considerable doubt, in our view, about whether rates will get anywhere near the 2.4% level priced in by markets for next year, given economic activity is set to slow sharply. 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.

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 ¥130. Meanwhile, the euro has risen from a low of ¥115 two years ago to around ¥138 recently, with sizeable gains in the last two months in particular. Japan's inflation rate remains well below target at 1.2%, with the core rate at 0.8%, Thus, 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%. Meantime, we have seen significant rate hikes and sharp rises in bond yields elsewhere. The widening interest rate differentials are putting severe downward pressure on the yen, with outflows into much higher yielding currencies. The yen has fallen to twenty year lows against the dollar—the US currency has not been above the ¥130 level since 2002. The yen could continue to lose ground as interest rate differentials widen even further. Forex intervention to try to stabilise the currency seems pointless with the BoJ engaged in large scale QE to cap bond yields. The next major support level is ¥135 against the dollar, which may well be tested in the months ahead.







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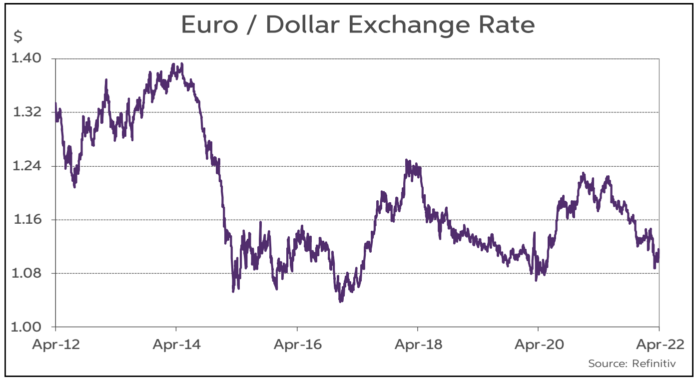
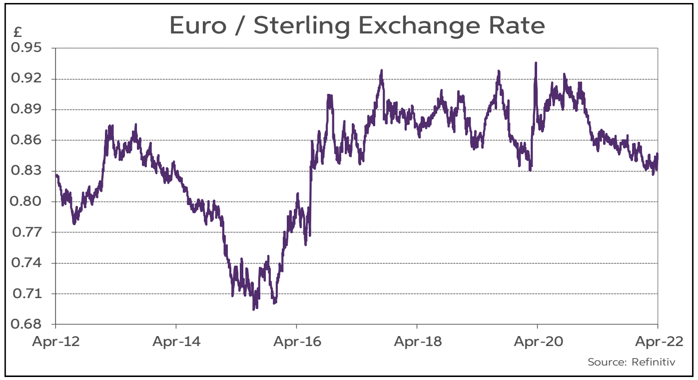
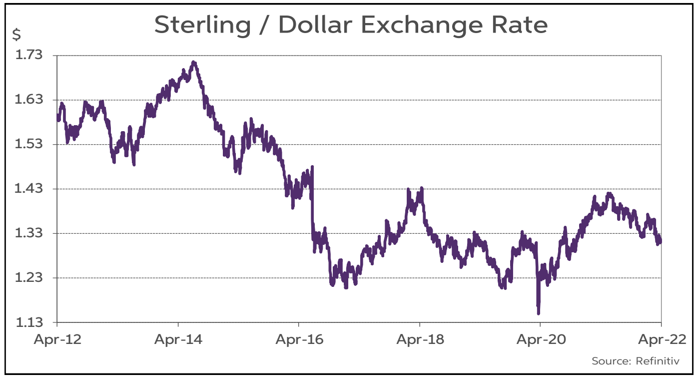
Summary of Exchange Rate Forecasts

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

Euro Versus	Current	Q2-2022	Q3-2022	Q4-2022	Q1-2023
USD	1.055	1.02-1.08	1.03-1.09	1.04-1.10	1.05-1.10
GBP	0.855	0.82-0.88	0.83-0.89	0.84-0.90	0.85-0.91
JPY	136.94	135-141	138-144	141-147	142-148
CHF	1.04	1.05	1.06	1.07	1.08
US Dollar Versus					
JPY	129.75	128-134	130-136	132-138	132-138
GBP	1.235	1.21-1.27	1.20-1.26	1.20-1.26	1.19-1.25
CAD	1.30	1.31	1.30	1.28	1.26
AUD	0.70	0.69	0.70	0.71	0.72
NZD	0.63	0.63	0.64	0.65	0.66
CNY	6.72	6.80	6.75	6.65	6.50
Sterling Versus					
JPY	160	162	164	166	165
CAD	1.60	1.62	1.60	1.57	1.54
AUD	1.76	1.80	1.76	1.73	1.69
NZD	1.95	1.97	1.92	1.89	1.85







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