Weekly Market Brief

AIB Treasury Economic Research Unit

7th –11th September 2020

Two Be or Not Two Be: That is the Question

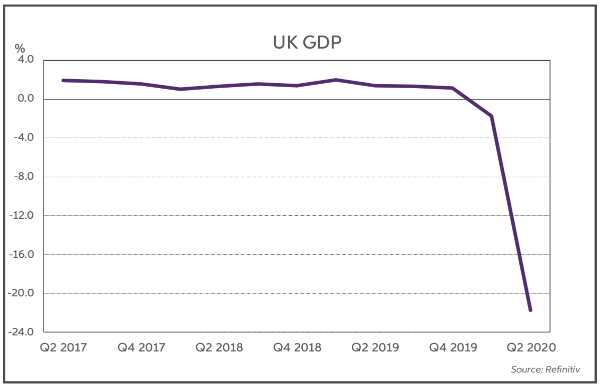
- **The euro briefly tested the key strong resistance point of $1.20 this week** as the dollar came under further pressure following the Fed move to a more accommodative monetary policy framework. The fact that this support level held for the dollar is testimony to its strength and durability. The euro has risen above the $1.20 level only once since the ECB moved to negative interest rates in 2014, and then for just a short period of time in early 2018. Market positioning is also very short the dollar, making it even more difficult to overcome this major resistance level. The failure to do so is not to minimise the significance of the change to the Fed policy framework. It is arguably the biggest policy shift since the early 1980s when the Fed under Paul Volcker, took aim to squeeze inflationary pressures out of the US economy, raising rates to 20% in the process,

- **This time the problem is a lack of inflation.** The past decade has seen the US unemployment rate drop to a fifty year low of 3.5%, but inflation remained stubbornly below the Fed's 2% target. The Fed believes low inflation will be a feature of the next cycle also. The Fed has a dual mandate of maintaining stable prices while maximising employment. It will now give greater weight to achieving its employment goal under its new policy framework by allowing inflation move "moderately above 2% for some time". It is now targeting an average inflation rate of 2% over time rather than a specific 2% target. This revised framework according to the Fed, reflects an appreciation of the benefits of a strong labour market, particularly for those on low and moderate incomes.

- **This suggests that the US will be able to move back to full employment without the need to raise interest rates to prevent signs of overheating emerging in the economy.** It implies that rates are going to be maintained at their current very low levels for a longer period of time, even if a robust recovery takes hold in the economy and inflation rises somewhat above the 2% target. Indeed, interest rates could remain very low even when the economy has returned to full employment, provided inflation stays well behaved.

- **Normally greater tolerance of inflation would unnerve bond markets and see curves steepen as long-term rates rise.** There was a brief rise in yields in response to the Fed policy shift, but it did not last and the spike quickly reversed. This suggests markets believe that even the new looser Fed monetary stance will not be sufficient to drive inflation back above 2%. There is simply too much slack in the economy, and inflation in any event has been dormant for more than a decade now. Indeed, negative interest rates in the Eurozone over the past six years were not enough to see the ECB come anywhere near reaching its inflation rate target of close to 2%. The real test for the new Fed policy regime then is years away and not a concern for bond markets at the present time. However, we don't think they would be quite as sanguine if inflation moved above 2% at some time in the future when the economy was performing strongly and moving towards full employment if rates were still near zero.

- **Turning to the week ahead, the ECB will hold its September policy meeting.** However, no changes to policy are expected as the ECB continues to assess the recovery in the Eurozone. Therefore, the deposit rate is set to be maintained at –0.5%, while the PEPP envelope is expected to remain at its current size and duration, of €1,350bn until at least June 2021. No doubt, we can expect the ECB President Lagarde to face questions about whether the ECB would consider adopting the Fed's new approach of average inflation, rather than a specific target. The ECB's policy review is expected to be completed in late 2021. It will be interesting to see also, what the ECB makes of the recent sharp drop in inflation, and rise in the euro.



- **Data–wise, some of the main highlights come from the UK.** July's estimate of GDP will be looked at for further signs of recovery in the economy. Businesses began to reopen in June, yet, this could not stop the UK from reporting its worst quarterly GDP figure on record at –20.4% in Q2. Although, the economy expanded by 8% in June, and investors will be looking for signs that this recovery continued in July. Also in the UK, Industrial output in July is forecast to have increased by 4.1%**.** Meanwhile, Brexit negotiations resume this week, with both sides remaining far apart on the key issue of regulatory alignment.

- **In the US, headline CPI is expected to rise by 1.2% YoY,** with Core CPI to remain unchanged at 1.6%. Meanwhile, initial claims fell below 1m for only the second time since March last week, and investors will be looking to see if this is repeated. **Moving closer to home, Irish GDP for Q2 is set for release**. The hit from the Covid-19 crisis could see the economy contract by 22% YoY in Q2, in line with the fall in average hours worked. As ever with Irish GDP, there is a wide margin of error attached to the forecast. Also, the Covid–19 Adjusted rate of unemployment is forecast to fall to 14.5% in August, from 16.7% in July. Irish CPI for August will be released on Wednesday. The expectation is for inflation to decline to –1.0% YoY following a cut in VAT.

Interest Rate Forecasts

	Current	End Q3 2020	End Q4 2020	End Q1 2021
Fed Funds	0.125	0.125	0.125	0.125
ECB Deposit	-0.50	-0.50	-0.50	-0.50
BoE Repo	0.10	0.10	0.10	0.10
BoJ OCR	-0.10	-0.10	-0.10	-0.10

Current Rates Reuters, Forecasts AIB's ERU

Exchange Rate Forecasts (Mid-Point of Range)

	Current	End Q3 2020	End Q4 2020	End Q1 2021
EUR/USD	1.1797	1.20	1.21	1.23
EUR/GBP	0.8936	0.90	0.87	0.88
EUR/JPY	125.55	127	127	127
GBP/USD	1.3204	1.33	1.39	1.40
USD/JPY	106.37	105	104	104

Current Rates Reuters, Forecasts AIB's ERU

ECONOMIC DIARY

Monday 7th September - Friday 11th September

AIB Treasury Economic Research

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Date	*UK & Irish Time (GMT+1)*		*Release*	*Previous*	*Forecast*
This Week:	**ECB Speakers:**		Fernandez-Bollo (Wednesday); **Lagarde**, de Guindos, Schnabel, Lane (Friday)		
Mon 7th	**GER:**	07:00	Industrial Production (July)	+8.9%	+4.8%
	EU-19	09:30	EU Sentix Index (September)	-13.4	-10.8
	CHINA:	09:30	Trade Balance (August)	\$62.3bn	\$50.5bn
			- Exports	(+7.2%)	(7.1%)
	IRL:	***11:00***	***GDP (Q2)***	***(+5.1%)***	***(-22.0%)***
Tue 8th	**UK:**	00:01	BRC Retail Sales (August)	(+4.3%)	
	JPN:	00:50	GDP (Q2: Second Reading)	-27.8% s.a.a.r.	-28.6%
	GER:	07:00	Trade Balance (July)	€14.5bn	
			- Exports	+14.9%	
	EU-19:	10:00	Employment (Q2: Final Reading)	-2.85 (-2.9%)	
	EU-19:	10:00	GDP (Q2: Third Reading)	-12.1% (-15%)	`-12.1% (-15%)
	US:	11:00	NFIB Business Optimism (August)	98.8	
	US:	20:00	Consumer Credit (July)	+\$8.9bn	+\$12.5bn
Wed 9th	***IRL:***	***11:00***	***Unemployment (August)***	***5.0%***	***5.2%***
			- Covid Adjusted Rate	***16.7%***	***14.5%***
Thurs 10th	**JPN:**	00:50	Core Machinery Orders (July)	(-22.5%)	(-18.3%)
	FRA:	07:45	Industrial Output (July)	+12.7%	+5.1%
	ITA:	09:00	Industrial Output (July)	+8.2%	+4.0%
	IRL:	***11:00***	***CPI (August)***	***-0.2% (-0.4%)***	***-0.3% (-1.0%)***
	EU-19:	12:45	ECB Refi Rate Announcement	0.00%	0.00%
			- Deposit Rate	-0.50%	-0.50%
	EU-19:	13:30	ECB Press Conference		
	US:	13:30	Initial Jobless Claims (w/e 31st August)	881,000	
	US:	13:30	PPI (August)	(-0.4%)	(-0.3%)
Fri 11th	**GER:**	07:00	Final HICP (August)	(0.1%)	(-0.1%)
	UK:	07:00	GDP (July)	+8.7% (-16.8%)	+6.7% (-11.2%)
	UK:	07:00	Industrial Output (July)	+9.3% (-12.5%)	+4.1% (-8.7%)
			- Manufacturing	+11.0% (-14.6%)	+5.0% (-10.5%)
	UK:	07:00	Goods Trade Balance (July)	-£5.116bn	-£7.0bn
			- Non-EU	£0.296bn	
	US:	13:30	CPI (August)	(+1.0%)	(+1.2%)
			- Core	(+1.6%)	(+1.6%)

♦ *Month-on-month changes (year-on-year shown in brackets)*
All forecasts AIB ERU, historical data in the Economic Diary derived from publicly available sources