Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Coronavirus pandemic causes world economy to enter very deep recession in H1 2020. This is not a cyclical downturn, but a sudden shock. Should see a strong rebound as virus subsides

- Most forecasters anticipate that economic rebound will commence in the summer, but difficult to predict. It may also be constrained by scarring effects, or a smaller second wave to the virus

- Central banks everywhere have responded aggressively with rates cuts, large QE asset purchase programmes and enhanced liquidity measures. Rates now likely to be even lower for longer

- Forex markets turn more becalmed after initial volatility. Central banks open large swap lines to meet huge demand for dollars, which has relieved sharp upward pressure on the US currency

- Sterling very volatile, but has recovered significant ground after an initial very sharp sell-off

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Global Economic Outlook

Signs of a pick-up in activity snuffed out as Covid-19 triggers sudden, deep recession

There were some green shoots about at the turn of The year, following the marked slowdown in the world economy over the previous eighteen months. The pace of global economic activity had accelerated to a ten month high by January according to PMI survey data. The Global Composite PMI hit 52.2 in the month, the third consecutive monthly rise in the index. Encouragingly, growth strengthened in both manufacturing and services.

However, these signs of an economic upturn have been snuffed out with the outbreak of the coronavirus in China becoming a global pandemic which has seen large parts of the world economy shut down. The PMIs for February showed a marked weakening in activity in some major Asian economies that have been impacted by the coronavirus. Data are now beginning to flow through for March and are showing the extent of the unprecedented shock that has hit the world economy. The most eye-catching figure is the surge in weekly initial jobless claims in the US, which have rocketed from circa 300,000 to 6.6 million in two weeks. Previous highs reached were below the 700,000 level, set during the recessions in 1982 and 2009.

Meanwhile, early flash March PMI data show very steep falls in activity in the services sector of economies in particular. Other March survey data have also been very weak. The data highlight the severity and suddenness of the economic downturn and that it is also broad based, impacting virtually all sectors and all economies. This is only the beginning. Data are going to get much worse in the next couple of months given that large parts of the world economy have effectively been put into cold storage.

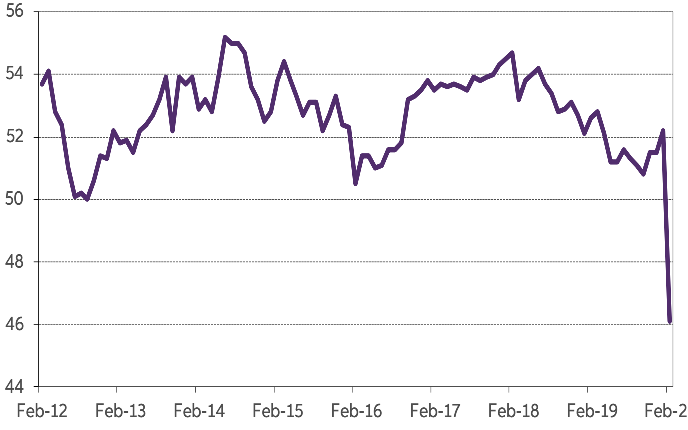
Extraordinary measures are being taken by both governments and central banks to cushion the economic impact of the coronavirus pandemic. These include direct income support payments for households, as well as bank loan guarantees for companies in some countries. These actions won't prevent a very deep recession, but they will help to ameliorate some of the most severe impacts and lay the groundwork for a recovery when the virus fades.

Naturally, there is a lot of focus on the depth of the recession that economies are now entering. We have not seen this type of recession before. There are forecasts that GDP could contract by 10% or more in the first half of 2020 in many advanced economies. However, the recession, though very deep, will most likely prove short lived. Activity should rebound during the second half of the year. The Bank of England at its MPC meeting in late March noted that while the scale of the economic shock will be large and sharp, it should "ultimately prove temporary".

There is much uncertainty about the exact timing and strength of the rebound. It could be impeded by scarring effects, such as lingering damage to confidence, lasting negative impacts on some businesses and tighter financial conditions. There is also the risk of a second smaller wave to the virus later in the year. GDP growth had been expected to range between 1% and 2% in 2020 in the major advanced economies. Now there are forecasts that it could contract by 5%, which would put it on a par with the recession in 2009 during the financial crisis.

Even if the recovery is modest during the second half of 2020, resulting in a very sharp fall in GDP for the year as a whole, economies can be expected grow at very strong rates in 2021. Thus, to get a more complete picture, we need to look at not just the deep recession, but also the recovery that follows, including into next year. Meanwhile, with oil prices collapsing to circa $20 a barrel and the world economy suffering a demand shock, which will see unemployment rise sharply, inflation can be expected to fall to very low levels during 2020.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2018	2019 (e)	2020 (f)	2021 (f)
World	3.6	2.9	3.3	3.4
Advanced Economies	2.2	1.7	1.6	1.6
US	2.9	2.3	2.0	1.7
Eurozone	1.9	1.2	1.3	1.4
UK	1.3	1.3	1.4	1.5
Japan	0.3	1.0	0.7	0.5
Emerging Economies	4.5	3.7	4.4	4.6
China	6.6	6.1	6.0	5.8
India	6.8	4.8	5.8	6.5
World Trade Growth (%)	3.7	1.0	2.9	3.7
Advanced Economies Inflation (CPI %)	2.0	1.4	1.7	1.8

Source: IMF World Economic Outlook Update, January 2020

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Interest Rate Outlook

Central banks pull out all the stops to counter deep Covid-19 recession shock

Monetary policy returned to easing mode last year in response to the slowdown in the global economy. This was most clearly seen in the US, with the Fed cutting rates by 75bps in H2 2019. Meanwhile, the ECB also lowered rates last autumn and restarted its QE asset purchase programme. Other central banks, including in Australia, New Zealand, India and Thailand, also reduced interest rates, with rate cuts implemented in China too.

The policy loosening in 2019 was extensive, with a total of 71 rate cuts by 49 central banks in the year according to the IMF. It was the most synchronised easing of monetary policy since the global financial crisis over a decade earlier. Somewhat ironically, the IMF commented that without this monetary easing, we could have been looking at a global recession. Little did it know what was in store for the world economy in 2020 as a global pandemic took hold, sending the world economy into a sudden, deepen recession.

The recession may not last too long, but the world economy is facing its most severe crisis, probably since the Great Depression of the 1930s. The impact of the coronavirus pandemic on activity is more severe than the global financial crisis of 2008-09 as it has hit virtually every sector of every economy. Hopefully, the impact will be short lived. This is not a cyclical downturn in activity, but rather a sudden, severe shock to both demand and supply. The expectation is that economies will bounce back once the virus abates and restrictions on activity are lifted.

Central banks globally have been pulling out all the stops to try and ameliorate some of the most severe impacts on economies and lay the groundwork for a recovery when the virus fades. Rates have been cut to close on zero in the US and UK, enormous QE bond purchase programmes have been put in place and measures adopted to enhance the supply of liquidity and ease funding pressures, notably in regard to the dollar. The motto from central banks and, indeed, governments, is that they are prepared to do whatever it takes to prevent the sudden, severe contraction in economies from morphing into a prolonged downturn in activity.

It would seem that we have now reached the lower bound in interest rates for the main central banks. The ECB and BoJ are obviously not keen to move interest rates even deeper into negative territory and have focused instead on large scale non-standard policy easing measures. Both the Fed and BoE have indicated a reluctance to move rates into the negative domain and so are unlikely to go beyond their recent rate cut moves that brought rates to zero. The focus for any new measures is likely to be on expanding their non-standard policy measures also.

All central banks are indicating that monetary policy will remain very loose for as long as is required. Markets expect interest rates to remain low for a very long period of time. The first 10bps hike in the ECB deposit rate from its current level of –0.5% is not priced in until late 2023. The deposit rate is seen as still being negative at end 2025. Markets see the recent 15bps cut in the BoE Bank Rate to 0.1% being reversed at end 2021. However, short-sterling contracts would suggest that the Bank rate is unlikely to be further increased to 0.5% until end 2025.

Fed futures contracts would appear to be looking for a 0.125% rate hike to 0.25% in H2 2022, with 3-month contracts pointing to the Fed funds rate getting to 0.5% in late 2023. However, the Fed rate is expected to remain below 1% until late in the decade—three month US rates are not seen rising above 1% until 2027.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	1.44	1.00	0.48	0.51
June'20	0.125	1.25	0.90	0.45	0.50
Sept'20	0.125	1.00	0.80	0.45	0.50
Dec'20	0.125	0.75	0.70	0.50	0.55

** 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	-0.25	-0.17	-0.30	-0.22
June'20	-0.50	-0.30	-0.20	-0.30	-0.22
Sept'20	-0.50	-0.35	-0.25	-0.30	-0.22
Dec'20	-0.50	-0.40	-0.30	-0.30	-0.20

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.57	0.83	0.49	0.50
June'20	0.10	0.50	0.75	0.50	0.50
Sept'20	0.10	0.45	0.70	0.50	0.50
Dec'20	0.10	0.40	0.65	0.50	0.55

** Swap Forecasts Beyond 1 Year*

Dollar retains upper hand in volatile trading over past month

The dollar has been at elevated levels for the past five years. It has been aided by strong US economic growth. Indeed, this economic expansion has been the longest on record. As a result, the jobless rate has fallen to a 50 year low of 3.5%. Widening interest rate differentials and bond spreads also helped the US currency in recent years, with the Fed steadily tightening policy in 2017-18, raising the fed funds rate by 200bps to 2.25-2.5%.

The US currency became more range bound in 2019 as the economy slowed and the Fed cut rates. Most notably, the euro-dollar rate was confined to just a six cent corridor of $1.09-1.15 for the whole of 2019, but with an underlying trend of the euro edging lower for most of the year. The euro moved within a $1.12-1.15 band in H1 and then $1.09-1.12 in H2 2019. The dollar, though, climbed by close to 3% in trade-weighted terms in early 2020, making significant gains against a wide range of currencies. This saw the euro fall below the key $1.09 support level in mid-February, hitting a three year low of $1.08.

The initial response of the market to the growing coronavirus pandemic was to take the dollar lower as US rates were cut sharply to zero, removing the currency's interest rate spread advantage. The euro spiked higher to near $1.15. However, in volatile trading, a major scramble for dollars developed resulting from both safe-haven flows into the world's most liquid currency and to repay dollar borrowings. It was the dollar's turn to spike higher, with EUR/USD falling sharply to the $1.07 level.

Central banks, led by the Fed, responded by opening large dollar swap lines to meet the big demand for dollar funding. This has brought a bit more stability to FX markets, with the EUR/USD pair trading around the $1.10 level in recent days. Overall though, the dollar remains at elevated levels against a broad range of currencies, with the notable exceptions of the yen and Swiss franc, two other safe haven currencies. On a trade-weighted bases, it has returned close to the highs hit in early 2017. This is not surprising given the strong risk-off tone to markets and the dollar's status as a safe-haven currency.

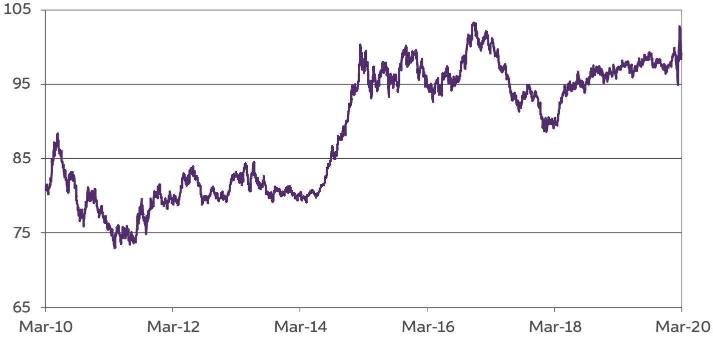
It is hard to make a case for currencies to strengthen against the dollar in the current risk averse environment. On the other hand, the action of central banks, led by the Fed, to increase the supply of dollars into the market has relieved the upward pressure on the currency. Thus, we could be back to range trading in most FX markets.

Technical levels are important in this type of environment. With regard to the EUR/USD pair, a move down below the recent $1.07 low, would be a signal of renewed upward pressure on the US currency. This could see the EUR/USD lows of $1.04-1.05 hit in the 2015-2017 period tested. A breach of these levels would open a move down towards parity. We view this as unlikely, but if it occurred, it might trigger market intervention by central banks to halt the dollar's rise. Meantime, the euro has not traded above the $1.15 level since late 2018. In this regard, money market rates in the Eurozone are now expected to remain negative into the second half of this decade, thereby continuing to act as an on-going headwind for the euro. Another possible headwind could be rising political tensions in the Eurozone over support measures for countries in weaker fiscal positions.

Overall, we think that as in 2019, EUR/USD could trade in a narrow range over the coming months. Most of the action may be contained in a $1.07 to $1.12 corridor. Later in the year, assuming the virus abates and stock markets and economies start to recover, currencies may start to edge higher against the dollar.

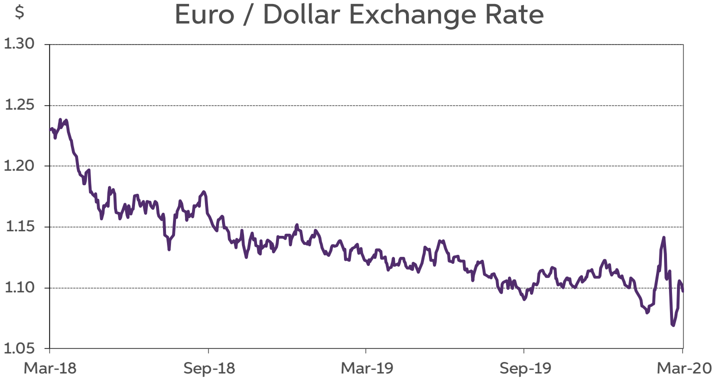
US Dollar Trade Weighted Index Versus Majors

(March 1973 =100)



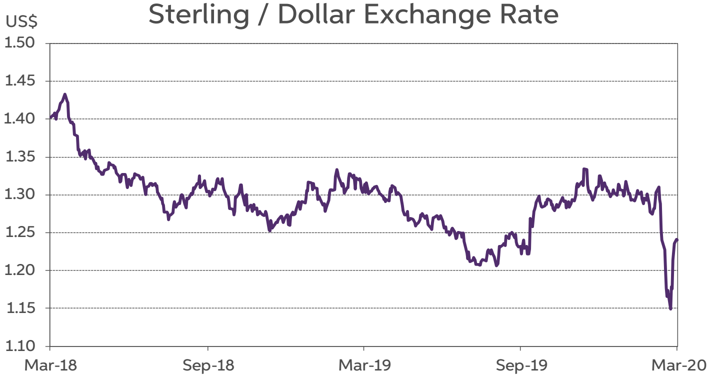
Source: Refinitiv

Euro / Dollar Exchange Rate



Source: Refinitiv

Sterling / Dollar Exchange Rate



Source: Refinitiv

Forex Market Outlook

Sterling recovers after steep fall, with still uncertain outlook for the currency

We thought sterling had a very volatile year in 2019, rising and falling in response to the ebb and flow of news on Brexit. However, these moves were a pale shadow of what occurred during the past month, with the currency nose-diving before it managed to recover much of the lost ground. Cable fell rapidly from $1.32 in early March to $1.15 by the middle of the month, its lowest level since the mid-1980s. Meantime, the euro rose from 84p to 95p, with some very big intra-day price movements. It is unclear what triggered the very sharp fall in sterling in such a short period Poor liquidity conditions may have exacerbated the price moves as the heaviest selling pressure emerged at a time when markets were generally in a fraught state.

The UK currency had clearly become oversold, given that it fell sharply in a matter of days to historically low levels. It has subsequently staged a strong recovery, again without any obvious triggers. Cable has risen back up to near $1.25, with the euro falling back to 88p. The extreme volatility of the past month obviously highlights the difficulties in making sterling forecasts in the current very uncertain environment, but it is clear that the UK currency can move very sharply in a short space of time.

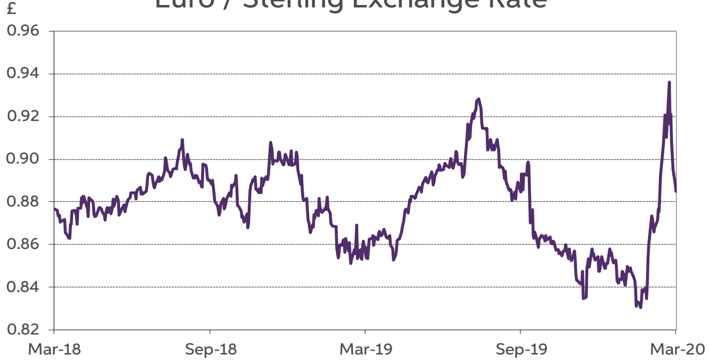
Thus, the outlook for sterling looks quite uncertain. It has been buffeted by the fraught market trading conditions created by the coronavirus pandemic. Concerns have also been raised that the UK may be undergoing a permanent shift towards a looser fiscal policy and thus will be slow to bring down the sharp rise in its budget deficit that is going to be brought about by the coronavirus pandemic and measures to mitigate it. This is of particular concern as regards the UK, given its already large current account deficit. Indeed, the UK has become the first large sovereign to be downgraded as a result of the coronavirus outbreak.

For the near-term, we are inclined to look at past trading ranges as a guide to predicting sterling movements. In this regard, the EUR/GBP rate was generally confined to an 85-91p range over the period from mid-2017 to late 2019. It is now back in the middle of this trading range, having moved in a wide band between 83p and 95p since last December. We tentatively forecast that it will remain within this narrower trading range in the coming months, now that currency markets appear to have settled down after a period of very volatile trading.

Meanwhile, over the medium-term, Brexit and the EU-UK talks on their future trade relationship are still likely to remain a key influence on the currency. The UK's orderly departure from the EU at end January does not mean that Brexit has been completed and thus no longer poses a risk to sterling. The EU-UK trade talks, which have been interrupted by the coronavirus outbreak, are likely prove to be very difficult and fractious. These will determine the future trading relationship between the UK and EU and thus the real shape of Brexit.

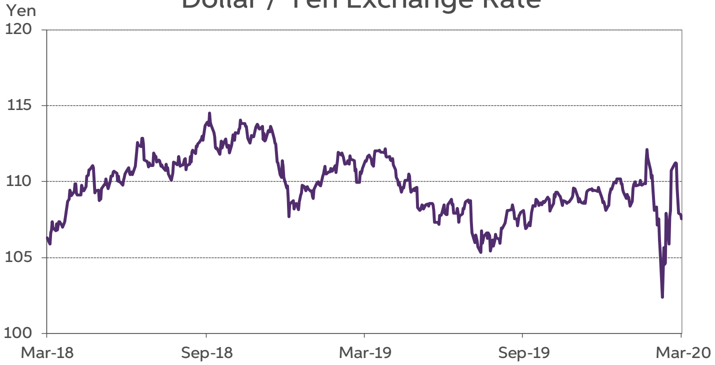
A new element of uncertainty is that the UK had ruled out extending the deadline for the talks beyond when the current transition period is due to expire at end 2020. The UK target was to have a Free Trade Agreement in place by the end of this year. This was always a challenging deadline and the delays in the talks' process as a result of the coronavirus outbreak suggests that an extension to the transition period is now quite possible. Such an extension could be announced in June. Our expectation is that a free trade deal will eventually be agreed, as it is in the best interest of both parties, but it is likely to prove a very rocky road in getting there. The only real alternative post the transition period is WTO rules, which would effectively be a delayed hard Brexit.

Euro / Sterling Exchange Rate



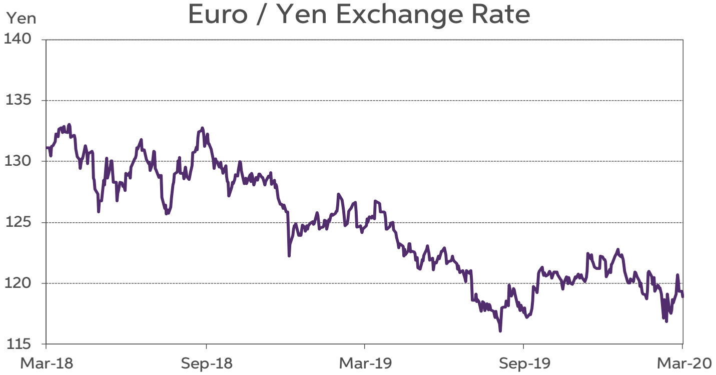
Source: Refinitiv

Dollar / Yen Exchange Rate



Source: Refinitiv

Euro / Yen Exchange Rate



Source: Refinitiv

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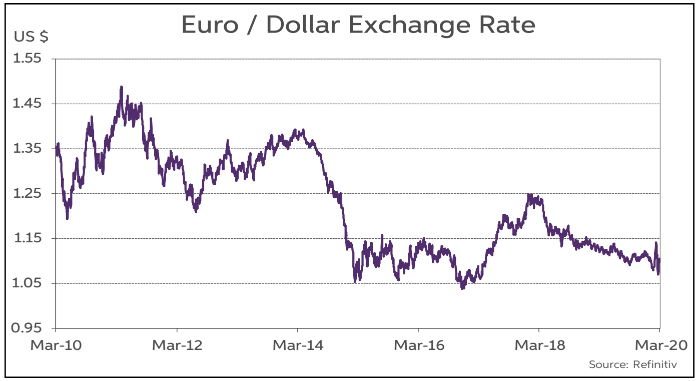
Summary of Exchange Rate Forecasts

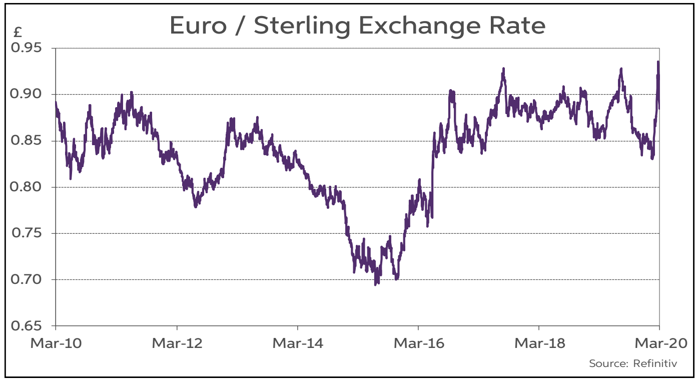
("Spot" Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

	Current	Q2-2020	Q3-2020	Q4-2020	Q1-2021
Euro Versus					
USD	1.093	1.06-1.12	1.07-1.13	1.08-1.14	1.09-1.15
GBP	0.879	0.85-0.91	0.85-0.91	0.86-0.92	0.86-0.92
JPY	117.27	114-120	115-121	117-123	119-125
CHF	1.06	1.06	1.06	1.07	1.08
US Dollar Versus					
JPY	107.27	104-110	104-110	105-111	106-112
GBP	1.244	1.21-1.27	1.22-1.28	1.22-1.28	1.23-1.29
CAD	1.41	1.41	1.39	1.37	1.35
AUD	0.61	0.61	0.62	0.63	0.65
NZD	0.60	0.60	0.61	0.62	0.63
CNY	7.10	7.10	7.05	6.95	6.85
Sterling Versus					
JPY	133	133	134	135	137
CAD	1.76	1.75	1.74	1.71	1.70
AUD	2.04	2.03	2.02	1.98	1.94
NZD	2.09	2.07	2.05	2.02	2.00



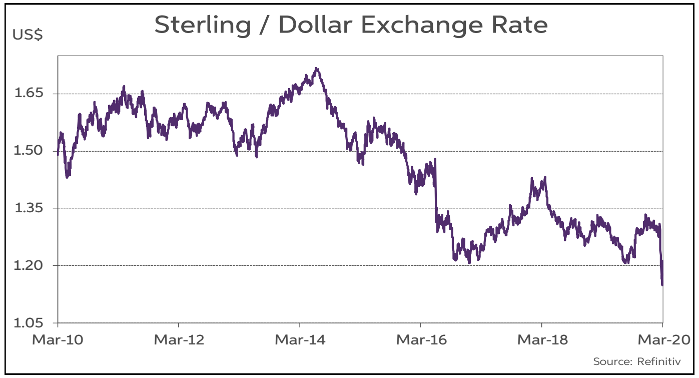
Euro / Dollar Exchange Rate

Source: Refinitiv



Euro / Sterling Exchange Rate

Source: Refinitiv



Sterling / Dollar Exchange Rate

Source: Refinitiv

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