Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

12th February 2019

- The world economy loses momentum, with activity already having weakened in Europe, China and Japan during 2018 and the US economy expected to slow this year

- Reasonable global growth, though, still anticipated for 2019/20, but risks are tilted to downside

- Fed turns cautious on policy as it indicates that rates could move in either direction. BoE on hold as it awaits clarity on Brexit. ECB also turns more cautious on economic outlook

- Dollar remains underpinned by relatively high US rates, even though the Fed is now on hold. Other currencies finding it hard to make ground vs. dollar as their rates are set to stay very low

- Sterling awaits clarity on Brexit. Recovers some ground, but still very range bound against the euro. Asymmetric risk for the currency depending on how Brexit unfolds

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Conor Beakey
Economist

www.aibeconomics.com

Global Economic Outlook

World economy loses momentum as downside risks rise

Both the OECD and IMF have lowered their growth forecasts for the world economy again in recent months, as economic data outside of the US continue to disappoint. In mid-2018, their expectation was that the world economy would grow by close to 4% this year. Both the IMF and OECD are now projecting that the global economy will expand by around 3.5% in both 2019 and 2020. Thus, while not as robust as previously expected, they still anticipate quite solid global growth in the next couple of years.

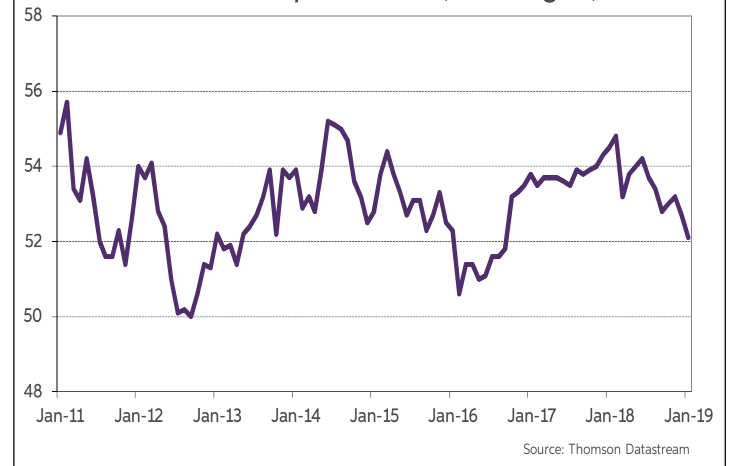
The OECD and IMF both warn, though, that the risks to the world economy are tilted to the downside. Growth in global trade slowed last year, with escalating trade tensions having adverse effects on confidence, investment activity and financial markets. Any further escalation in trade tensions would be a real risk to the global outlook. Notably, the Chinese economy has already lost momentum following the imposition of tariffs on many of its exports to the US, while the European economy has faltered on weaker export growth in recent quarters.

Indeed, both the European Commission and Bank of England recently scaled back their 2019 growth forecasts for the Eurozone and UK economies, respectively, on the back of recent weak data. Meanwhile, there are concerns that growth in the strongly performing US economy could slow quite sharply in the coming year, once the fiscal stimulus fades and higher interest rates begin to impact on activity. More generally, it is concerning that the JP Morgan Global Composite PMI, a good gauge of global economic activity, is continuing to decline. It fell to 52.1 in January from 52.7 in December, its lowest level since September 2016 and well below its recent peak of 54.8 reached a year ago, with particularly weak readings for European economies.

High levels of public and private debt remain a concern. The gradual tightening of monetary policy in the US, and associated strengthening of the dollar, had adverse impacts last year on some big emerging-market economies with high foreign currency debt levels. It put severe downward pressure on their currencies, forcing their central banks to raise interest rates to punitive levels. Some large emerging economies are now in recession.

More broadly, although markets have had a good start to 2019, financial conditions could tighten again, just as they did in the closing months of last year. Both the IMF and OECD have warned that the easy monetary conditions in place for much of this decade has led to a build-up of vulnerabilities in financial markets. This can lead to volatile trading conditions. In addition, the IMF has highlighted that a protracted period of high Italian interest rates or disruptive no-deal hard Brexit could have negative spill-over effects into European markets and economies. It also notes that concerns about the health of the Chinese economy could trigger abrupt sell-offs in financial markets and have a broader impact on the global economy and trade.

The general expectation, though, is that despite the numerous downside risks, the global economy should regain momentum as the year progresses. Monetary policy is set to remain accommodative globally, which will help support growth. Fiscal policy is also expected to remain supportive of growth in most economies. Household spending power will be boosted by declining headline inflation and a pick-up in wage growth. A resolution to some of the factors that have been weighing on growth in various economies in recent times, such as Brexit, new fuel emissions standards in Germany and the US-China trade dispute, should also help the world economy regain strength. However, a close eye will need to be kept on the data in the coming months, especially the key survey indicators, to assess the trend in the global economy.



GDP (Vol % Change)

	2017	2018(e)	2019 (f)	2020 (f)
World	3.8	3.7	3.5	3.6
Advanced Economies	2.4	2.3	2.0	1.7
US	2.2	2.9	2.5	1.8
Eurozone	2.4	1.8	1.6	1.7
UK	1.8	1.4	1.5	1.6
Japan	1.9	0.9	1.1	0.5
Emerging Economies	4.7	4.6	4.5	4.9
China	6.9	6.6	6.2	6.2
India	6.7	7.3	7.5	7.7
World Trade Growth (%)	5.3	4.0	4.0	4.0
Advanced Economies CPI Inflation (%)	1.7	2.0	1.7	2.0

Source: IMF World Economic Update, January 2019

AIB

Interest Rate Outlook

Central banks very cautious on tightening monetary policy as global economy slows

Central banks have turned very cautious about tightening monetary policy as concerns mount about the growth prospects for the world economy. The persistence of very subdued inflation gives central banks the latitude to be patient about monetary tightening, thereby maintaining very loose monetary conditions for an even longer period of time. Markets now see rates remaining on hold virtually everywhere this year, with the balance of risk tilting towards an easing of policy rather than a tightening. Indeed, the Bank of India cut rates earlier this month, while the Bank of China has introduced measures to loosen financial conditions.

In the US, the Fed performed quite a summersault on the outlook for interest rates at the January FOMC meeting. Indeed, despite very robust payrolls data for January and December, the Fed appears to have dropped its tightening bias, saying rates could now move in either direction. It had indicated at its December meeting that two further rate hikes were likely in 2019, with an additional hike probable in 2020. This represents quite a sea-change in the Fed's view in the absence of any signs that the US economy is starting to lose momentum.

The Fed, though, has now moved into line with the market, which thinks that rates have peaked in the US. With Q1 GDP growth likely to be weak in the US owing to the government shutdown, severe weather and usual seasonal adjustment problems, the Fed now looks off the pitch on rates for some time. It is still too early, though, to call the peak in US rates, given the strong momentum in the economy, loose macro policies still in place and the upward pressure on wages in the tight labour market. We still expect the Fed to hike rates later this year.

In the UK, markets have also lowered their expectations for rate hikes. They now believe that the next BoE rate hike will not occur until end 2020, taking rates up to 1%, with a further hike not anticipated until end 2022. Previously, they had expected rates to rise to 1.5% in the next couple of years.

In any event, BoE policy is set to stay on hold until we get clarity around the nature of the UK's departure from the EU. In the event of a soft Brexit, we think the BoE could tighten policy by more than markets expect as the latest BoE Inflation Report suggests that rates may need to rise by 50bps by end 2020 to meet its inflation target. On the other hand, if a no-deal hard Brexit materialises, then rates could be cut this year, given the negative impact that such an event would have on the UK economy.

Turning to the ECB, it ceased net asset purchases under its QE programme at the end of last year. However, it continues to indicate that it intends to keep interest rates at their current very low levels until at least the end of this summer. The ECB does not see inflation rising to its 2% target level in the next three years, so interest rates in the Eurozone are likely to remain very low for a long time. The ECB deposit rate is currently at -0.4%, resulting in negative interbank rates, with swap rates also negative out to three years.

Futures contracts have softened in the Eurozone too in recent months, with markets expecting rates to remain lower for longer. Given that the ECB indicated at its January meeting that the risks for the economy have moved to the downside, a rate hike now looks increasingly unlikely this year. Indeed, fresh liquidity measures could be announced at the next ECB meeting in March. Overall, rates are now seen as rising by just 20bps by end 2020, compared to 50bps previously. Markets also now believe that three month money rates will not turn positive until mid-2021, or get to 1% until well into the middle of the next decade, much longer than before.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.375	2.69	2.92	2.62	2.57
Mar '19	2.375	2.70	2.95	2.65	2.60
Jun '19	2.375	2.75	3.00	2.75	2.70
Sept '19	2.625	3.00	3.25	3.00	2.95

** Swap Forecasts Beyond 1 Year. Current Rates Sourced From Reuters, Forecasts AIB ER*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.33	-0.18	-0.16	0.12
Mar '19	-0.40	-0.33	-0.17	-0.15	0.15
Jun '19	-0.40	-0.32	-0.15	-0.13	0.20
Sept '19	-0.40	-0.30	-0.13	-0.10	0.30

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	0.88	1.14	1.04	1.19
Mar '19	0.75	0.89	1.15	1.05	1.20
Jun '19	0.75	0.90	1.15	1.07	1.25
Sept '19	0.75	0.95	1.20	1.15	1.35

** Swap Forecasts Beyond 1 Year*

Dollar underpinned by favourable interest rate differentials

The US dollar remains at high levels against a broad range of currencies. After losing ground in 2017 and early 2018, the dollar recovered strongly from last spring. This saw the EUR/USD rate fall back appreciably from a high of $1.25 in early 2018 to largely trade in a $1.12-1.15 range over the final quarter of the year and early part of 2019. Meanwhile, cable declined from above $1.40 to around $1.30. The yen has been the only major currency able to keep pace with the dollar in recent times, benefitting from safe-haven flows.

The dollar has been aided by continuing strong US economic data at a time when other economies have lost momentum. Most large economies have seen downgrades to their economic forecasts, apart from the US. Widening interest rate differentials and bond spreads also helped the currency as the Fed continued to steadily tighten policy during 2018, raising the fed funds rates by 100bps in total to a 2.25-2.5% range by end year.

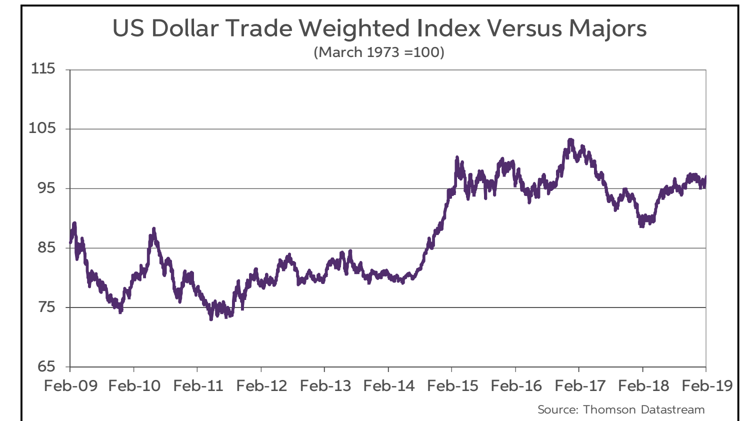
Rising risk aversion in financial markets has also been supportive of the highly liquid US currency. Escalating tensions over global trade, difficulties in emerging markets and geopolitical concerns have all sparked flights-to-quality episodes in to safe-haven currencies like the dollar, yen and Swiss franc. The dollar also benefitted from a big jump in the repatriation of funds by US companies last year to take advantage of cuts in US corporate taxes.

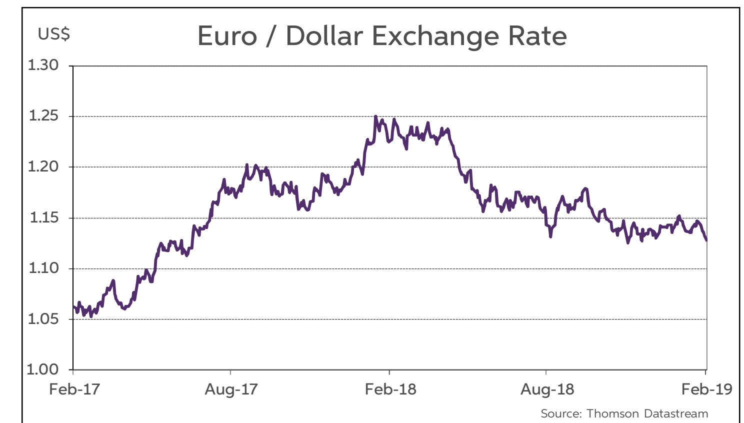
However, the US currency has found it harder to make further gains since the autumn. This may be partly due to the fact that FX positioning has become very long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. The US economy is also expected to slow in the coming year, while the Fed has turned much more cautious about further rate increases. Indeed, the market has come to the view that US rates have peaked and the next move in rates could be a cut.

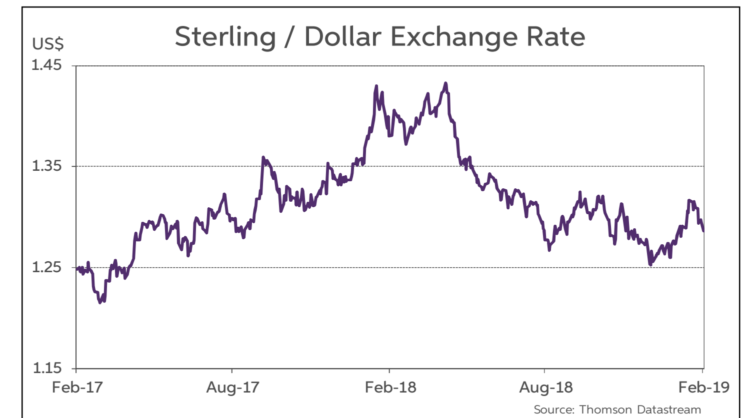
However, the relative strength of the US economy, wide interest rate differentials and geopolitical uncertainties all remain supportive of the US currency. Indeed, we think that US rates could be increased somewhat further later in 2019. Meanwhile, political uncertainty in the EU, a general rise in euro-scepticism especially in the context of the upcoming European Parliament elections, the slowdown in the Eurozone economy and continuing very low ECB interest rates are all headwinds for the single currency. The euro, though, has been quite range bound against the dollar since the autumn, with trading largely confined to a narrow $1.12-1.15 band. There is strong technical support for the euro versus the dollar in the $1.10-1.12 area.

While relatively high interest rates should help underpin the US currency, there are factors that could cause the dollar to lose some ground this year. The rising US twin deficits (fiscal and BoP) could start to weigh on the exchange rate. The marked jump in the repatriation of funds following the cuts in US corporate taxes last year is likely to abate, lessening demand for the currency. The US economy is also likely to slow in 2019. A US-China trade deal is also expected to be agreed this spring, which should improve risk appetite in markets.

The persistence of very low interest rates elsewhere, though, is making it difficult for other currencies to make any ground against the dollar. The euro remains pinned down around $1.13. There would probably need to be a renewed pick-up in activity in Europe and elsewhere that would bring monetary tightening back on to the agenda for currencies to start to make ground against the dollar. Such a pick-up is expected by most forecasters later this year, which may see currencies start to make some ground against the dollar before the end of 2019.







Sterling rises on expectations that a hard Brexit will be avoided

Sterling fell sharply in the aftermath of the Brexit referendum vote in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. The Brexit vote also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to around 93p by August 2017.

Sterling has since moved off these lows. It has largely traded in an 87-91p range against the euro since September 2017, as markets await clarity on what shape Brexit will take. Against a weakening dollar, sterling rose to a post-referendum high of $1.43 last April. However, cable dropped back again when the dollar strengthened once more last year, declining to below the $1.30 level in Q4 2018.

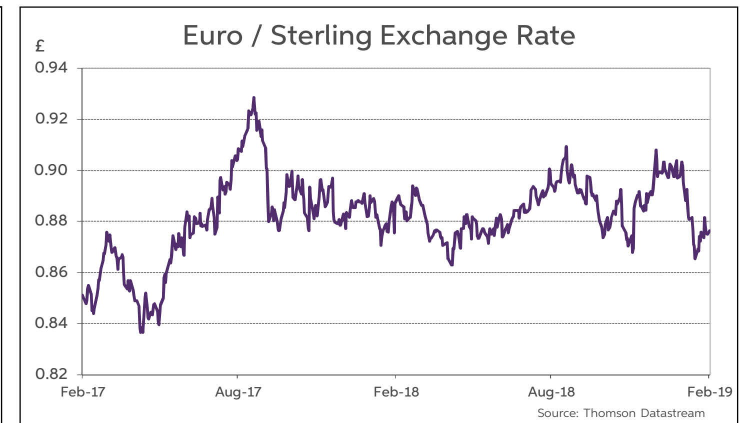
The Withdrawal Agreement reached between the EU and UK allows for a soft Brexit, as it includes a transition period to last until at least end 2020. This would keep the current trading arrangements in place over this time. However, it is proving very difficult for the UK Government to get the Withdrawal Agreement through Parliament. There is strong opposition from some Conservatives, as well the DUP, to the so-called Irish backstop contained in the Agreement. The deal was voted down by a large majority in the House of Commons in mid-January.

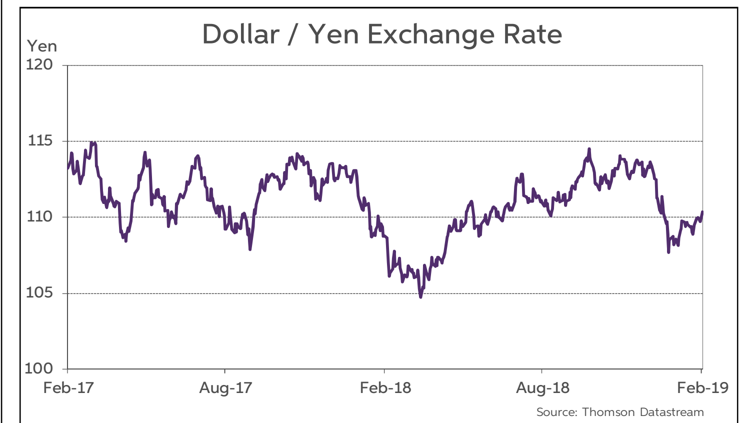
In a subsequent vote, though, later in the month, Parliament indicated that it would accept the Withdrawal Agreement if the Irish backstop was replaced by alternative arrangements to avoid a hard border in Ireland. However, the EU has indicated that the Withdrawal Agreement is not open for re-negotiation and the backstop must stay. Thus, yet again we are at an impasse in the talks and it is unclear how the process will evolve from here, with an increasing likelihood that Brexit will be delayed by a number of months.

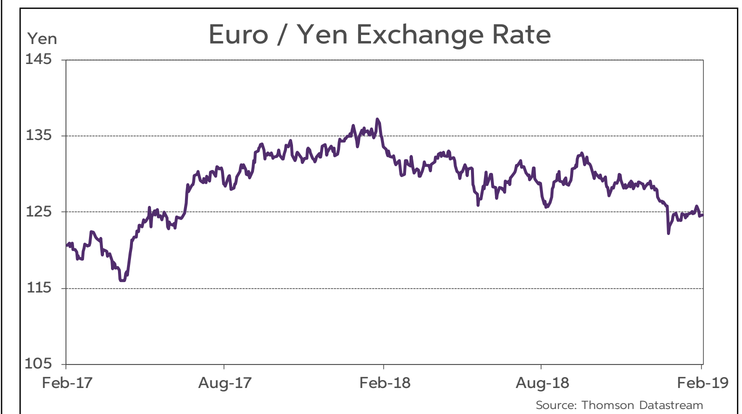
Sterling has remained quite range bound against the euro in recent times despite the mounting uncertainty over Brexit. The market seems to be of the view that a way will be found to avert a hard Brexit, as it is the strong wish of Parliament to avoid such an outcome. This has allowed sterling mae modest gains since the start of the year, with EUR/GBP moving down from 90p to below the 88p level, even getting to 86.5p at one stage.

The UK seems likely to seek an extension to Article 50 to delay Brexit in the event that the Withdrawal Agreement is not ratified soon by Parliament. We expect that the Brexit discussions between the EU and UK will drag on into March, making an extension to Article 50 almost inevitable, possibly to end June. A hard Brexit is the default position if the UK still cannot ratify the Agreement. This would see it leave the EU without a deal and fall back on WTO trade rules. If fears start to grow that a no-deal hard Brexit is increasingly likely, then sterling will come under pressure. EUR/GBP is likely to rise to the 93p level that it hit in summer 2017. It could reach the 95p mark that was last seen during the financial crises back in 2009. EUR/GBP may even hit parity if the UK crashes out of the EU with no deal in a very disorderly, chaotic Brexit.

On the other hand, even if the Withdrawal Agreement is eventually ratified by the UK Parliament, it will still not be clear for a number of years what is going to be the long term EU-UK trading relationship. Uncertainty will persist and further difficult negotiations with the EU on trade will lie ahead for the UK. As a result, the upside for sterling may be limited in this situation, with EUR/GBP moving down to the 85-86p level. This remains our base case.





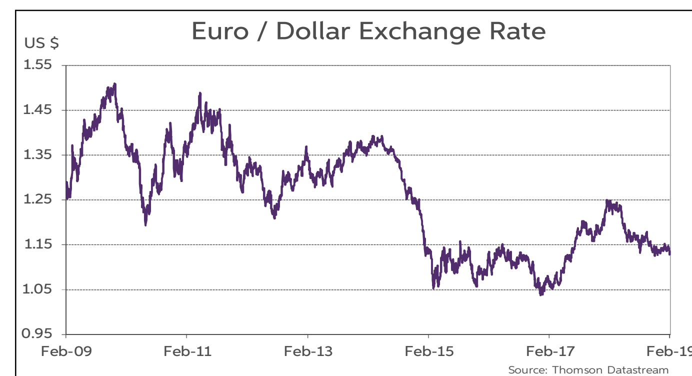


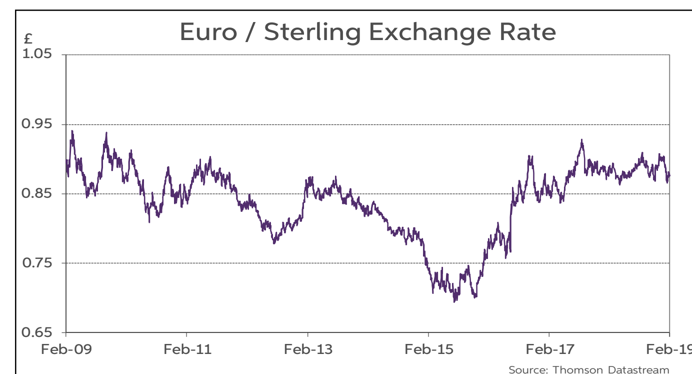
AIB

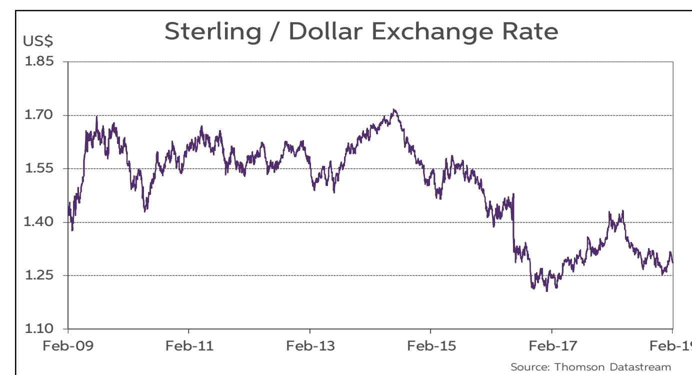
Summary of Exchange Rate Forecasts

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

Euro Versus	**Current**	**Q1-2019**	**Q2-2019**	**Q3-2019**	**Q4-2019**
USD	1.128	1.10-1.16	1.11-1.17	1.12-1.18	1.14-1.20
GBP	0.878	0.84-0.90	0.83-0.89	0.83-0.89	0.83-0.89
JPY	124.65	121-127	122-128	122-128	123-129
CHF	1.14	1.13	1.13	1.14	1.15
US Dollar Versus					
JPY	110.49	107-113	107-113	106-112	105-111
GBP	1.285	1.27-1.33	1.30-1.36	1.31-1.37	1.33-1.39
CAD	1.33	1.33	1.32	1.31	1.29
AUD	0.71	0.71	0.72	0.73	0.74
NZD	0.67	0.67	0.68	0.69	0.70
CNY	6.77	6.80	6.75	6.70	6.65
Sterling Versus					
JPY	142	143	146	146	147
CAD	1.71	1.73	1.75	1.75	1.76
AUD	1.82	1.83	1.85	1.84	1.84
NZD	1.91	1.94	1.96	1.94	1.94







AIB Treasury Economic Research Unit

This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by First Trust Bank. In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and First Trust Bank are trade marks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com