Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Omicron to have short-lived and limited impact on global economic recovery, though supply bottlenecks, including labour shortages, high inflation and rising rates are headwinds to growth
- Concerns that inflation will stay high for much of this year amid supply shortages and renewed rise in energy prices. Should start to ease in H2'22, but may be slow to fall back to target
- Significant rate hikes expected in 2022-23 from both the Federal Reserve and Bank of England as inflation rises to a far great extent than expected, with US CPI rate hitting 40-year high of 7%
- Meanwhile, markets price in rate increases from later this year in the Eurozone, though ECB still indicating rate hikes are very unlikely in 2022, as it expects the rise in inflation to prove temporary
- Dollar rally peters out, with market positioning very long the US currency. Sterling makes ground on hawkish BoE, but upside may be limited as economy faces numerous headwinds

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Global Economic Outlook

Headwinds to recovery as inflation surges to high levels

The global economy performed much better than expected in 2021 on the back of the relatively successful vaccine rollout programmes, as well as economies becoming better able to cope with restrictions and high Covid case numbers. Additional fiscal supports provided by governments also supported activity. As a result, the OECD estimates that the world economy grew by 5.6% last year, with output in developed economies rising by 5.3%.

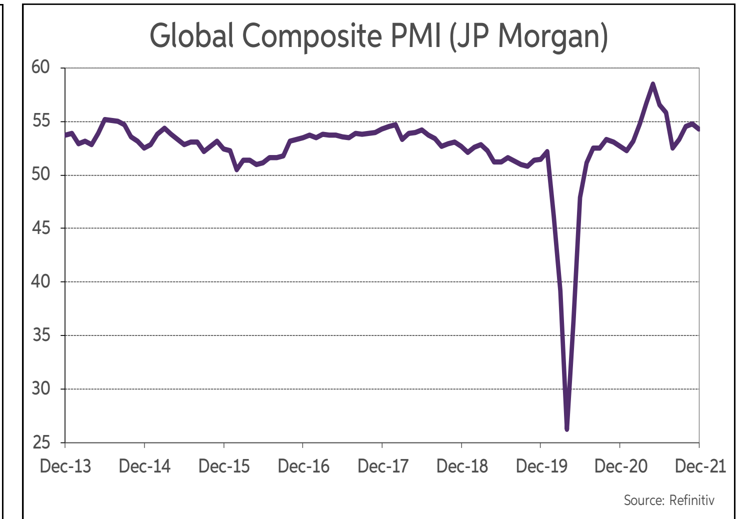
However, the recovery did lose momentum over the second half of the year. Some slowing in growth was always likely as the initial surge in activity after economies re-opened on the lifting of Covid restrictions, started to abate. However, other factors have also been at work. While vaccinations have proved effective in helping to reduce the risks in relation to Covid-19, the much more transmissible Delta and Omicron variants saw a renewed surge in infection numbers post the summer. This resulted in the re-imposition of some restrictions on activity in many economies. Meanwhile, supply bottlenecks came more to the fore in the second half of the year, with shortages of raw materials, key inputs and workers, as well as capacity constraints in transportation, resulting in delays and rising supplier delivery times. This has held back output in some industries, most notably the auto-sector.

Rising inflation, which is eroding real spending power, will also act to dampen growth. The combination of supply constraints alongside the release of pent-up demand and a rebound in commodity prices, especially in the energy sector, has caused inflation to surge over the past year. The CPI rate has risen to 7% in the US, 5.4% in the UK and 5% in the Eurozone, with the UK rate expected to rise to 6.5-7% in late spring. The sharp rise in inflation was expected to prove temporary, but there is now an increased level of uncertainty regarding this assumption.

What is clear is that the spike in inflation will persist for longer than previously envisaged. There have been marked upwards revisions to 2022 inflation forecasts in nearly all countries. An easing in supply chain disruptions is not expected to emerge until around the second half of 2022, with the Omicron variant adding to production and delivery delays. Oil prices have also surged again in the past month, while gas prices remain elevated, with tensions between Russia and NATO an additional risk to this market. Central banks now don't expect inflation to start to decline until the second half of the year, but still see it falling back close to target during 2023.

The biggest medium-term inflation risk may well be the labour market, if a shortage of workers puts sustained upward pressure on wages. The unemployment rate has fallen to circa 4% in the US and UK and near 7% in the Eurozone. The number of job vacancies has risen to very high levels in many economies. The concerns around tight labour markets and high inflation have seen some of the major central banks signal that significant rate hikes are in store in 2022. This will be an additional headwind to growth. Another headwind for growth will be a less accommodative stance to fiscal policy. The Biden administration is struggling to have further fiscal measures passed by Congress, while fiscal policy is set to be tightened in the UK from this spring as taxes start to rise. Governments Covid supports have also ended in most countries, or are in the process of being wound down.

The OECD is forecasting that the world economy will grow by circa 4.5% in 2022, before slowing to around its trend rate of 3.2% in 2023. Growth in the OECD region itself is forecast at 4% this year and 2.5% in 2023. The OECD notes that significant risks remain around these growth projections, with considerable uncertainly still about the evolution of the pandemic. It also calls out in particular a risk that inflation continues to surprise on the upside, forcing central banks to tighten monetary policy to a greater extent than is currently envisaged.



GDP (Vol % Change)

	2020	2021 (e)	2022 (f)	2022 (f)
World	-3.4	5.6	4.5	3.2
Advanced Economies	-4.7	5.3	3.9	2.5
US	-3.4	5.6	3.7	2.4
Eurozone	-6.5	5.2	4.3	2.5
UK	-9.7	6.9	4.7	2.1
Japan	-4.6	1.8	3.4	1.1
Emerging Economies	-2.2	5.8	4.9	3.8
China	2.3	8.1	5.1	5.1
India	-7.3	9.4	8.1	5.5
World Trade Growth (%)	-8.4	9.3	4.9	4.5
Inflation -PCE Deflator Advanced Economies (%)	1.5	3.5	4.2	3.0

Source: OECD Economic Outlook, December 2021

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Interest Rate Outlook

Markets price in significant rate hikes everywhere during 2022-2023

Monetary conditions have been exceptionally loose globally over the past two years as central banks pulled out all the stops to try and ameliorate the most severe impacts of the Covid-19 pandemic and associated restrictions on economic activity. This included cutting interest rates to very low levels, implementing enormous QE bond purchase programmes and providing enhanced liquidity supports to markets.

Economies have rebounded at a much quicker than anticipated pace over the past year, inflation has picked up by far more than expected, while labour markets are also tightening rapidly. Thus, central banks have started to scale back on their policy accommodation. QE programmes have been either wound down or curtailed in the past few months. Meanwhile, some central banks have already started to raise rates, including the Bank of England before Christmas. The year ahead is going to be one of a further withdrawal of monetary supports, with a series of rate hikes also on the cards in some leading economies.

The December FOMC meeting saw the Fed announce an acceleration in the pace of QE tapering, with the programme now set to be fully wound down by the end of the first quarter of this year. The Fed also signalled a far more aggressive pace to rate tightening, projecting three 25bps hikes in both 2022 and 2023, with a further two increases in 2024, taking the Funds rate up to 2.125%. The catalyst for the more hawkish policy signals was marked upward revisions to the Fed's inflation forecasts, as well as downward adjustments to its unemployment projections, with the economy now expected to return to full employment later this year.

The minutes of the Fed meeting suggested an even more hawkish bias, with strong hints that the first rate hike could come as early as March. US futures contacts have hardened considerably in the past couple of months. The markets are now pricing that there could be four rate hikes and thus 100bps of tightening before year end, and see the funds rate getting to 1.75% by end 2023 as policy is tightened further next year. Markets, though, do not see much more in terms of rate hikes beyond that, with a hike of just 12.5bps priced in for 2024.

The Band of England wrapped up its QE bond purchase programme in December and also hiked the Bank rate by 15bps to 0.25%. Further rate increases are in store in 2022. The BoE noted late last autumn that a 1% Bank rate would be consistent with it reaching its 2% inflation target. Markets, though, are now pricing in 100bps of rate hikes for this year and a further 25bps hike in 2023, which would take official rates up to 1.5%, before they level off. It is anticipated that growth in the UK economy will decelerate sharply to trend or below next year and beyond, and thus that further policy tightening will not be required post 2023.

Meanwhile, the ECB has been engaged in lowering the pace of its asset purchases in the past few months. This scaling back of QE bond buying is set to continue steadily over the course of this year. Markets are pricing in that the ECB will begin raising rates later in 2022 and have priced in at least 50bps in rate hikes by end 2023. However, the ECB continues to emphasise that despite the current surge in prices, it believes that the outlook for inflation over the medium term remains subdued. Thus, it has indicated that it believes conditions for rate hikes in the Eurozone are very unlikely to be in place this year. Furthermore, its 2023-24 below target inflation forecasts would not point to rate hikes next year either. Thus, quite a divergence has opened up between the ECB and the market on their views of the projected path of interest rates. Eurozone inflation will need to start falling back in the second half of 2022 and be on a clear downward path to 2% or lower in 2023 to avoid rate hikes.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.26	0.80	1.20	1.69
Mar'22	0.375	0.50	1.00	1.40	1.80
June'22	0.625	0.75	1.20	1.55	1.85
Sept'22	0.875	1.00	1.40	1.70	1.90

** 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	-0.58	-0.49	-0.23	0.13
Mar'22	-0.50	-0.56	-0.47	-0.20	0.15
June'22	-0.50	-0.50	-0.43	-0.15	0.20
Sept'22	-0.50	-0.45	-0.35	-0.10	0.25

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.25	0.54	0.81	1.42	1.52
Mar'22	0.50	0.75	1.00	1.50	1.60
June'22	0.75	1.00	1.20	1.65	1.70
Sept'22	1.00	1.15	1.35	1.75	1.75

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar rally peters out, with market positioning very long the US currency

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade, underpinned by relatively high US interest rates. However, it moved steadily lower in 2020, losing 12% against the other major currencies, as US rates were cut to virtually zero. The dollar, though, recovered ground last year, helped by a firming of US interest rates along the curve amid growing expectations of significant rate hikes in 2022-23 on the back of big upgrades to US GDP and inflation forecasts,.

In particular, the dollar held a stronger tone from mid-2021 until near to the end of the year against a broad range of currencies. This occurred in the context of the Fed preparing the ground for QE tapering as well as the central bank turning more hawkish in its projections on interest rates. The US currency rose by 5% in trade-weighted terms over this period. The euro was a notable casualty, falling from $1.22 in June to a low of $1.12 in late November, as the key support level of $1.16-1.17 eventually gave way during the autumn.

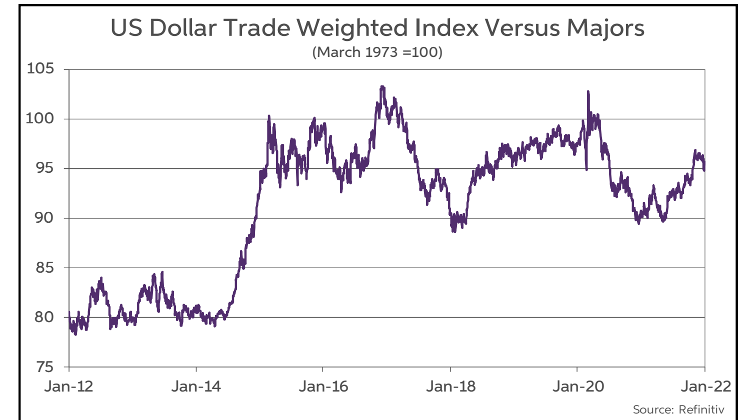
The general view has been that the dollar will remain well underpinned in 2022, with the US Federal Reserve embarking on a fairly aggressive rate tightening cycle. Rates are expected to rise by 100bps this year, with further hikes anticipated in 2023. The dollar, though, lost some ground against a broad range of currencies in opening couple of weeks of the new year. The EUR/USD rate rose above $1.14, while sterling climbed to as high as $1.37 from $1.32 before Christmas.

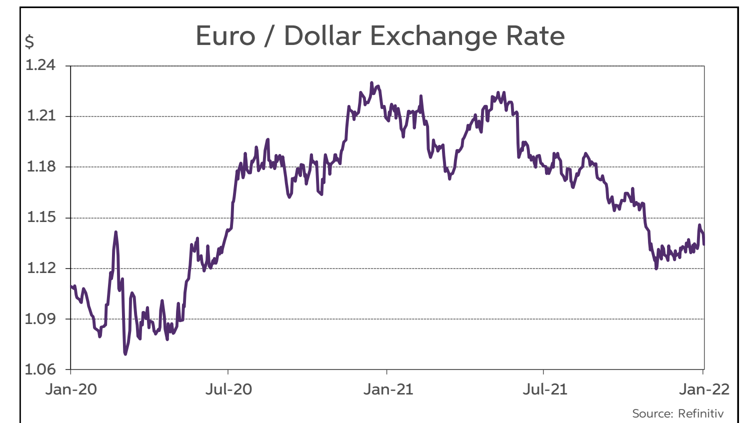
One explanation is that the market ended 2021 very long the US currency. Traders may now be looking to exit dollar positions after the gains made since mid-2021, and with the market having moved to price in a considerable amount of Fed tightening over the course of 2022-23. It is also the case that rates are rising in other countries as well, lessening the dollar's attractiveness. Indeed, some central banks have already started to tighten policy. It could also be a more general signal by markets that the worst of the Covid-19 pandemic is behind us. The dollar can often act as a counter-cyclical currency, which strengthens at times of stresses in the world economy and loses ground as global growth recovers. Expectations that the risks to economic activity posed by Covid-19 are abating, resulting in solid and better balanced global growth, should reduce demand for safe-haven currencies, like the dollar.

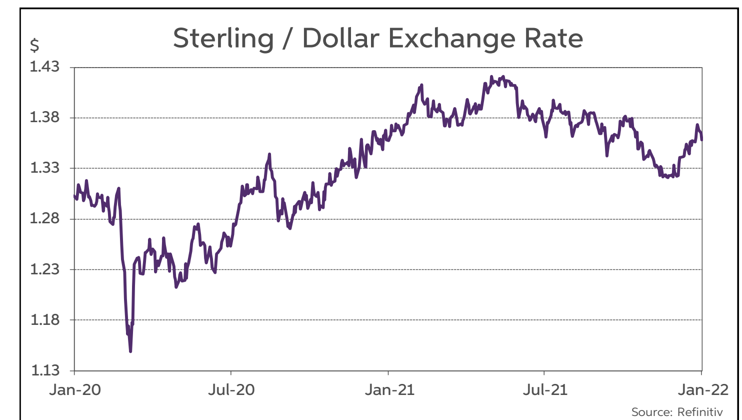
We don't envisage a major fall in the dollar, though, as it should be supported by higher US interest rates and widening differentials. Indeed, it has recovered some ground in recent days. From a euro viewpoint, it is hard to see any obvious factor that would drive the currency higher in the near term given the ECB's continuing resistance to hiking interest rates this year. Thus, the euro may find it hard to rise above $1.17, unless the ECB changes tact on rates. However, it could start to rise later in the year if rate hikes are coming into view by then.

Meanwhile, the downside for the single currency should be limited as there is considerable support for the euro in the $1.10-1.13 range. Beyond that, the $1.08 level offers very strong support, which most notably held in the first half of 2020. Overall then, EUR/USD may trade in a narrow $1.12-1.17 corridor in the coming months.

One possible source of downside risk for the dollar could be a sustained rise in US inflation relative to elsewhere. While US rates would have to rise, high inflation is usually a harbinger for currency weakness. Another possible headwind for the dollar would be if the twin US deficits - fiscal and balance of payments, come to the fore again as a factor impacting investor's appetite for the currency, especially when global risks abate.







Forex Market Outlook

Sterling rises on back of BoE's hawkish policy stance

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 rising inflation.

The BoE started to turn quite hawkish on monetary policy from October onwards, culminating in a 15bps rate hike in December. Sterling has performed quite well in the past month or so, on the back of a marked hardening of rate hike expectations in the UK. Markets are now pricing in that UK rates could rise by 100bps this year, with a further 25bps hike anticipated in 2023. This would take the Bank rate up to 1.5%. Until recently, the expectation was that UK rates would top out at about 1%. Cable (GBP/USD) has risen from $1.32 before Christmas, to as high as $1.37 since then, while the euro has fallen back from above 85p to around the 83.5p level.

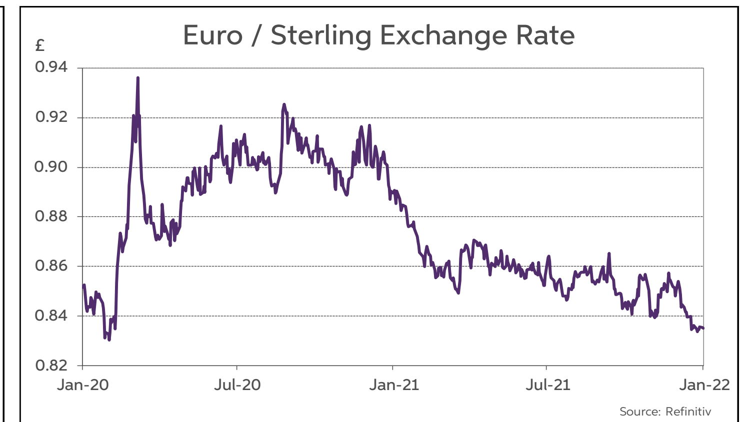
While the UK looks set to record another strong rise in GDP in 2022, this is partly due to carryover effects. The economy is expected to lose momentum as the year progresses in the face of a tightening of fiscal and monetary policy. There are also concerns that global supply shortages in both goods and especially labour markets could be accentuated in the UK by the fact it is no longer in the Single Market or Customs Union. This may hold back the pace of growth in the economy and at the same time, add to inflationary pressures. There are also ongoing Brexit tensions between the UK and EU regarding the Northern Ireland protocol, with the UK threatening that it may take unilateral action on the matter that could prove damaging to trade relations with the EU.

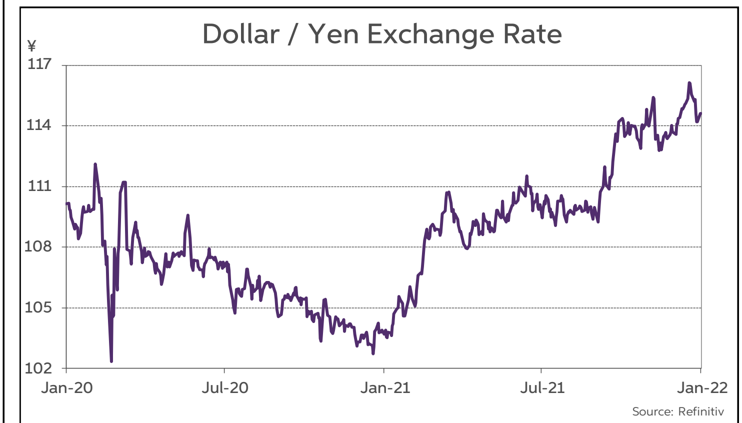
In the near term, though, further rate hikes are likely in the UK, which should support sterling. The 83p level is a major support point for the euro, which has not been overcome by sterling since the Brexit referendum in 2016. The euro has fallen close to this level recently and it may well give way as UK rates rise. However, there is good technical support for the euro in the 80-83p region, so we don't envisage sterling making further large gains against the single currency. Meanwhile, cable could rise towards the $1.40 level. Longer term, any further gains by sterling may not be sustained given the headwinds facing the UK economy.

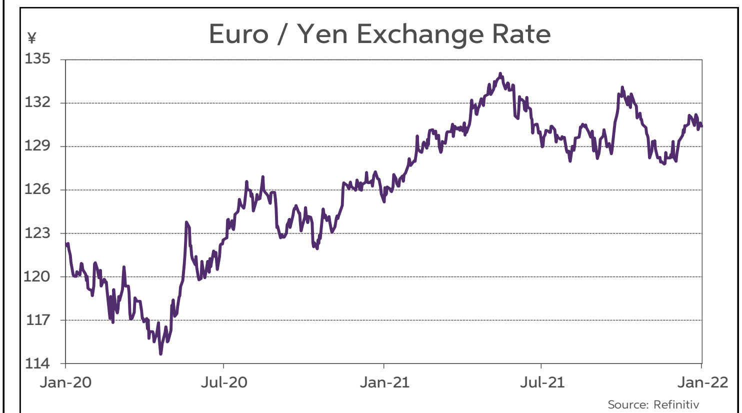
Yen loses ground as long term rates rise elsewhere

The yen lost considerable ground against the stronger dollar over the past year, with the US currency climbing from ¥103 to around the ¥115 level recently. Its losses, though, have been much more modest against most other currencies. The euro rose from ¥126 in early 2021 to around the ¥130 level in recent months. There was hardly any rise in long term interest rates in Japan last year, in marked contrast to what has happened in Europe and the US. This weighed on the yen as investors moved into higher yielding currencies.

Market positioning is relatively short the yen, which should be supportive of the currency and it has been more stable over the past couple of months. A lot of rate tightening has also been priced into other markets at this stage. Thus, the Japanese currency could continue to remain relatively stable against the other major currencies. Longer term, though, it could be vulnerable to renewed falls, if interest rates rise more than expected elsewhere and global bond yields increase further, but remained anchored at very low levels in Japan, causing increased investment outflows.







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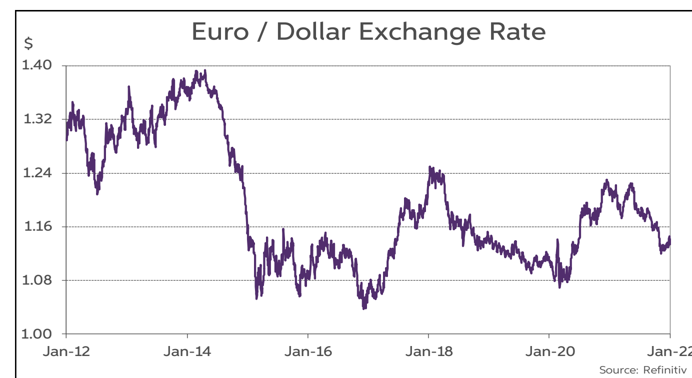
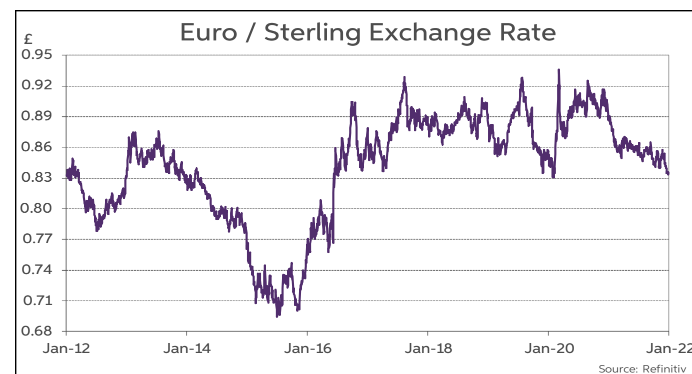
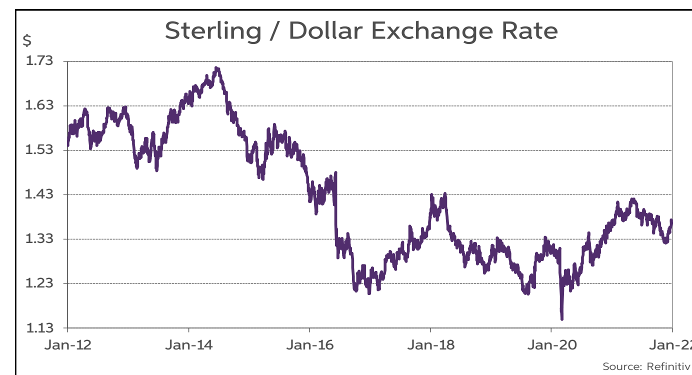
Summary of Exchange Rate Forecasts

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

Euro Versus	Current	Q1-2022	Q2-2022	Q3-2022	Q4-2022
USD	1.134	1.11-1.17	1.11-1.17	1.12-1.18	1.13-1.19
GBP	0.832	0.79-0.85	0.79-0.85	0.80-0.86	0.81-0.87
JPY	129.66	128-134	128-134	128-134	129-135
CHF	1.04	1.04	1.05	1.05	1.06
US Dollar Versus					
JPY	114.35	112-118	112-118	111-117	111-117
GBP	1.364	1.36-1.42	1.36-1.42	1.36-1.42	1.35-1.41
CAD	1.25	1.25	1.24	1.23	1.22
AUD	0.72	0.72	0.73	0.73	0.74
NZD	0.68	0.68	0.69	0.69	0.70
CNY	6.34	6.35	6.30	6.30	6.25
Sterling Versus					
JPY	156	160	160	158	157
CAD	1.70	1.74	1.65	1.63	1.74
AUD	1.89	1.93	1.90	1.90	1.86
NZD	2.01	2.04	2.01	2.01	1.97







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