Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Economies re-open as vaccine rollout gathers momentum, with signs of a marked pick-up in activity during the second quarter of the year
- Strong growth expected to continue in H2 '21. Global growth forecasts upgraded to 6.0% for this year, with further strong growth of circa 4.5% expected in 2022. Stokes some inflation concerns
- Futures contracts have firmed since start of year, especially in US and UK, with first hikes now expected around mid-2022. Central banks, though, say no need for any early rate increases
- Focus to be on tapering in H2'21, with Fed and ECB likely to signal slower bond purchases
- Main currency pairs remain quite range bound, with activity strengthening everywhere and central banks keeping policy on hold. Euro could struggle if rates start rising elsewhere in 2022

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Daniel Noonan
Economist

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Global Economic Outlook

Optimistic outlook for global economy; inflation continues to rise

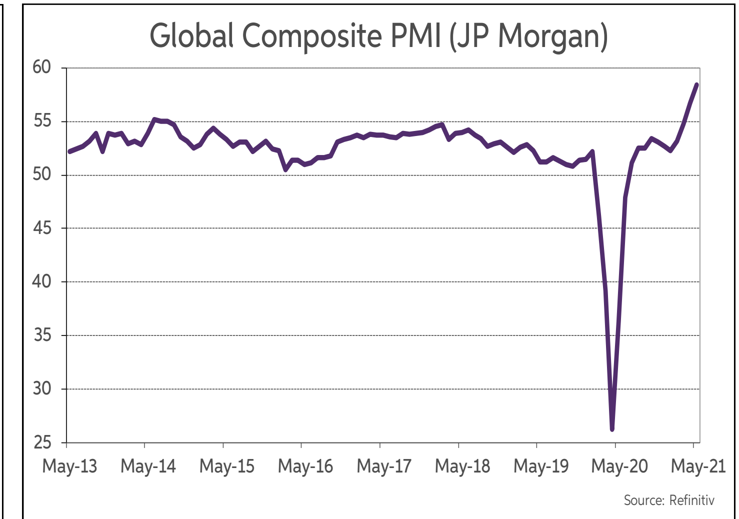
Optimism regarding the outlook for the global economy has increased in recent months. This is on the back of the relatively successful vaccine rollout programmes, economies proving better able to adapt to restrictions in place than previously envisaged, and additional fiscal supports. This more upbeat perspective is evident in the raft of international agencies revising higher their economic growth forecasts. The most recent upgrade in this regard came from the OECD. It is forecasting the global economy to grow by 5.8% this year and 4.4% in 2022, following a 3.5% contraction in 2020. This compares to its projections at the end of 2020 for growth of 4.2% and 3.7% in 2021 and 2022, respectively. Meanwhile, world trade is anticipated to recover strongly by the OECD, after contracting by 8.5% last year. A rise of 8.2% is being pencilled in for this year, followed by growth of 5.8% in 2022.

The OECD has pointed out the marked differences to the economic recovery across economies. It notes that in many emerging-market economies, the slow deployment of vaccinations, further Covid infection outbreaks, associated containment measures and reduced capacity for policy supports will continue to act as a headwind on activity for quite some time. There is one notable exception to this, China, where output is expected to remain on a robust path in H2'21 and into 2022, amid a strong rebound over the past year.

Meanwhile, in the advanced economies, the on-going progress in the various vaccination rollouts has begun to allow many of the sectors that were severely curtailed by containment measures to gradually re-open. At the same time, additional fiscal stimulus this year is helping to boost demand, reduce spare capacity and lower the risks of the long-term scarring from the pandemic restrictions. A large accumulation of private sector savings over the past year, combined with improved confidence and fewer public health restrictions should encourage strong growth in consumer spending. GDP growth in the OECD area is forecast to rise by 5.3% in 2021, led by a strong upturn in the US economy. Growth is seen easing to 3.8% in 2022.

The OECD notes that there are significant upside and downside risks to its forecasts. The key downside risk relates to the vaccine rollout not being fast enough to stop the spread of the virus or prevent the emergence of new variants. In such instances, confidence and private sector spending would fall, especially if restrictions need to be introduced. On the upside, the OECD references the extent to which household savings are normalised and excess savings are rundown at a quicker than expected pace. The OECD also notes the potential for greater than envisaged longer term benefits from policy supports. Overall, the OECD judges the risks to its forecasts as broadly balanced over the medium term. Meantime, although the rise in unemployment has been modest to date, it could move higher later in 2021 as government labour market support schemes are wound down.

On inflation, the OECD acknowledges that signs of higher input costs have emerged in recent months. However, similar to the IMF and a raft of central banks, the OECD believes that sizeable spare capacity in the global economy should prevent a sustained marked pick-up in underlying inflation. The most recent upturn in headline inflation rates reflects the recovery of oil and other commodity prices, a surge in shipping costs, the normalization of prices in hard-hit sectors and an unwinding of indirect tax cuts. These factors are expected to prove temporary. The OECD sees inflation in advanced economies at 3.1% in Q4 2021, easing back to 2.4% in Q4 2022. The biggest inflation risk could be the labour market, if a shortage of workers emerges, putting upward pressure on wages. US data are being closely watched in this regard, as job growth there has slowed unexpectedly in recent months.



GDP (Vol % Change)

	2019	2020	2021 (f)	2022 (f)
World	2.7	-3.5	5.8	4.4
Advanced Economies	1.6	-4.8	5.3	3.8
US	2.2	-3.5	6.9	3.6
Eurozone	1.3	-6.7	4.3	4.4
UK	1.4	-9.9	7.2	5.5
Japan	0.0	-4.7	2.6	2.0
Emerging Economies	3.7	-2.3	6.2	4.9
China	6.0	2.3	8.5	5.8
India	4.0	-7.7	9.9	8.2
World Trade Growth (%)	1.9	1.5	2.7	2.4
Inflation -PCE Deflator				
Advanced Economies (%)	1.3	-8.5	8.2	5.8

Source: OECD Economic Outlook, May 2021

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Interest Rate Outlook

Fed turns more hawkish, but main central banks content with current policy stance

Central banks globally pulled out all the stops last year to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems, which were hit by a sudden and very deep recession. Interest rates were cut sharply to 0.125% and 0.1% in the US and UK, respectively. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and ease funding pressures in markets.

Central banks actions this year have been largely confined to tweaking their QE programmes. The ECB announced in March that it was increasing the pace of asset purchases to prevent a tightening of financial conditions as upward pressure emerged on bond yields. Both the Canadian and UK central banks, however, have scaled back the size of their weekly asset purchases. Overall, though, central banks have been very clear in their communications that monetary policy is set to remain exceptionally loose over the next couple of years.

Nonetheless, interest rate futures contracts have firmed considerably since the start of the year. There has been a marked hardening of rate expectations in the US and UK in particular, with a consequent rise in long term bond yields in the opening quarter of the year on the back of improving growth prospects for the respective economies, aided by the rapid rollout of vaccines.

More recently, the Fed themselves have turned more hawkish. At its June meeting, there was a significant shift in its interest rate projections. 11 of the 18 FOMC members now believe that interest rates will start to rise in 2023 compared to 2024, at the earliest, previously. The median projection is now for two 25bps hikes in 2023. However, Fed Chair Powell did emphasise that these projections should be taken with a “big grain of salt” as they encompass a timeframe that is still full of uncertainty. The other key aspect from the June FOMC meeting was that the conversation about slowing down its rate of monthly asset purchases (i.e. QE tapering) has started, with markets expecting that an announcement on this issue could come at the very end of summer.

Despite, the upward move in the Fed’s rate projections, this is still less aggressive than the trajectory of rate hikes that the market is expecting. Futures contracts indicate that the market is pricing in the Fed will start to hike interest rates in the second half of 2022, with the fed funds rate rising to 0.375% by end year. The market is envisaging rates getting to 1% by end-23 versus the Fed’s projection of 0.625%.

UK futures contracts have also hardened this year, with markets initially pricing out a move to negative rates. With big upward adjustments to growth forecasts, markets now see rates being hiked by 25bps over the course of 2022 and getting to 1% by mid-2025. This is a much slower pace of rate hikes than in the US. The firming in rate expectations has been much less pronounced in other markets, most notably in the Eurozone and Japan. Markets do not expect the ECB deposit rate to be increased from its current level of –0.5% until the second half of 2023, and then to be raised very slowly thereafter, only getting to zero per cent by mid-2025.

With the recent meetings of the ECB and BoE indicating that both central banks are unlikely to alter their policy stance anytime soon, the focus is very much on the Fed and QE tapering. If the US economy continues to improve, then we would expect guidance from the Fed on the start of tapering could be forthcoming later in the summer. This would likely see the Fed start to taper QE around the end of this year or in early 2022.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.15	0.25	0.32	0.94
Sept'21	0.125	0.15	0.27	0.33	0.95
Dec'21	0.125	0.16	0.28	0.35	1.00
Mar'22	0.125	0.17	0.30	0.40	1.05

** 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	-0.55	-0.49	-0.46	-0.25
Sept'21	-0.50	-0.55	-0.48	-0.45	-0.23
Dec'21	-0.50	-0.54	-0.47	-0.43	-0.20
Mar'22	-0.50	-0.53	-0.45	-0.40	-0.15

** 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	0.08	0.18	0.37	0.70
Sept'21	0.10	0.08	0.18	0.38	0.70
Dec'21	0.10	0.09	0.19	0.40	0.75
Mar'22	0.10	0.10	0.20	0.45	0.80

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar looks to have some upside potential over medium term, in contrast to euro

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 the final three quarters of last year, losing 12% against the other major currencies, as US rates were cut to virtually zero. The euro was one notable beneficiary of the dollar weakness as the ECB kept rates on hold, climbing to circa $1.23 by the start of 2021 from around $1.08 early in 2020. This was only the second time that the euro has risen above $1.20 since the ECB moved to negative rates back in 2014.

The dollar, though, recovered some ground against all the main currencies in Q1'21, helped by a firming of US interest rate future contracts and associated marked rise in long term US interest rates, on the back of big upgrades to US growth forecasts for 2021/22. The market was also very short the US currency at the start of 2021, which helped the dollar make gains as some of these positions were closed out. All these factors saw the euro drop back to a low of $1.17 by end March from $1.23 at the start of the year.

The dollar lost ground, though, over the April/May period as many of the above factors reversed, with the euro climbing back up to $1.21-1.22. However, the more hawkish tone from the June Fed meeting saw the dollar gain the upper hand again. This was evident in the EUR/USD pair falling back to around $1.19.

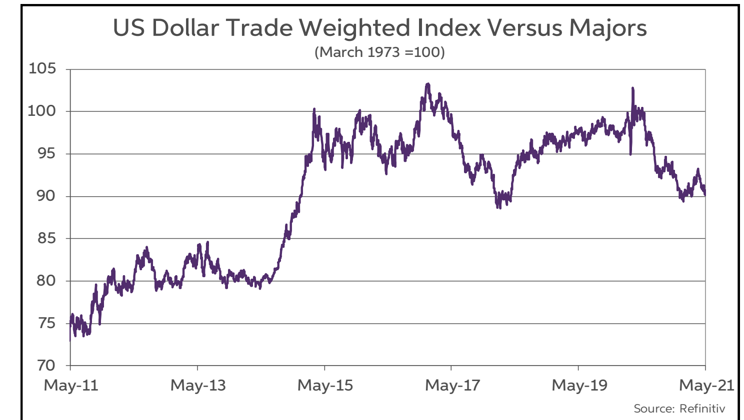
However, despite all these moves, the broader picture is that the euro-dollar exchange rate has been confined to a narrow $1.17-1.23 corridor since last July. There is very strong support for the single currency in the $1.16-1.18 range, which held in the spring when the euro came under pressure. Meanwhile, the dollar has again found strong support this year in the $1.23-25 region. Indeed, the single currency has failed to ever rise above this level since the ECB moved to negative interest rates back in 2014.

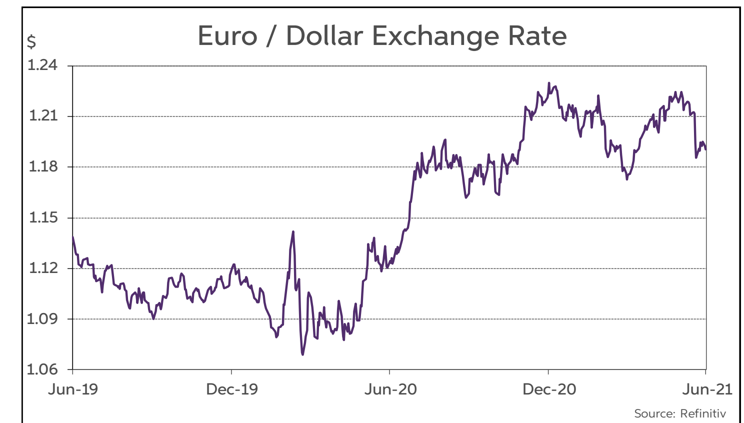
We are likely to see strong growth in both the US and the Eurozone over the second half of the year. Any changes to official interest rates are still quite a long way off, with the Fed and ECB also maintaining substantial QE asset purchase programmes in H2 2021, though both may be in the process of starting to taper their bond buying. All this suggests that ongoing range trading may be in prospect for EUR/USD in the months ahead as it continues to move in a $1.17-1.23 corridor.

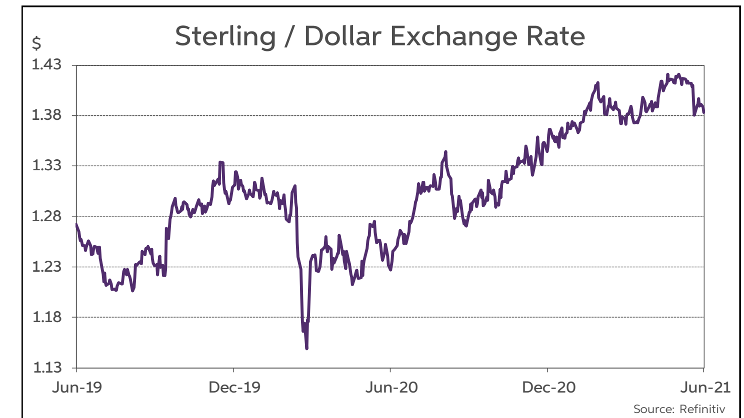
However, at some stage, this tight trading range will break down and we will get significant moves in the euro-dollar rate. Interest rates are an important driver of forex markets, and their stability has been key to the narrow trading ranges for the pair over the past year. Rate hikes are quite possible in the US next year, while Eurozone rates look set to stay on hold and thus remain deeply negative. A widening of interest rate differentials, if it was to materialise next year, should be supportive of the dollar.

Meantime, we find it hard to think of what could drive the euro higher. Indeed, Germany and France are facing potentially difficult elections this year and next, which may weigh on the euro. Market positioning is also quite short the dollar at present. Thus, while range trading looks set to remain the order of the day in the near term, longer term, the balance of risk points to upside potential for the dollar.

The one fly in the ointment for the dollar could be a sustained rise in inflation in the US relative to elsewhere. Though US rates would have to rise, high inflation is usually a harbinger for currency weakness.







Forex Market Outlook

Sterling in consolidation mode

The EU-UK trade deal that was finally agreed at the end of last year had no immediate impact on sterling as the outcome of the negotiations was largely in line with market expectations. The currency, though, appreciated steadily during the opening quarter of 2021, most notably versus the euro. The rapid rollout of Covid vaccines in the UK was supportive of the currency. It allowed restrictions on activity to be eased considerably and growth forecasts for the UK economy in 2021 were revised sharply higher.

This includes the Bank of England, which now sees UK GDP growth picking up to 7.25% in 2021, despite the economy being in lockdown in the opening months of the year, with further strong growth of 5.75% projected for 2022. The Bank now sees output returning to its pre-Covid levels by the end of this year, much earlier than had been initially expected. As a result, markets have moved from, at the start of the year pricing in a move to negative interest rates, to now expecting that UK rates will start to rise over the course of next year. This has seen short-dated Gilt yields turn positive in 2021, while ten year yields have risen by 50bps since the start of the year to around 0.75%.

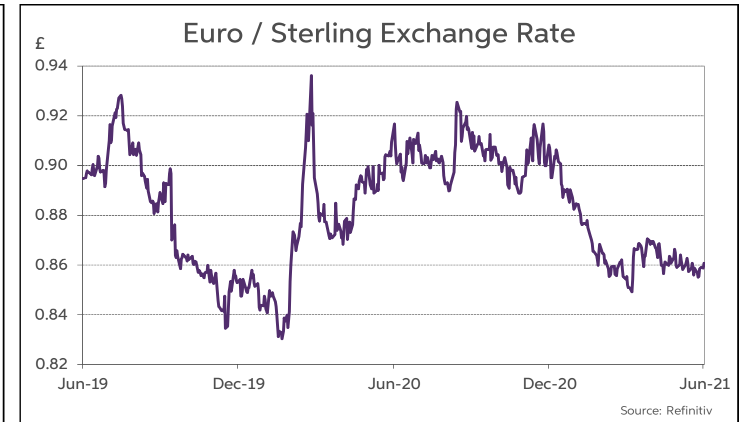
EUR/GBP fell steadily from around 90p at the start of 2021 to the 85p level by end March. Cable climbed to a high near $1.42, before moving back down to below $1.40. The 85p level is a strong technical support point for the euro, with the single currency also helped by a marked pick up in the EU's vaccination rollout during Q2. Overall, EUR/GBP has largely traded in a very tight 85.5-86.5p range since early May. More broadly speaking, after gaining ground earlier in the year, sterling has consolidated and entered a period of range trading.

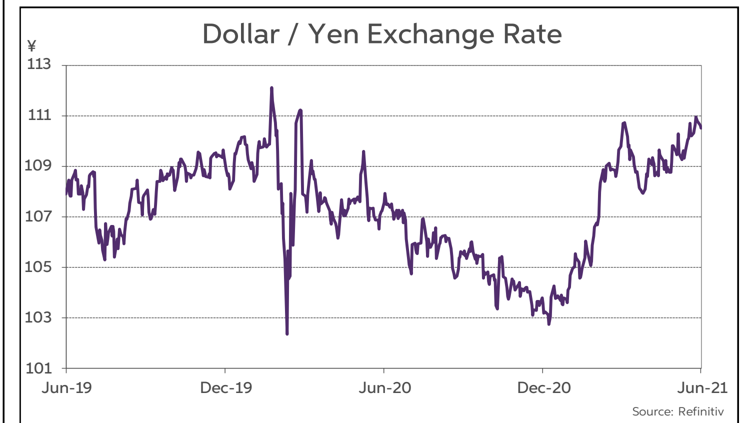
It is hard to call the next major move in the UK currency. Market positioning is now quite long sterling which may limit the scope for neat term gains. However, with the economy regaining considerable momentum, sterling could continue to remain within its recent narrow ranges in the coming months. Further out, if rate hikes materialise in the UK next year as markets expect, it could provide a fillip for sterling against currencies with zero or negative interest rates, most notably the euro.

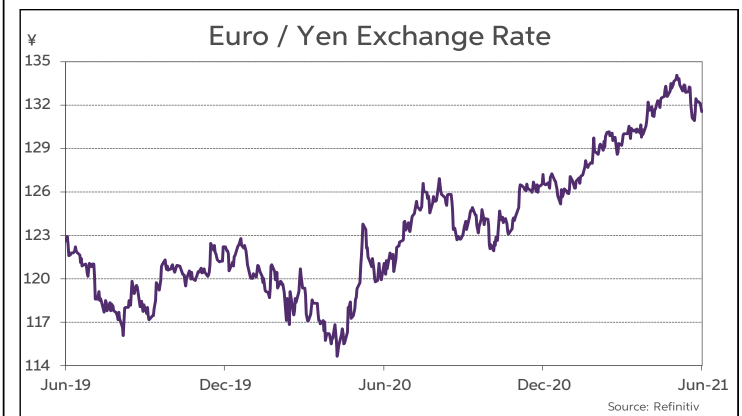
Weaker yen as yields rise elsewhere

The yen performed strongly in recent years, registering significant gains up until this year with the dollar falling to around ¥103 by the start of 2021 from a peak of ¥125 back in 2015. Meanwhile, the euro fell from a high of ¥140 in 2015 to a trough of ¥115 in mid-2020, before recovering. The yen benefitted from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency.

The yen, though, lost ground in H1 2021, with the dollar climbing from ¥103 to a ¥108-111 range and the euro rising from ¥126 in January to a ¥132-134 range in the past couple of months. There has been hardly any rise in long term interest rates in Japan this year, in marked contrast to Europe and the US, which has weighed on the yen as investors move into higher yielding currencies. Upgrades to global growth forecasts, the rollout of vaccines and improving risk appetite on markets have also lessened the safe haven appeal of the yen. Given that market positioning is now short the yen, its downside may be limited from here, but the much wider yield differentials now pertaining could limit the scope for fresh gains by the currency. Thus, continuing range trading may now be in prospect for the yen in H2 2021. Again, it could be vulnerable if interest rates rise elsewhere next year.



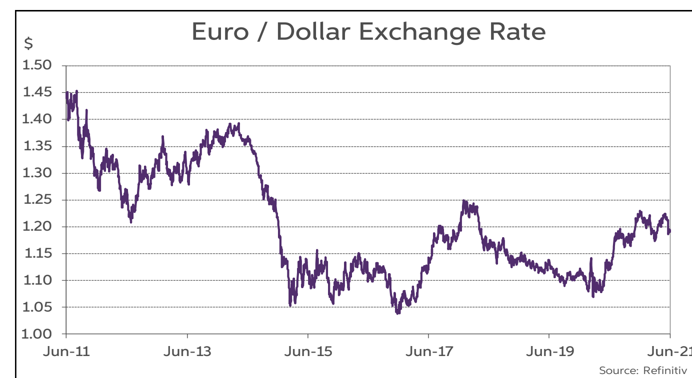


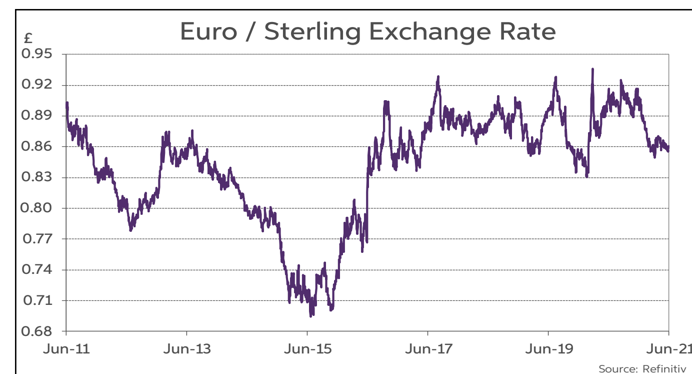


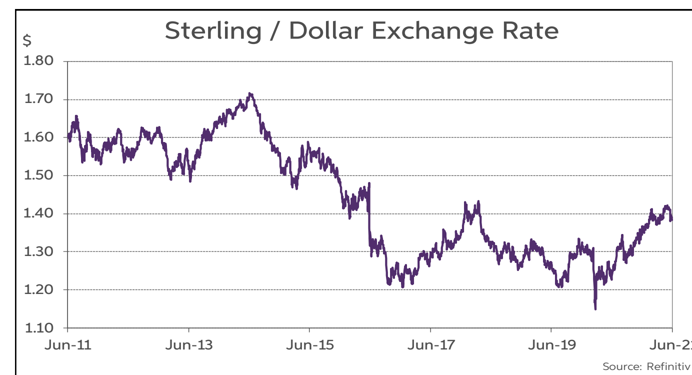
Summary of Exchange Rate Forecasts

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

	Current	Q3-2021	Q4-2021	Q1-2022	Q2-2022
Euro Versus					
USD	1.189	1.16-1.22	1.15-1.21	1.14-1.20	1.13-1.19
GBP	0.858	0.83-0.89	0.82-0.88	0.81-0.87	0.80-0.86
JPY	131.45	128-134	128-134	128-134	128-134
CHF	1.10	1.10	1.10	1.11	1.11
US Dollar Versus					
JPY	110.52	107-113	108-114	109-115	110-116
GBP	1.387	1.35-1.41	1.36-1.42	1.36-1.42	1.37-1.43
CAD	1.24	1.24	1.25	1.26	1.27
AUD	0.75	0.75	0.75	0.74	0.73
NZD	0.70	0.70	0.70	0.69	0.68
CNY	6.46	6.45	6.40	6.35	6.30
Sterling Versus					
JPY	153	152	154	156	158
CAD	1.72	1.72	1.74	1.76	1.96
AUD	1.85	1.84	1.85	1.88	1.92
NZD	1.98	1.97	1.99	2.01	2.06







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AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit