Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Signs global economy regaining momentum, though supply bottlenecks, including labour shortages, high inflation and rising interest rates are headwinds to growth.

- CPI rates hit 30-40 year highs. Concerns that inflation will stay elevated for much of this year amid supply shortages and further sharp rise in oil prices, added to by geo-political risks.

- Significant rate hikes expected in 2022 and 2023 in many economies as inflation rises to a far greater extent than expected. Interest rates seen levelling off after that.

- ECB no longer ruling out a rate hike in 2022, but still seems of the view that only limited tightening required. Markets, though, see a series of rate hikes from the autumn.

- Major currency pairs remain remarkably range bound given all the forces at work in markets. Main reason may be that interest rates are expected to rise in most economies this year.

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Global Economic Outlook

Activity regaining momentum, but risks remain 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 IMF estimates that the world economy grew by 5.9% last year, with output in developed economies rising by 5%.

However, the recovery lost momentum over the second half of the year. The much more transmissible Delta and Omicron COVID 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 H2 2021, with shortages of raw materials, key inputs and workers, as well as capacity constraints in transportation. This resulted in delays and rising supplier delivery times, holding back output in some industries.

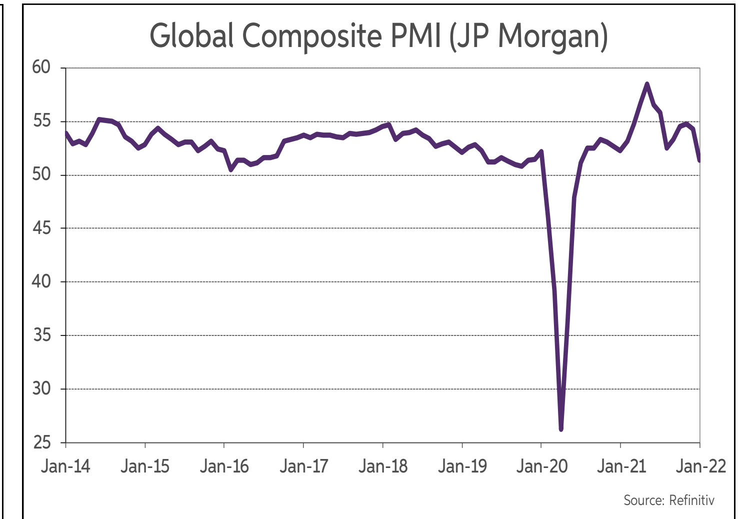
Activity has regained momentum in the opening month of 2022 as the latest wave of COVID subsides. Retail spending rebounded strongly in the US and UK in January, with very strong labour market data also. Meanwhile, PMI survey data rose strongly in February in all the main economies. Good global growth is expected this year as economies continue to rebound from the deep recession of 2020. Both the IMF and OECD are forecasting that the world economy will grow by circa 4.5% in 2022, with advanced economies expanding by around 4%.

Headwinds to growth are increasing, though. Rising inflation, which erodes real spending power, will 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 7.5% in the US and over 5% in the Eurozone, with the UK rate expected to rise to 7.5% in late spring. The pick-up in inflation has proved far greater than expected and is set to persist for much longer than previously envisaged. There have been marked upward 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. Oil prices have surged by a further 30% over the winter, while gas prices remain elevated. Low inventories of oil and gas combined with the ongoing tensions between Russia and NATO regarding Ukraine suggest energy prices may remain high this year. The biggest medium-term inflation risk, though, 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 7% in the Eurozone. The number of job vacancies has risen to very high levels in many economies. There are already signs of upward pressure on wages in the US and UK.

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 and IMF are forecasting that growth in advanced economies will slow to around 2.5% in 2023, with the world economy growing by circa 3.5%. Significant risks remain in particular that inflation continues to surprise on the upside, forcing central banks to tighten monetary policy to an even greater extent than is currently envisaged.



GDP (Vol % Change)

	2020	2021 (e)	2022 (f)	2022 (f)
World	-3.1	5.9	4.4	3.8
Advanced Economies	-4.5	5.0	3.9	2.6
US	-3.4	5.6	4.0	2.6
Eurozone	-6.4	5.2	3.9	2.5
UK	-9.4	7.2	4.7	2.3
Japan	-4.5	1.6	3.3	1.8
Emerging Economies	-2.0	6.5	4.8	4.7
China	2.3	8.1	4.8	5.2
India	-7.3	9.0	9.0	7.1
World Trade Growth (%)	-8.2	9.3	6.0	4.9
Inflation -PCE Deflator				
Advanced Economies (%)	0.7	3.1	3.9	2.1

Source: IMF World Economic Outlook, January 2022

Interest Rate Outlook

Markets gear up for 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. The months ahead are going to see further withdrawals of monetary supports, with a series of rate hikes on the cards in some leading economies.

The US Federal Reserve is set to begin raising interest rates from next month, when it will also fully wind down its QE asset purchase programme. In its last set of rate projections in December, the Fed signalled a significant amount of rate tightening was in store, 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 markets now see these rate hikes being brought forward. There is some talk that the Fed could hike by 50bps in March and futures contracts see rates getting near to 1.75% by end year and above 2% in 2023, levelling off thereafter. The Fed has warned, though, that rates may have to go higher than in the last tightening cycle when they reached 2.375%. Meantime, it is expected to commence quantitative tightening or asset sales later this year as it starts to reduce its enormous balance sheet.

The Bank of England wrapped up its QE bond purchase programme in December. It hiked the Bank rate by 15bps to 0.25%. in December, with a further 25bps hike in February. Indeed, it came close to a 50bps hike in February, with the MPC vote 5:4 in favour of 25bps. Further rate increases are in store in 2022, including at its next meeting in March. The market sees UK rates getting to 1.875% by end year and then topping out at circa 2% in mid-2023. Rates are expected to start falling back somewhat from 2024. The Bank of England foresees a major slowdown in the UK economy from next year, with inflation moving back below target. Thus, it is not surprising that markets think some of the BoE policy tightening may eventually be reversed. Meanwhile, the BOE has also indicated that it will begin QT or some asset sales when official rates get above 1%.

The ECB has been engaged in lowering the pace of its asset purchases over the past few months. This scaling back of QE bond buying is set to continue in the coming months. Meantime, in a notable change of view, it is no longer ruling out that rates may have to be raised this year. Markets believe that the ECB will begin raising rates later in 2022 and are currently pricing in 35-40bps in hikes by end year. They see a further 80bps of rate increases in 2023, and so expect close to 125bps in total rate tightening over 2022-23. This would take the deposit rate from –0.5% to near 0.75%, which would certainly mark the end of the negative interest regime that has been in place since 2014. There will be considerable interest in the new set of ECB macro forecasts due to be published at its March policy meeting. If these show that inflation is expected to settle at 2% over the medium term, it would validate markets expectations that the ECB will move away from its negative interest policy.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.46	1.26	1.76	1.97
Mar'22	0.375	0.69	1.40	1.80	2.00
June'22	0.875	1.10	1.60	1.95	2.10
Sept'22	1.375	1.50	1.80	2.10	2.20

** 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	-0.53	-0.28	0.21	0.65
Mar'22	-0.50	-0.50	-0.25	0.20	0.65
June'22	-0.50	-0.40	-0.15	0.25	0.70
Sept'22	-0.50	-0.30	-0.05	0.40	0.80

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	0.88	1.66	1.98	1.92
Mar'22	0.75	1.00	1.75	2.05	1.95
June'22	1.25	1.50	1.85	2.10	1.98
Sept'22	1.50	1.65	1.95	2.15	2.00

** Swap Forecasts Beyond 1 Year*

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Forex Market Outlook

FX Markets remain remarkably range bound against volatile backdrop

The dollar moved steadily lower in 2020, losing 12% against the other major currencies, as US rates were cut from over 2% to virtually zero. However, it recovered ground last year, helped by a firming of US interest rates along the curve, amid growing expectations of significant Fed 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, rising by 5% in trade-weighted terms over this period.

The euro was a notable casualty of the dollar strength, falling from $1.22 last June to $1.12 in late November, with the key support level of $1.16-1.17 giving way during the autumn. The dollar rally, though, ran out of steam towards the end of last year and the main currency pairs have been confined to quite narrow trading ranges in the opening two months of 2022. The EUR/USD rate has traded in a $1.11-1.15 band, while sterling has been largely confined to a $1.34-1.37 corridor. The yen has also been very stable against the dollar year-to-date.

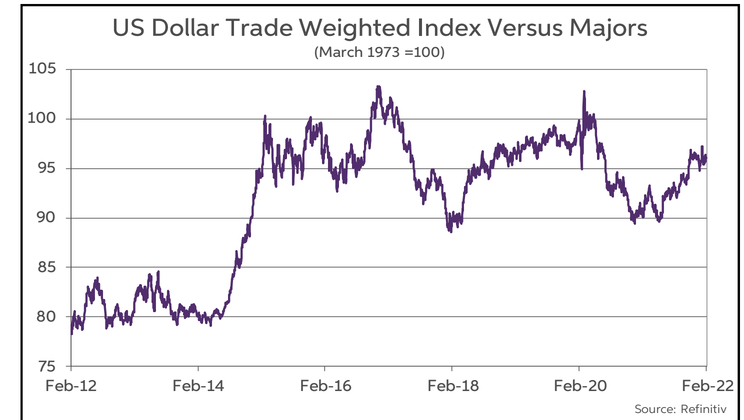
The stability in foreign exchange markets is quite remarkable given the volatility in both stock and interest rate markets and elevated geo-political tensions in regard to Ukraine. Market stability has been helped by the fact that positioning is not overly stretched in any of the main currencies at the present time. The fact that all of the main central banks, with the exception of the Bank of Japan, are expected to hike interest rates over the course of 2022-23 may be the main reason behind the narrow trading ranges seen so far this year in forex markets.

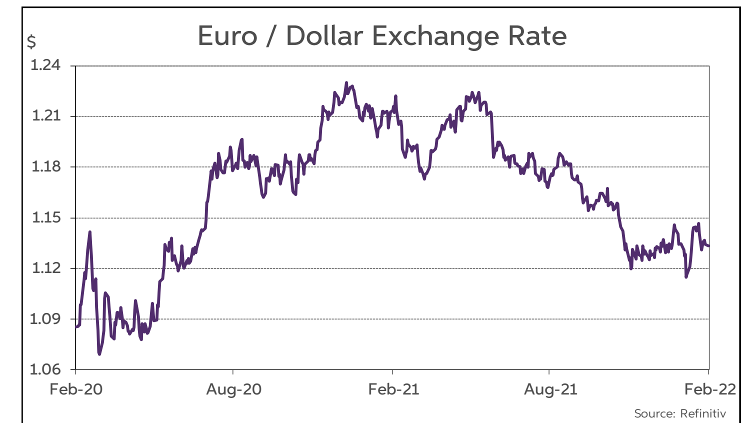
Furthermore, data this year show activity is picking up momentum again in all economies as the latest wave of the COVID-19 pandemic subsides. More generally, expectations that the risks to economic activity posed by Covid-19 are abating, resulting in solid and better balanced global growth, may be acting to reduce demand for safe-haven currencies, like the dollar. Heightened geo-political tensions relating to Russia and Ukraine are having a limited impact on forex markets to date also.

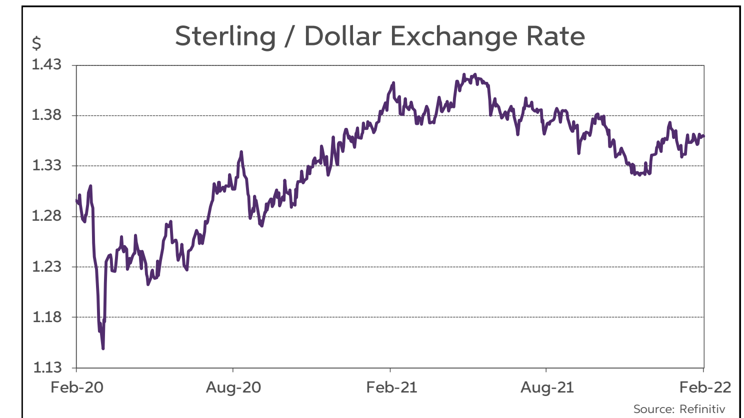
We do not envisage any significant fall in the dollar this year as it should be supported by a steady move upwards in US interest rates. The Fed is set to commence hiking from next month, with rate increases expected at nearly every FOMC thereafter. Markets are pricing in a total of 150bps in US rate rises this year. From a euro viewpoint, the fact that the ECB is no longer ruling out rate increases in 2022 is supportive of the currency. The next ECB policy meeting in March could be important for the currency. However, any ECB rate increases in 2022 will be relatively modest compared to the Fed and BoE. Thus, while the euro may make some gains later in the year as the ECB begins to hike rates, it may find it hard to rise above $1.17 level if US rates are at 1.5% or above and still rising.

Meanwhile, the Ukraine crisis could still pose a risk for the euro. However, 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 continue to trade in a narrow $1.11-1.15 corridor in the coming months.

Longer term, 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 looks well underpinned for now, but with downside risk over medium term

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 and another 25bps increase in February. Markets are pricing in that UK rates could rise by a further 135bps this year. This would take the Bank rate up to 1.85%, with UK rates seen reaching 2% in 2023. The hardening of UK rate hike expectations has seen Cable (GBP/USD) rise from $1.32 before Christmas, to trade in a $1.34-1.37 range recently. Meanwhile, the euro has fallen back from above 85p to around the 83-84p level.

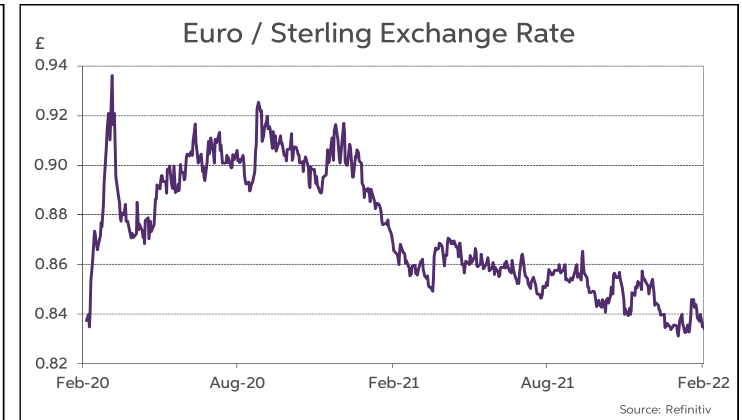
In the near term, further UK rate hikes are likely to remain supportive of sterling. The 83p level is a major support point for the euro, which has not been overcome by sterling since the Brexit referendum in 2016. The euro has been tested at this level on a number of occasions recently, but it has held, helped by growing expectation of ECB rate hikes in the second half of the year. Even if it were to give way, there is good technical support for the euro in the 80-83p region. Thus, we do not envisage sterling making large gains against the single currency from current levels. Meanwhile, with significant rate hikes expected in both the UK and US over the rest of the year, cable may remain largely confined to its recent narrow trading range in the months ahead.

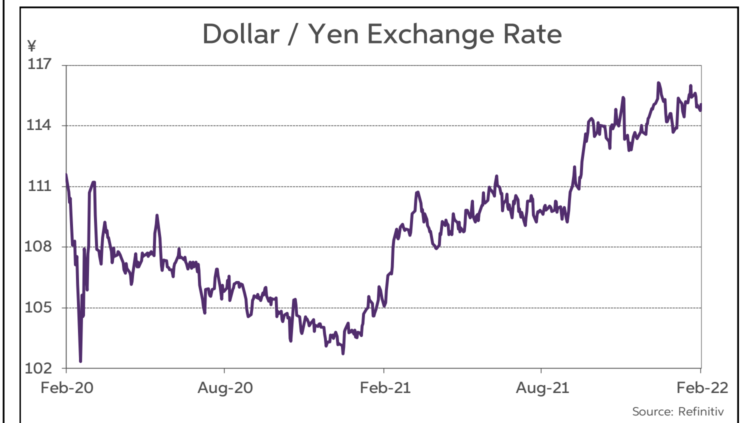
We would have some concerns about sterling, though, over the medium term. While the UK is expected to record another strong rise in GDP in 2022, this is partly due to carryover effects. The economy is likely to lose momentum as the year progresses in the face of a tightening of fiscal and monetary policy. The Bank of England is quite downbeat on the UK economy's growth prospects as a result of a squeeze on real disposable income from higher taxes as well as elevated inflation. Brexit has also acted to depress trade with the EU. The BoE sees UK growth moving well below trend in 2023 and 2024, with unemployment rising. Markets have started to build in rate cuts in the UK post 2023. Thus, while sterling should remain well underpinned in the near term, it could start to lose ground later in the year if UK growth does indeed seem set to move below trend in 2023-24.

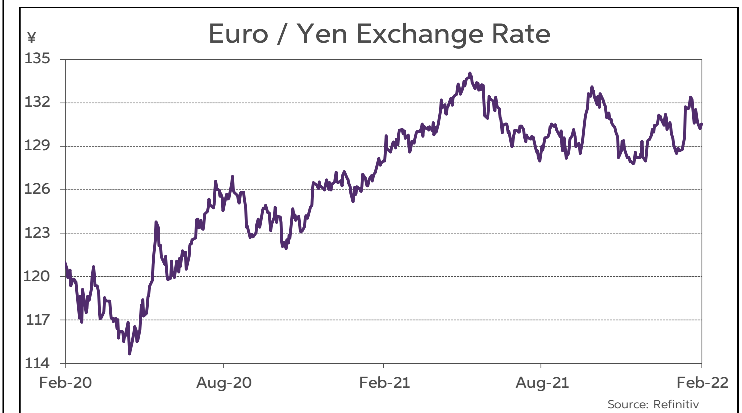
Yen should remain quite stable

The yen has been much more stable against the dollar in the past three months, having lost considerable ground against the appreciating US currency in 2021. The dollar climbed from ¥103 at the start of last year to ¥115 by November. Since then, the dollar-yen rate has been largely confined to a narrow ¥113-116 range. Meantime, the euro-yen rate has moved in a relatively narrow ¥128-134 range over the past year. This indicates that in the last 12 months, movement in the dollar-yen rate have been mainly driven by the US currency side of the pair.

Market positioning is somewhat short the yen, which should be supportive of the currency. 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. ¥118 is also a big support level for the currency, which has only been breached by the dollar during one occasion in the last fifteen years.



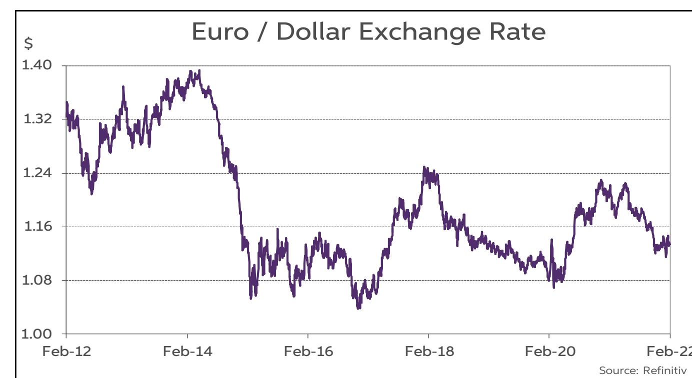


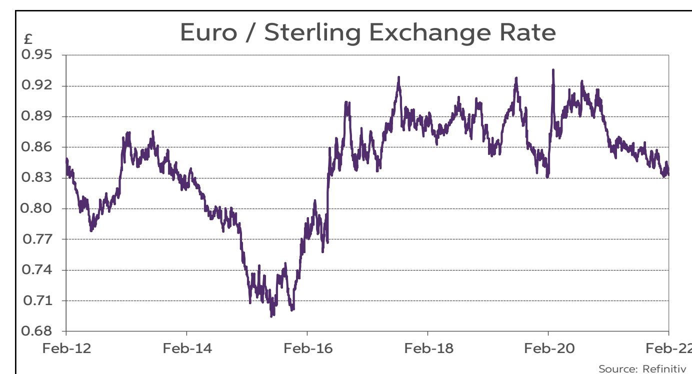


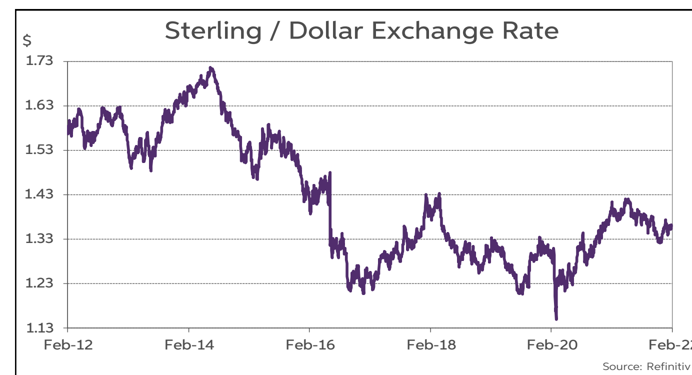
Summary of Exchange Rate Forecasts

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

	Current	Q1-2022	Q2-2022	Q3-2022	Q4-2022
Euro Versus					
USD	1.134	1.10-1.16	1.11-1.17	1.11-1.17	1.12-1.18
GBP	0.835	0.80-0.86	0.80-0.86	0.81-0.87	0.82-0.88
JPY	130.56	127-133	128-134	127-133	128-134
CHF	1.04	1.04	1.04	1.05	1.06
US Dollar Versus					
JPY	115.11	112-118	112-118	111-117	111-117
GBP	1.359	1.33-1.39	1.34-1.40	1.33-1.39	1.32-1.38
CAD	1.27	1.27	1.26	1.25	1.25
AUD	0.73	0.73	0.73	0.73	0.73
NZD	0.68	0.68	0.68	0.69	0.69
CNY	6.32	6.32	6.30	6.25	6.25
Sterling Versus					
JPY	156	156	158	155	154
CAD	1.73	1.73	1.67	1.64	1.77
AUD	1.87	1.86	1.88	1.86	1.85
NZD	2.00	2.00	2.01	1.97	1.96







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