Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Economic data, especially on labour markets, have generally surprised to the upside in 2023, though GDP growth was sluggish in Q1. Global economy still facing considerable headwinds

- Central banks remain on rate tightening path, though Fed and ECB appear to be nearing end of their hiking cycle. BoE has further to go, with markets pricing in another 150bps of UK rate hikes

- With core inflation still high and proving to be sticky, the risk of more persistent inflation has intensified. As a result, rate cuts are not now expected to begin until midway through 2024

- Dollar edging lower, but overall, quite range bound in 2023. Fed easing could pose a risk to it next year. Yen needs BoJ policy shift to recover the considerable ground lost since early 2022

- Sterling firms in H1 2023 on more resilient UK economy/higher rate expectations. However, further sterling gains could prove difficult on both technical factors and economic grounds

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Global Economic Outlook

Data hold up, but tighter credit conditions and persistent inflation risks to growth

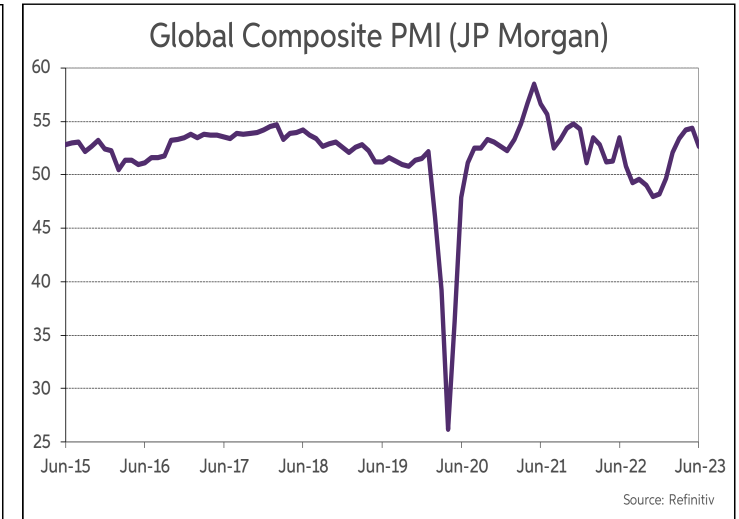
The global economy lost considerable momentum over the course of last year after it had rebounded strongly in 2021 from the impact of COVID-19. Surging inflation combined with a marked tightening of monetary policy, amid an environment of weakening confidence levels and heightened geo-political tensions, especially in relation to Ukraine, saw the world economy slow sharply during 2022. However, concerns that advanced economies could be facing a recession in 2023 largely abated over the winter as economic data printed ahead of expectations, helped by falling commodity prices, the start of a decline in headline inflation and continuing strong labour markets. GDP data for Q1 2023, though, showed growth remained weak.

The stresses that have emerged in parts of the global banking system this spring are an additional risk to the economic outlook. There had already been a tightening of financial conditions and lending standards for loans over the past year. Both Fed and ECB surveys show bank lending conditions have tightened while credit demand has weakened. The US Fed believes that tensions seen in the banking system are likely to result in tighter credit conditions for households and businesses in the US, and that this will weigh on economic activity, employment and inflation. However, it also notes the extent of these effects are uncertain. The impact is not expected to be as great in Europe.

The OECD in its latest update, though, warned that higher interest rates could continue to expose underlying financial vulnerabilities, with potential for rising loan defaults. most notably in weaker low-income countries, where signs of debt distress are becoming increasingly evident. Broader financial contagion, though, from recent events has been limited so far, with central banks noting that the banking system remains strong in terms of its capital and liquidity positions. Overall, growth in advanced economies is expected to remain subdued in 2023-24. The OECD is forecasting GDP growth of 1.4% in both 2023 and 2024 for the OECD region, with the world economy projected to expand by less than 3% in both years.

In terms of inflation, falling commodity prices have seen headline CPI rates decline in most economies. Oil, gas and global food commodity prices most notably, have fallen sharply. Furthermore, economic activity remains subdued with clear signs of a marked easing in inflationary pressures in the manufacturing sector. However, price pressures have become more broad-based, most notably in the services sector, meaning core inflation rates are proving to be quite sticky. Central banks are paying particularly close attention to wage growth given the tightness of labour markets, but they have also noted that profit margins have widened too. In recent weeks, central banks and other institutions, such as the BIS and the OECD, have warned that signs of "persistent" inflationary pressures are emerging, which will necessitate a more aggressive monetary policy response, with rates remaining higher for longer. However, inflation is generally still expected to continue to decline, albeit more slowly than previously anticipated. The most up-to-date forecasts are for core inflation rates to average 4.0-5.5% in many of the large advanced economies this year, with core rates remaining above target at 2.5-3.5% in 2024.

Overall then, economic activity has held up better than expected year-to-date in the main economies, but growth remains sluggish. Optimism that a recession can be avoided has given way to fresh concerns that economic activity could be further dampened if stresses in part of the global banking system result in a marked tightening of credit conditions, most notably in the US. Uncertainty about the economic outlook is elevated, so a close eye needs to be kept on the data, with core inflation in particular, remaining a key concern for policymakers.



GDP (Vol % Change)

	2021	2022	2023 (f)	2024 (f)
World	6.1	3.3	2.7	2.9
OECD Economies	5.7	3.0	1.4	1.4
US	5.9	2.1	1.6	1.0
Eurozone	5.2	3.5	0.9	1.5
UK	7.6	4.1	0.3	1.0
Japan	2.2	1.0	1.3	1.1
Non-OECD Economies	6.5	3.7	3.9	4.1
China	8.4	3.0	5.4	5.1
India	9.1	7.2	6.0	7.0
World Trade Growth (%)	10.4	5.0	1.6	3.8
Inflation -CPI OECD Economies (%)	3.8	9.3	6.9	4.3

Sources: OECD Economic Outlook June 2023

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Interest Rate Outlook

Higher for longer interest rates required to tame persistent inflation

After an 18 month period, characterised by aggressive monetary policy tightening, most central banks appear to be nearing the end of their tightening cycles. The period of rapid rate hikes was against the backdrop of inflation rising to 10% or above in many economies and labour market conditions remaining tight. More recently though, there are signs that headline inflation is past its peak and on a downward trajectory. Central banks now also have to factor in the stresses that emerged in parts of the global banking system earlier this year, into their decisions. A significant tightening of credit conditions could have a significant deflationary impact on economies. However, central banks have dampened expectations of rate cuts before year-end, indicating that policy will need to be kept tight to restore price stability in the face of sticky core CPI rates amid more persistent inflationary pressures.

For the first time since January 2022, the Fed left US rates unchanged in June. The Fed, though, has raised rates by 500bps already this cycle, with the target range for the funds rate now at 5.00-5.25%. However, all bar two FOMC members expect to have to raise rates again this year. The median projection in the updated interest rate dot-plot shows that most participants anticipate an additional 50bps of rate hikes this year. Markets had largely ignored the Fed's projection for the peak in rates, pricing in just one final 25bps hike in Q3, taking the funds rate to 5.25-5.50%. More recently, though, on the back of continuing strong US data, they have started to consider the possibility of two 25bps rate hikes in H2 2023, in line with Fed guidance. Meanwhile, the market is no longer pricing in rate cuts before year end, with policy easing not envisaged to materialise now until Q2 2024. Nevertheless, futures contracts indicate significant rate cuts are anticipated in 2024-25, with the funds rate falling to 4.25% by the end of next year and around 3.75% at end 2025.

The BoE re-accelerated the pace of rate hikes, raising the Bank rate by 50bps in June. The decision followed two 25bps increases in March and May, and brought Bank rate up to 5%. In justifying the decision to up the pace of rate hikes in June, the MPC noted that second-round impacts in domestic prices and wages arising from external shocks were likely to take longer to unwind than had previously been expected They also referenced the "upside news" in recent macro data against the backdrop of a "tight labour market and continued resilience in demand", resulting in more persistent inflation. There has been a notable firming in UK futures contracts in recent weeks, with the market now envisaging that Bank rate will rise by around a further 150bps to 6.5% by early next year. However, rates may not be raised by as much as the market anticipates, given the BoE is forecasting only weak growth for the UK economy this year and next, conditional on a much lower path for interest rates. Thus, rates rising to 6.5% could push the economy into recession and see inflation fall rapidly to below the 2% target.

Meanwhile, the ECB hiked rates by 25bps for the second consecutive meeting in June, which brought the Deposit rate up to 3.5%. The ECB was again quite direct in stating that inflation is expected to remain too high, for too long. At the same time, President Lagarde telegraphed that another 25bps increase can be anticipated this month, saying that the ECB has more ground to cover in tightening policy. Futures contracts are pricing that the ECB will hike by 25bps at its next policy meeting this month, and by 25bps again in September, with the Deposit rate peaking at 4% and remaining at this level until the middle of 2024. The Deposit rate is then seen as ending next year back at around 3.625% and 3.25% at end 2025. Overall, given the ECB's focus on bringing inflation under control and maintaining a restrictive policy for as long as required amid sticky core inflation, rates may go even higher than 4% and could be slower to fall back next year than the market currently envisages.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	5.125	5.56	5.63	5.13	4.38
Sept'23	5.375	5.60	5.65	5.20	4.60
Dec'23	5.375	5.55	5.55	5.55	4.50
Mar'24	5.375	5.45	5.40	5.00	4.35

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	3.50	3.64	4.02	3.94	3.44
Sept'23	4.00	4.10	4.25	4.10	3.60
Dec'23	4.00	4.05	4.20	4.00	3.50
Mar'24	4.00	4.05	4.10	3.90	3.40

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	5.00	5.49	6.34	6.27	5.56
Sept'23	5.50	5.85	6.50	6.40	5.65
Dec'23	5.75	6.00	6.55	6.40	5.55
Mar'24	5.75	5.90	6.35	6.20	5.30

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar edging slowly lower. Its decline could accelerate in 2024

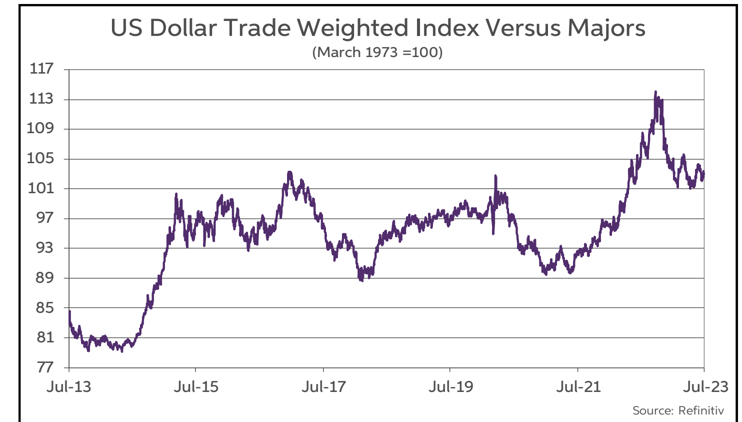
The final quarter of 2022 through to end January 2023 saw a change in the dollar's fortunes. It lost significant ground as other central banks stepped up the pace of rate hikes. Beforehand, the greenback had been very much in the ascendancy, reaching its highest level on a trade-weighted basis in 20 years. However, EUR/USD moved back up to parity, before rising up to the $1.05-1.06 level late last year and then moving above $1.09 at end January. Meantime, sterling rose from a low of $1.04 to as high as $1.24, while the dollar fell back from above ¥150 against the yen in October to below ¥130 by January. Overall, EUR/USD traded in a $1.05-1.10 range from December to March, while cable traded between $1.18-1.24.

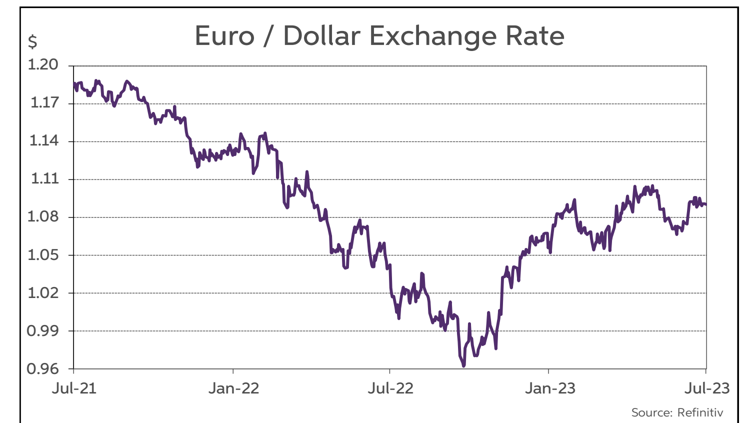
The dollar lost some further ground amid the emergence of stresses in parts of the global banking system, in particular in the US, in the March-April period, with markets moving to price in a lower peak for rates and significant policy easing in the US in the second half of this year. EUR/USD traded to a year-to-date high just below $1.11 in late April. However, throughout May/early June, the dollar regained some momentum. US data remained strong, while there appears limited contagion to date from the stresses in the US banking system. Furthermore, US rate contracts firmed once again during the period, amid hawkish messaging from the Fed. At the same time, euro positioning, where net longs had hit a two and a half year high, weighed on the single currency throughout May and early June. In level terms, this saw EUR/USD fall back below the $1.07 threshold.

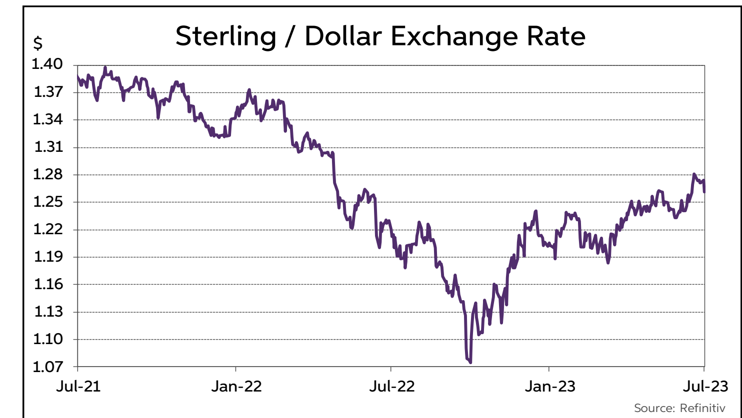
The Fed left interest rates unchanged at its June policy meeting. In contrast, the ECB raised rates by 25bps, and the BoE by 50bps around the same time. This resulted in the dollar coming under some modest downward pressure at the end of Q2. The greenbacks losses were limited by guidance of additional rate hikes from the FOMC, suggesting that the June meeting signaled a 'skip' and a not a 'pause' in rate tightening. Nevertheless, EUR/USD has moved to trade in and around $1.08-1.09 in recent weeks, with cable operating between $1.27-1.28. Overall, EUR/USD traded in a $1.06-1.11 range in Q2, little changed from the $1.05-1.10 corridor in Q1.

Interest rate markets expect the Fed to raise rates by 25bps in July, whereas the Fed is currently guiding for 50bps in additional rate hikes in H2. The Fed continues to maintain a hawkish bias in its recent comments on monetary policy. If the Fed was to deliver 50bps in hikes, this should provide support for the dollar. Meanwhile, any bouts of risk aversion on markets may add some additional 'safe haven' support to the currency. Market positioning is also quite short the dollar as present, giving it some upside potential. On the other hand, despite performing well in the first half of 2023, the US economy is expected to slow over the remainder of this year. The stresses that emerged in parts of the global banking system could have a bigger impact on the US economy than elsewhere, as it is likely to experience a more pronounced tightening of credit.

In terms of the euro, the ECB continues to attach a very high importance to getting inflation back down to its 2% target, and it too has warned of signs of persistent inflationary pressures, with further rate hikes in store. The evolution of the War in Ukraine remains a risk factor, though the EU appears to have largely weaned itself of its high dependence on Russian oil and gas imports. Overall, the euro could make some gains against the dollar in H2 2023 if the ECB delivers more rate hikes than the Fed. Further out, although, rate cuts are not expected to materialise in the US until mid-year 2024, in-line with elsewhere, rates are projected to be cut much more aggressively by the Fed. Thus, the dollar may loss further ground and at a quicker pace against the euro next year on the back of Fed easing, with the single currency moving up to near the $1.15 level.







Forex Market Outlook

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Sterling recovers ground amid BoE hikes and better than expected UK macro data

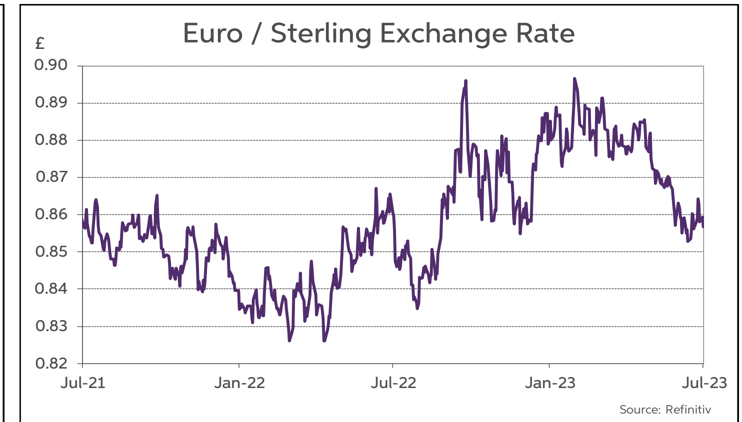
Sterling endured a difficult 2022 owing to concerns about the UK economy, especially following a badly received expansionary 'mini-budget'. Against a buoyant dollar, sterling fell sharply to a record low below $1.04 in late September, while EUR/GBP traded as high as 92p. Sterling, though, has regained significant ground since then, aided by reduced 'political risk' with a new UK Prime Minister and Chancellor championing fiscal restraint. Meantime, UK data have printed ahead of expectations since the autumn, with the economy avoiding falling into a recession that had been quite widely predicted. At the same time, UK rates have been raised to 5% and expectations of further hikes have continued to harden, providing further support for sterling.

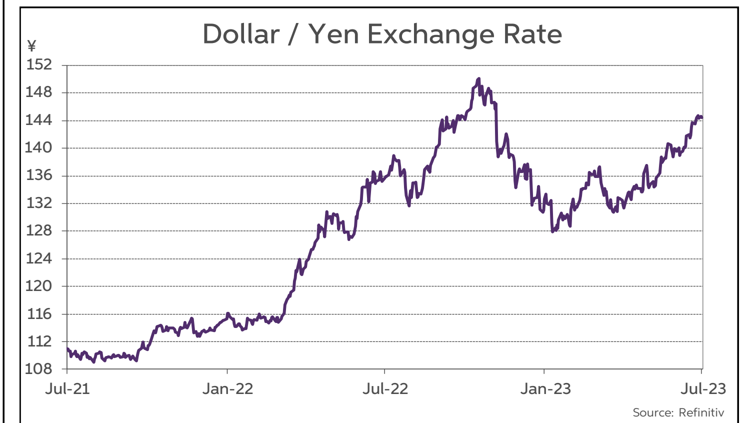
Cable has risen from $1.20 to $1.28 since the start of the year. Meanwhile, as sterling recovered, EUR/GBP has edged downwards, falling from the 89.5p earlier in the year to near the 85p level more recently. While UK macro news flow has been better than expected, the currency still faces a challenging outlook. The economy has basically flat-lined since Q2 2022, amid very high inflation and rising interest rates, with a considerable squeeze on real household disposable incomes. Brexit has also acted to depress trade with the EU and thus weigh on activity. Overall, the economy is expected to remain largely stagnant in 2023. Meanwhile, combined with the much higher costs of energy imports, Brexit has also seen a marked widening of the BoP deficit in the past couple of years.

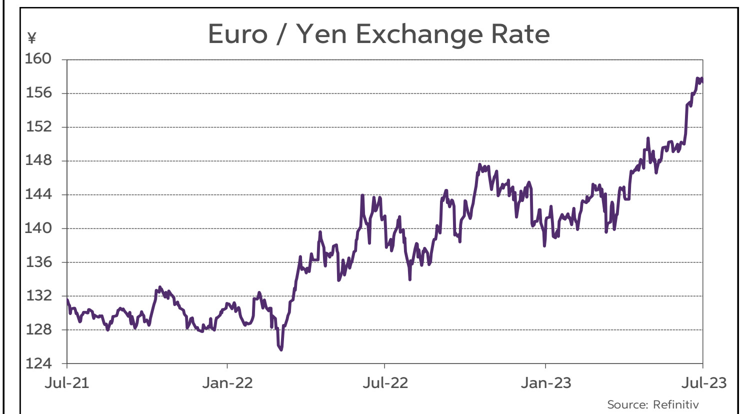
As already mentioned though, BoE policy tightening, is providing support for sterling, with rates now at 5.0% and expected to rise by a further circa 150bps, compared to the 25-50bps hikes anticipated in the Eurozone and US. However, if the BoE fails to deliver rate hikes to the extent the market anticipates, sterling may lose momentum. At the same time, by raising rates all the way to 6.5%, the BoE risks tipping the UK economy into recession, which would also act as a headwind for the currency. Meantime, the latest positioning data shows the market is now stretched long the pound. Thus, the near-term upside for sterling may be limited. We see sterling remaining confined to a narrow 85-87p corridor against the euro for the remainder of the year, but acknowledge there are risks in the short-term of the pair falling below 85p. If EUR/GBP does trade below 85p, there should be very strong support for the euro at 83-84p, which has represented a floor for the currency pair since the Brexit vote in 2016. Similar to the euro, sterling could make ground against the dollar, if US rates are put on hold there before elsewhere, with the potential for GBP/USD to rise above $1.30 as we enter 2024.

Continued dovish stance by BoJ under new Governor weighs on yen

In marked contrast to other central banks, the BoJ continued with its very accommodative policy in 2022. This resulted in USD/JPY falling to a 30-year low in the autumn, with the dollar rising above the ¥150 level in October. The yen moved off its lows late in the year, helped by the BoJ unexpectedly widening the yield corridor for ten year JGBs in December, effectively allowing them to rise by 25bps. This saw the USD/JPY rate fall back below ¥130 by January. However, the BoJ under new Governor, Ueda, continues to espouse a dovish outlook on policy, disappointing speculation of a possible change. This has resulted in renewed yen weakness, with the dollar rising to ¥144 and the euro up to the ¥156 level. The continuing very loose BoJ monetary policy stance is a major headwind for the currency. Furthermore, a change in policy direction does not seem imminent. Recent speculation of intervention from the BoJ on FX markets to support the yen, would also likely provide only a short-term tonic for the currency. Until, monetary policy is altered, the yen is likely to remain a very weak currency.







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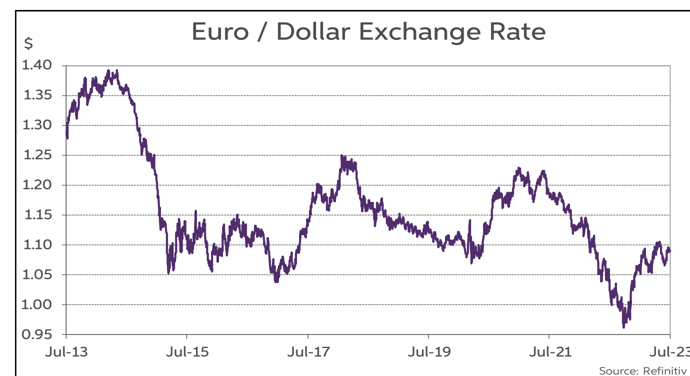
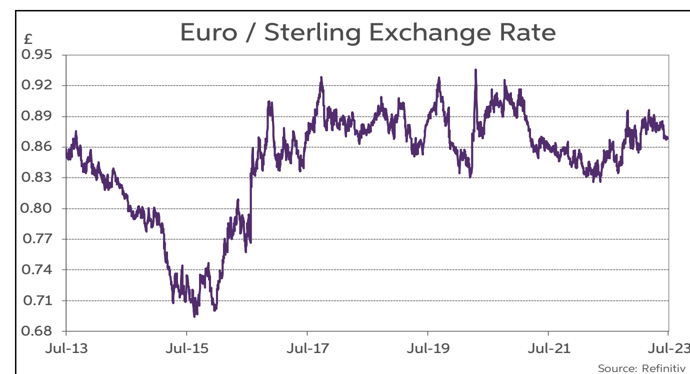
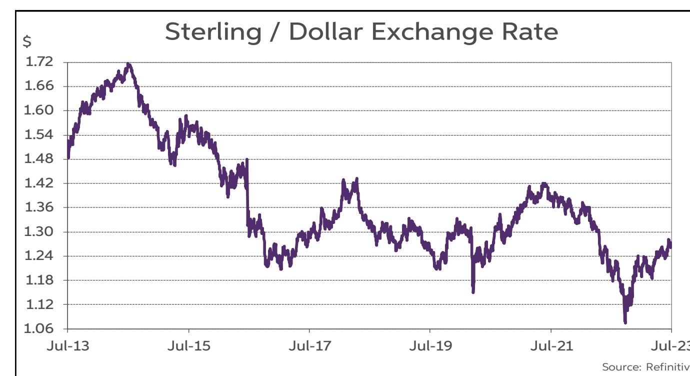
Summary of Exchange Rate Forecasts

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

	Current	Q3-2023	Q4-2023	Q1-2024	Q2-2024
Euro Versus					
USD	1.095	1.07-1.13	1.09-1.15	1.10-1.16	1.11-1.17
GBP	0.858	0.83-0.89	0.84-0.90	0.84-0.90	0.84-0.90
JPY	155.82	154-160	159-165	158-164	157-163
CHF	0.98	0.97	0.97	0.98	0.98
US Dollar Versus					
JPY	142.26	140-146	142-148	140-146	137-143
GBP	1.276	1.25-1.31	1.26-1.32	1.27-1.33	1.28-1.34
CAD	1.33	1.32	1.30	1.30	1.28
AUD	0.66	0.66	0.67	0.67	0.68
NZD	0.62	0.62	0.62	0.63	0.64
CNY	7.24	7.30	7.40	7.40	7.20
Sterling Versus					
JPY	182	183	187	186	183
CAD	1.70	1.69	1.67	1.69	1.68
AUD	1.92	1.94	1.93	1.94	1.93
NZD	2.07	2.06	2.08	2.06	2.05







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