Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Inflation hits very high levels, which combined with other headwinds such as the sharp tightening of monetary policy, will act as a significant drag on global economic activity in 2023
- Some countries likely to enter recession this winter, while a long downturn could be in store in the UK, as it is also confronted with significant fiscal tightening
- Numerous rate hikes implemented in 2022 by many central banks as they respond to sharply higher inflation, with the tightening cycle set to extend into first half of 2023
- Markets see EZ, UK & US rates rising to circa 3%, 4.6% and 5%, respectively, by mid-2023. BoE may not lift rates to this extent. Rates expected to remain high for a prolonged period
- Dollar gives back some of its gains recently as markets see shift to smaller US rate hikes. Sterling likely to remain volatile and vulnerable given the weak outlook for the UK economy

Oliver Mangan
Chief Economist

John Fahey
Senior Economist

Daniel Noonan
Economist

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Global Economic Outlook

Global recession risks remain high

The global economy has lost considerable momentum over the course of this year after it had rebounded strongly in 2021 from the impact of COVID-19. The Russian invasion of Ukraine saw a sharp rise in commodity prices, especially energy and food prices. This has contributed significantly to a sharp acceleration in inflation, with CPI rates rising to double-digit levels in many advanced economies. This is putting significant downward pressure on households' real disposable incomes. Central banks have responded to the surge in inflation with a marked tightening of monetary policy which in turn has had a further dampening impact on economic activity.

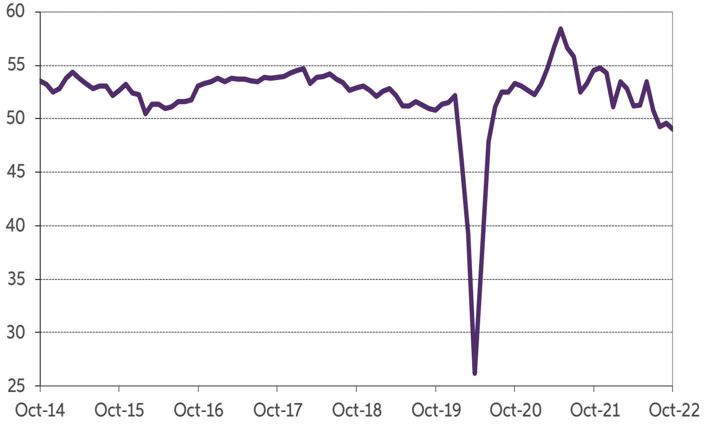
Against this very challenging backdrop, growth forecasts continue to be scaled back nearly everywhere. The OECD stated recently that the global economy is facing mounting challenges, noting the persistence of high inflation, weakening in confidence levels and heightened uncertainty. It is forecasting that the world economy will grow by 3.1% this year, slowing to 2.2% in 2023. These forecasts represent a marked slowdown from the 5.9% growth seen in 2021. Notably, the global Composite PMI has fallen below 50 recently. Growth in OECD economies is expected to slow even more sharply, from 5.6% last year, to 2.8% in 2022 and just 0.8% in 2023.

The OECD emphasises that growth prospects are becoming increasingly imbalanced. It notes that the major-Asian emerging-market economies will account for nearly three-quarters of global GDP growth next year, while both the US and European economies experience sharp slowdowns. It envisages high inflation and rising interest rates as significant restraints on the US economy. Growth in Europe is anticipated to slow sharply arising from the impact of the War in Ukraine, weak external demand, high energy/food prices, on-going supply bottlenecks, weak confidence and tighter monetary policy. As a result, it is forecasting both the US and Eurozone economies to register modest growth of 0.5% in 2023. The OECD is envisaging an even weaker outlook for the UK economy, with tighter fiscal policy acting as a additional headwind. It is pencilling in a 0.4% contraction for next year. Elsewhere, after weakening sharply this year to 3.3%, growth in China is projected at 4.6% in 2023. Meantime, the Japanese economy, is projected to grow by 1.8% next year, up slightly from 1.6% this year. Growth in western economies is expected to be very sluggish in 2024, at just 0.2% in the UK, 1% in the US and 1.4% for the Eurozone.

The OECD and IMF highlight the considerable uncertainty around economic forecasts and that the risks have become more skewed to the downside. The effects of the War in Ukraine could be even greater than assumed. In particular fuel shortages, especially for gas in Europe, could reduce growth even further. High inflation could prove to be more longer lasting than projected, weighing on global activity. There is also a growing concern that central banks in their aggressive moves to tighten policy to dampen inflation, may push economies into recession. Tighter conditions on financial markets could also cause distress in some emerging markets and economies. COVID also remains an ongoing risk, especially in China, which continues to implement lockdowns.

Inflation is at very high levels in many countries. There is a risk of a spill over into much higher wage inflation, which would make it more difficult to get CPI rates back down to their 2% target anytime soon. Indeed, a shortage of workers is already putting upward pressure on wages. The unemployment rate has fallen to below 4% in the US and UK, with a record low of 6.6% in the Eurozone. With price pressures becoming more broad-based, inflation is now expected to remain elevated for quite some time. PCE inflation in OECD economies is seen averaging 9.4% this year, moderating to 6.5% in 2023 and 5% in 2024. The rate is expected to average 3.4% in the UK and Eurozone and 2.6% in the US in 2024, with the 2% target coming closer into view by the end of the year.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2021	2022 (f)	2023 (f)	2024 (f)
World	5.9	3.1	2.2	2.7
OECD Economies	5.6	2.8	0.8	1.4
US	5.9	1.8	0.5	1.0
Eurozone	5.3	3.3	0.5	1.4
UK	7.5	4.4	-0.4	0.2
Japan	1.6	1.6	1.8	0.9
Emerging Economies	6.2	3.4	3.3	3.8
China	8.1	3.3	4.6	4.1
India	8.7	6.6	5.7	6.9
World Trade Growth (%)	10.0	5.4	2.9	3.8
Inflation -PCE OECD Economies (%)	3.8	9.4	6.5	5.1

Source: OECD Economic Outlook, November 2022

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Interest Rate Outlook

Central banks indicate may move to a less aggressive pace of rate hikes

With CPI rates rising to around 10% or above in many economies and tight labour markets, central banks have enacted aggressive policy tightening since the summer, despite weakening economic activity. This has seen some of the main central banks implement 50-75bps rate hikes at recent meetings. However, with tentative signs that inflation may be easing in some economies, as well as central banks being very cognisant of the risks to their respective economies from over tightening, the pace of rate hikes may slow from here on.

The US Fed implemented its fourth consecutive 75bps rate increase in early November. This saw the target range for the Fed funds rate move up to 3.75-4.00%. The Fed has now enacted 375bps worth of rate hikes since the start of its tightening cycle in March. The meeting statement gave a signal that the Fed was considering a pivot to a slower pace of rate hikes. However, Chair Powell's press conference struck a more hawkish tone. He stated that the Fed has "still some way to go" in its tightening cycle, as well as noting that the ultimate level of rates will be higher than previously expected. The release of the minutes from this meeting noted though, that a substantial majority of FOMC members judged that a slowing in the pace of increases would likely soon be appropriate. Futures contracts suggest this may occur at its next meeting on December 14th, with a 50bp rate hike priced in. The market currently envisages rates peaking at 5% in the Spring of 2023. The market expects the Fed to begin cutting rates at the end of 2023, but still keep policy restrictive over the medium term. Aside from the Feds policy announcement in December, attention will be centred on its updated interest rate projections and any additional guidance that is forthcoming from Chair Powell regarding the trajectory for US rates.

The BoE also hiked rates by 75bps in November, bringing the Bank Rate up to 3%. This was the eight consecutive meeting where the Bank tightened monetary policy. It also represented a further acceleration in the pace of rate hikes, following two 50bps rate increases in Q3. The BoE Governor, though, was quite clear in stating that the Bank believes the official interest rate will go up by less than priced in by markets. At the time of these comments, futures contracts were pricing in a peak rate near 4.75%. There has been quite a lot of volatility in UK futures contracts against the eventful fiscal/political backdrop. However, there has been a clear softening trend in rate hike expectations, which at one stage was as high as 6%. Markets are now envisaging a peak in the region 4.625%. Given the Governor's guidance, this level may not be realised. However, a 50bps rate hike at its upcoming December 15th meeting seems a reasonable expectation. We think rates may peak at 4.25% in the spring. Rate cuts are not expected to materialise in the UK until 2024-25 and prove quite modest.

The ECB ended QE at mid-year and implemented its first rate increase since 2011 at its Council meeting in July, when it hiked by 50bps. This brought an abrupt end to its negative interest rate strategy. Since then, it has hiked by a further 150bps, with two consecutive 75bps rate hikes at its September and October meetings, with the key deposit rate rising to 1.5%. The communications following the meeting from the ECB suggested that it may move to a slower pace of rate hikes going forward. The meeting statement noted that the ECB has "made significant progress in withdrawing monetary policy accommodation". Meantime, during the press conference, President Lagarde, sounded less hawkish by referencing the risk of recession. Eurozone futures contracts have been much less volatile than their UK counterpart. The market is anticipating a 50-75bps hike in December, which would see the Depo rate end 2022 at 2.00-2.25%. Market expectations are for the Depo rate to peak at 3% in mid-2023, to be followed by a modest cut in rates in 2024-25.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	3.875	4.76	5.55	4.78	3.93
Dec'22	4.375	5.25	5.70	4.85	4.05
Mar'23	5.125	5.50	5.85	5.00	4.20
June'23	5.125	5.40	5.70	4.85	4.05

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	1.50	1.98	2.79	2.88	2.68
Dec'22	2.00	2.50	3.10	3.10	2.80
Mar'23	2.75	3.10	3.35	3.25	2.90
June'23	3.00	3.20	3.25	3.15	2.80

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	3.00	3.66	4.57	4.55	4.04
Dec'22	3.50	4.25	4.80	4.65	4.10
Mar'23	4.25	4.60	5.00	4.75	4.20
June'23	4.25	4.50	4.90	4.60	4.10

** Swap Forecasts Beyond 1 Year*

Dollar's rally loses some momentum

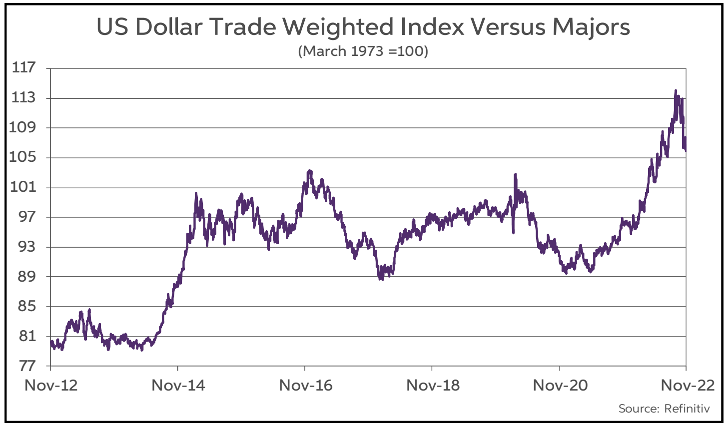
The dollar came into the ascendancy during the second half of last year, helped by growing expectations of significant Fed rate hikes in 2022-23. It rose by 5% in trade-weighted terms during this period. The euro was a notable casualty of the dollar's strength, falling from $1.22 in mid-2021 to $1.12 near year end. The Russian invasion of Ukraine triggered a further bout of dollar strength this spring, in terms of a flight-to-quality into the world's largest reserve currency as financial markets came under pressure. The Fed has also been the most vocal and aggressive of the main central banks on the need for significant rate tightening to counteract the further surge in inflation seen this year. The dollar has risen to its highest level on a trade-weighted basis since 2002, It has made significant gains against a broad range of currencies this year, with particularly large upward moves against the yen and sterling.

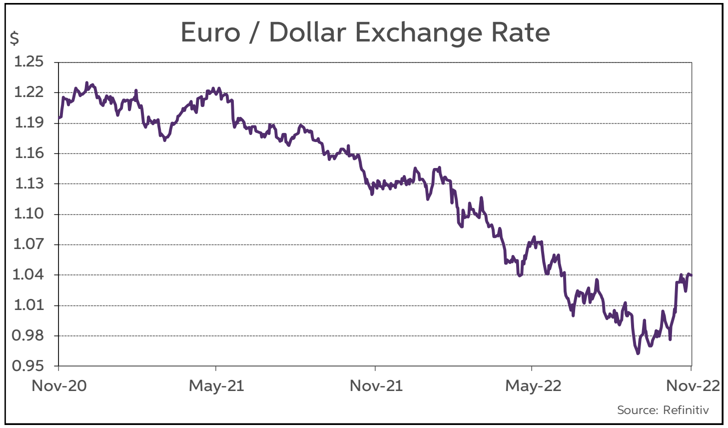
Not surprisingly, given the Eurozone's closer trade and financial ties with Russia and in particular its reliance on imports of gas from there, the euro came under more pressure following the invasion of Ukraine and the imposition of sanctions on Russia. Support at the $1.10 level against the dollar was easily breached. The key support level at $1.08, which had held during the early stages of the COVID-19 crises in the first half of 2020, also gave way. The major support level of $1.04, which was the lowest point hit by the euro in the past twenty years, initially held in early summer before giving way at mid-year, as the Fed stepped up the pace of rate tightening. The euro fell to parity initially, but then moved below this level in late summer, falling to a low of $0.95 as risk-off sentiment took hold in markets again and futures contracts priced in greater Fed tightening.

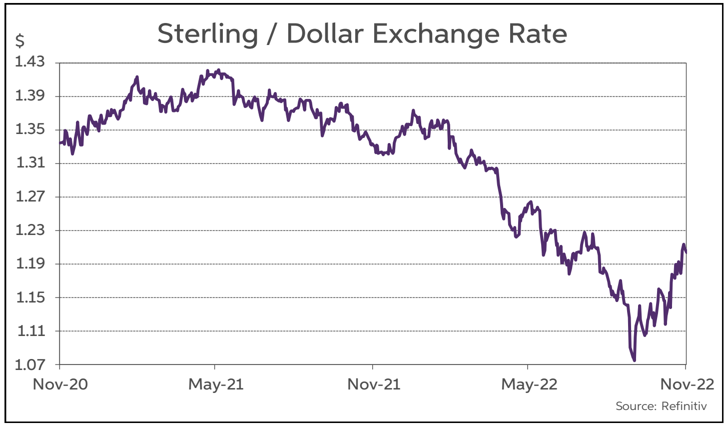
The aftermath of the November FOMC meeting provided an example of the sensitivity of currencies to monetary policy newsflow. The dollar weakened on the release of the meeting statement indicating a 'pivot' to a slower pace of rate hikes. More recently, the reaction of the dollar to US CPI inflation figures was even more noteworthy and highlighted sensitivity of currencies to data that can play a key role in determining the pace and extent that central banks will continue to raise rates. The weaker than expected CPI number for October saw the dollar lose between 3-5% on the exchanges within a couple of days. In level terms, this was reflected in EUR/USD moving back above parity to $1.03. The dollar experienced some more downward pressure amid reports of positioning adjustments, with the euro climbing to $1.05, before it edged back down below $1.04.

The coming year seems likely to be characterized by recession concerns as well as the likelihood that geo-political risks will remain to the fore, especially in regard to Russia and the war in Ukraine. At the same time, with inflation expected to remain elevated, central banks may be unable to ease policy. This could see markets remain volatile. This backdrop should be supportive of the US currency given its safe haven appeal.

From a euro viewpoint, the ECB's reversal of its negative interest rate strategy has helped to support the euro despite a challenging economic and geopolitical backdrop. The ECB's on-going rate tightening cycle should continue to act as a fillip to the currency. However, the war in Ukraine is likely to continue to pose a risk for the euro, especially in relation to energy supplies, which could be a key issue in 2023. The EUR/USD pair, as discussed above, has risen above parity recently to trade in a $1.02-1.05 range. Given the challenging macro economic conditions that are likely to prevail next year, including a recession in the Eurozone, as well as the on-going threat to the security of EU energy supplies and continuing war in Ukraine, the euro may struggle to make further appreciable gains against the dollar in 2023, unless US rate cuts come on to the agenda next year.







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Sterling remains vulnerable to bouts of volatility

Sterling gained good ground last year as the EU-UK Brexit trade deal lifted a cloud of uncertainty around the currency and the BoE started to turn quite hawkish on monetary policy, before hiking rates by 15bps to 0.25% in December. Sterling ended 2021 trading at around $1.35 versus the dollar and 84p against the euro.

The BoE has followed up with seven further rate hikes to date in 2022, totalling 275bps, which has brought the Bank rate up to 3%. Further rate hikes are on the cards, with inflation reaching 11.1% and expected to remain elevated over the coming months. Despite the rate increases, sterling lost considerable ground on the exchanges in late September and in the early part of October due to mounting concerns over the economic outlook and an expansionary 'mini-budget' which was badly received in financial markets. It called into question the fiscal credibility of the Truss led UK government. Against the buoyant dollar, sterling fell sharply to a record low below $1.04 in late September, before recovering to above the $1.10 level. Meanwhile, EUR/GBP at one stage traded as high as 92p. More recently, sterling has continued to regain ground. It has been aided by reduced 'political risk' with a new PM and Chancellor championing fiscal restraint and introducing measures to help plug the hole in the public finances. This has helped to repair to some extent the government's fiscal management credentials on markets. This combined with some loss of momentum in the dollar has seen cable move back up to around the $1.20 threshold, while EUR/GBP has tended to edge lower within its recent narrow 86-88p trading range.

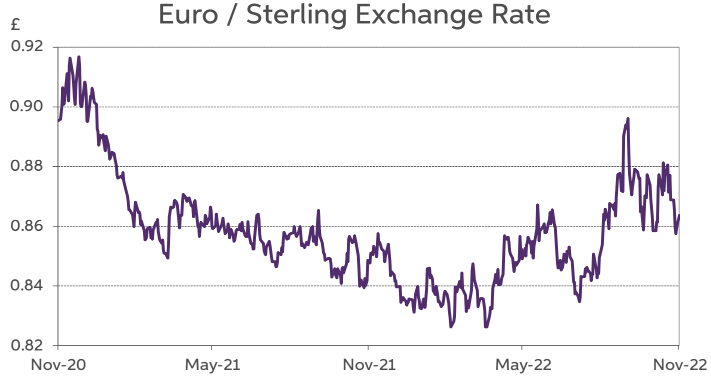
However, while sterling has regained some lost ground recently, the currency still faces a challenging outlook. The economy is now in contraction mode amid very high inflation and rising interest rates. The BoE is quite downbeat on the economy's growth prospects as a result of a squeeze on real household disposable incomes from high inflation. Brexit has also acted to depress trade with the EU, which combined with the much higher costs of energy imports, has seen a marked widening of the BoP deficit in 2022. The BoE sees the economy experiencing a prolonged downturn over the period 2023-24.

Further rate hikes should provide some support for sterling, but the BoE has given guidance that it is unlikely to raise rates to the extent expected by the markets. Meanwhile, a close eye should be kept on the current negotiations with the EU over the Northern Ireland Protocol as it may damage sterling if the talks break down. Overall, against the very weak UK macro backdrop, sterling seems likely to continue to be prone to bouts of volatility over the coming quarters. Sterling may well weaken again and EUR/GBP could rise towards 90p in 2023.

Can recent recovery in yen continue into next year ?

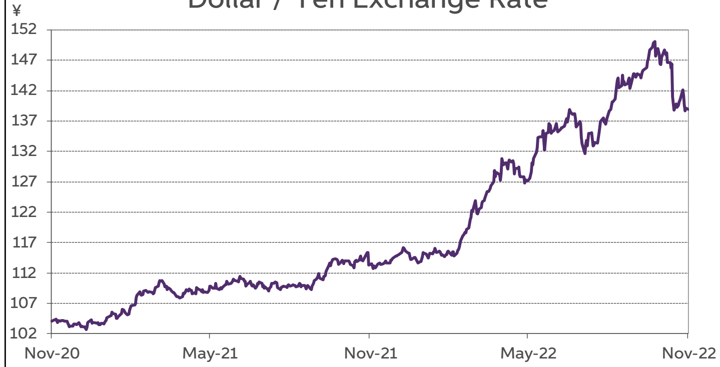
In marked contrast to other central banks, the BoJ has continued with its very accommodative policy, implementing large scale QE to cap ten year JGB yields at 0.25%, while keeping the key OCR in negative territory. Widening interest rate differentials has seen severe downward pressure on the yen, which fell to over 30-year lows against the dollar this autumn with the US currency rising above the ¥150 level. The BoJ intervened to support the currency for the first time since 1998. More recently, with some pairing back of rate hike expectations elsewhere, the yen has moved off its lows. The USD/JPY rate is now back below the ¥140 level. If market rates peak elsewhere as expected in H1 2023 and speculation of rate cuts by 2024 gathers momentum, the yen could recover some further lost ground next year. However, very wide interest rate spreads are likely to limit its gains.

Euro / Sterling Exchange Rate



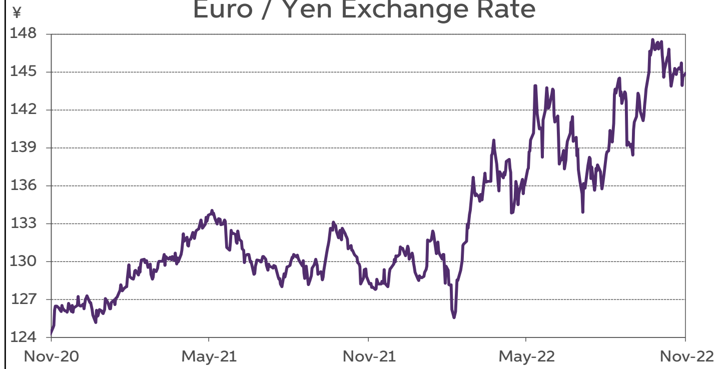
Source: Refinitiv

Dollar / Yen Exchange Rate



Source: Refinitiv

Euro / Yen Exchange Rate



Source: Refinitiv

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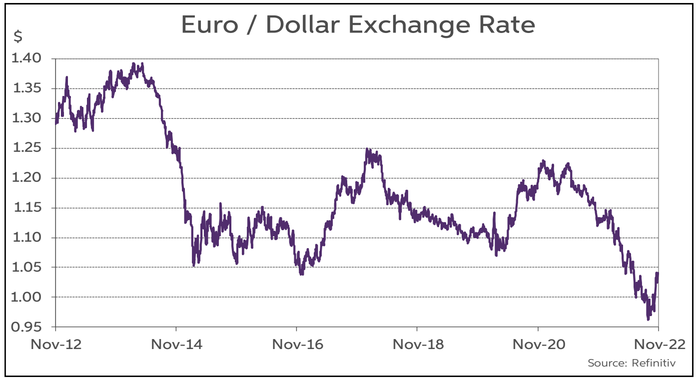
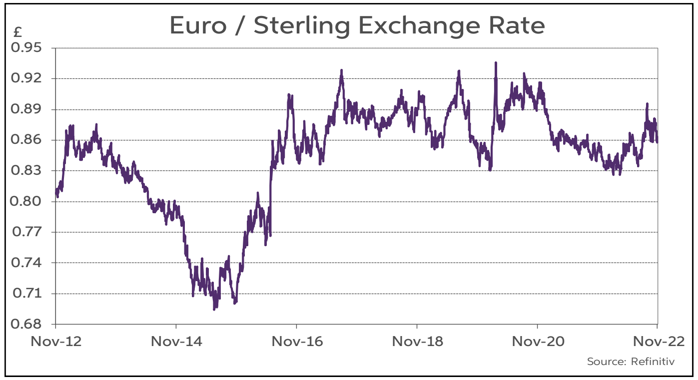
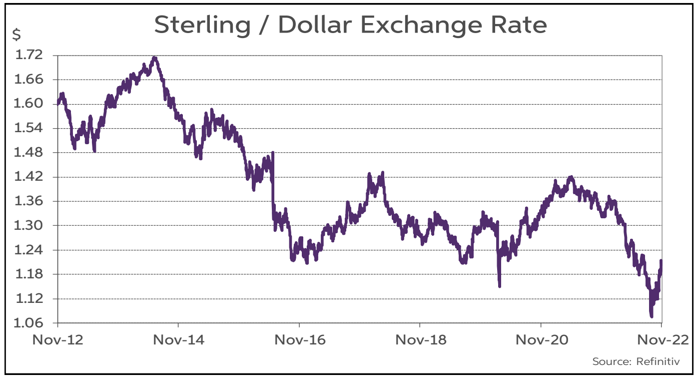
Summary of Exchange Rate Forecasts

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

	Current	Q4-2022	Q1-2023	Q2-2023	Q3-2023
Euro Versus					
USD	1.036	1.00-1.06	1.01-1.07	1.02-1.08	1.03-1.09
GBP	0.864	0.83-0.89	0.84-0.90	0.85-0.91	0.86-0.92
JPY	143.99	140-146	139-145	139-145	138-144
CHF	0.98	0.98	0.99	1.00	1.01
US Dollar Versus					
JPY	138.97	136-142	134-140	132-138	130-136
GBP	1.200	1.17-1.23	1.17-1.23	1.16-1.22	1.16-1.22
CAD	1.35	1.35	1.33	1.31	1.29
AUD	0.67	0.67	0.68	0.69	0.70
NZD	0.62	0.62	0.63	0.64	0.65
CNY	7.08	7.10	7.00	6.90	6.80
Sterling Versus					
JPY	167	167	164	161	158
CAD	1.62	1.62	1.59	1.56	1.54
AUD	1.78	1.79	1.76	1.72	1.70
NZD	1.92	1.94	1.90	1.86	1.83







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