Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

26th November 2018

- Global economy loses some momentum. Downside risks are mounting for world economy, with both the IMF and OECD scaling back their growth forecasts

- Fed to hike rates again in December. Further hikes likely in 2019. BoE on hold as it awaits clarity on Brexit. ECB ending QE but indicates that rates will stay very low for a prolonged period

- Dollar supported by rising US rates and strong economy. However, growing US imbalances and doubts about sustainability of current strong US growth point to risks for currency in 2019

- European politics and low interest rates weigh on euro, but finding floor against the dollar

- Sterling awaits clarity on Brexit. Big moves possible in either direction depending on what route UK takes on Brexit

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Global Economic Outlook

Global growth forecasts cut as risks mount for world economy

Recent months have seen both the OECD and IMF lower their growth forecasts for the world economy in 2018 and 2019. These are the first downward revisions to global forecasts for some time and encompass both advanced and emerging economies. The world economy is still forecast to record solid growth of 3.7% this year, broadly the same rate as in 2017, but down from earlier projections for growth of 3.9%. Indeed, global growth would probably have slowed this year but for the significant boost to the activity in the US from the marked loosening of fiscal policy there.

The most pronounced revisions are in relation to the forecasts for 2019. The OECD sees global growth slowing to 3.5% next year. At mid-year, both the OECD and IMF were forecasting that the world economy would grow by 3.9% in 2019. The OECD is forecasting that growth will remain at 3.5% in 2020.

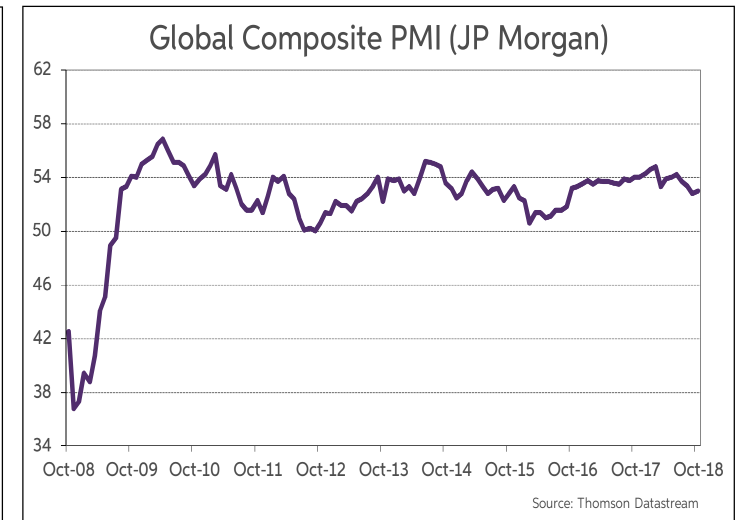
The OECD and IMF have been warning for some time that the risks to the world economy have shifted to the downside. Growth in global trade has slowed this year, with escalating trade tensions having adverse effects on confidence, investment activity and financial markets. Notably, the Chinese economy has lost some momentum following the imposition of tariffs on many of its exports to the US. The European and Japanese economies have also lost some momentum this year, although this seems mainly due to domestic factors.

Meanwhile, the gradual normalisation of monetary policy in the US, and associated strengthening of the dollar, is having adverse impacts on some big emerging-market economies that have high foreign currency debt levels and large external deficits. This has put severe downward pressure on their currencies, forcing their central banks to raise interest rates to punitive levels. Some large emerging economies have entered recession.

More generally, financial markets have become more risk averse and are experiencing much greater volatility in 2018 than in the previous couple of years. Stock markets have come under pressure, with all the major indices down year-to-date. Both the IMF and OECD continue to express concerns that the easy monetary conditions in place for much of this decade are contributing to a build-up of vulnerabilities in financial markets from elevated asset prices and high debt levels. They warn that still easy global financial conditions could tighten sharply, denting confidence and undermining investment, with emerging-market economies particularly vulnerable.

The JP Morgan Global Composite PMI fell to two year lows in September/October, moving down below the 53 level. This is still consistent with solid growth but it would be a worry if PMIs continue to decline over the winter months. Meanwhile, there has been a marked weakening of new exports orders in all major economies as global trade slows. There are also concerns that growth in the strongly performing US economy could slow quite sharply over the next couple of years once the fiscal stimulus fades and higher interest rates begin to impact on activity. There are already some signs that activity in the housing market and manufacturing sector may have peaked.

Crucially, inflation is expected to stay subdued. The IMF is forecasting that the CPI rate in advanced economies will average 1.9% next year, compared to 2.0% in 2018. This should allow monetary policy to remain accommodative in most countries, supporting economic growth. Indeed, inflation may be even lower if the recent fall in oil prices proves sustained. Nonetheless, it could prove a challenge for the world economy to achieve even the lower growth rate of 3.5% being forecast for 2019 and 2020 given the mounting downside risks.



GDP (Vol % Change)

	2017	2018(f)	2019 (f)	2020 (f)
World	3.6	3.7	3.5	3.5
Advanced Economies	2.5	2.4	2.1	1.9
US	2.2	2.9	2.7	2.1
Eurozone	2.5	1.9	1.8	1.6
UK	1.7	1.3	1.4	1.1
Japan	1.7	0.9	1.0	0.7
Emerging Economies	4.6	4.7	4.7	4.7
China	6.9	6.6	6.3	6.0
India	6.7	7.5	7.3	7.4
World Trade Growth (%)	5.2	3.9	3.7	3.7
Advanced Economies PCE Inflation (%)	2.0	2.3	2.6	2.5

Source: OECD Economic Outlook, November 2018

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Interest Rate Outlook

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Monetary tightening expectations soften as markets worry about growth prospects

Although it is anticipated that policy will be tightened somewhat, the general expectation is that monetary conditions will remain very loose in all the major economies in 2019-20, apart from the US, where the Fed has hiked rates at a steady pace over the past two years. However, even the expectations for limited policy tightening in the next couple of years have been scaled back somewhat over the past month as concerns mount about the growth prospects for the world economy in 2019-20.

In the US, the Fed is set to hike rates by a further 25bps to 2.375% at its mid-December meeting, the eighth rate hike in the past two years. It has been indicating that a further 100bps of tightening is likely in the next two years, taking rates up to 3.375% by 2020. The markets have always been doubtful about this. Futures contracts had been pricing in just two rate hikes in 2019, with official rates seen levelling off thereafter at 2.875%.

More recently, markets have been taking note of comments by Fed officials about signs of slower global growth. This has seen traders scale back their expectations for rate hikes. Futures contracts now see rates rising to around 2.7% in 2019, thus pointing to little more than one 25bps hike next year. The labour market continues to tighten, though, and wage inflation has picked up to over 3%. It will be interesting to see if the Fed lowers its rate hike projections at the upcoming December FOMC meeting. We continue to anticipate that the Fed funds rate will rise to around 3% in this cycle given the upward pressure on wages and continuing strength of the US economy.

In the UK, the markets have also lowered their expectations for rate hikes. They now see the BoE hiking rates by 25bps in early 2020 and again in mid-2021, taking rates up to 1.25%. Previously, they had expected rates to rise to 1.5% by then, given persistence of above target inflation amidst a tightening labour market where underlying wage inflation has picked up to over 3%.

BoE policy is set to remain on hold until we get clarity around the UK's departure from the EU in March. Thereafter, the options facing the BoE look binary. In the event of a soft Brexit or no Brexit, we think the BoE could tighten policy by more than markets expect, with the next rate hike coming as early as May. Rates could rise to 1.5% by end 2020. On the other hand, if a no-deal hard Brexit materialises, then rates could be cut by 50bps next year, given the negative impact that such an event would have on the UK economy.

Meantime, the ECB has scaled back net asset purchases under its QE programme this year and is set to cease them completely in December. However, it has indicated that it intends to keep interest rates at their current very low levels until at least the end of next summer. The ECB does not see inflation rising to its 2% target level in the next three years, so interest rates in the Eurozone are likely to remain very low for a long time.

The ECB deposit rate is currently at -0.4%, resulting in negative interbank rates. Futures contracts have also softened recently in the Eurozone. They show wholesale rates starting to rise from next September onwards, with the first small 10bps rate rise priced in for end 2019. Three month money rates are not expected to turn positive until September 2020. Overall, rates are seen as rising by just over 40bps between now and end 2020, and are not expected to get to 1% until late 2023. We would expect short-term money market rates to remain between the deposit and refi rates in the next few years, given the ample market liquidity. However, the gap between the two official rates could eventually narrow to 25bps, from 40bps at present, as rates are increased.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	2.125	2.69	3.12	2.99	3.02
Dec '18	2.375	2.80	3.20	3.10	3.10
Mar '19	2.625	3.00	3.35	3.30	3.30
Jun '19	2.875	3.20	3.45	3.45	3.45

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.37	-0.22	-0.14	0.31
Dec '18	-0.40	-0.36	-0.20	-0.12	0.33
Mar '19	-0.40	-0.35	-0.18	-0.10	0.40
Jun '19	-0.40	-0.33	-0.15	0.05	0.50

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.75	0.89	1.14	1.15	1.36
Dec '18	0.75	0.90	1.15	1.18	1.40
Mar '19	0.75	0.95	1.20	1.25	1.50
Jun '19	1.00	1.10	1.35	1.40	1.70

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Dollar retains upper hand as US economy continues to outperform

The US dollar had a weak start to the year, with EUR/USD rising above $1.20 and then reaching $1.25. However, it has recovered strongly since early spring, gaining ground against a broad range of currencies. This saw the EUR/USD rate fall back appreciably and it has been trading at around the $1.13-1.14 level recently.

The dollar has been aided by strong US economic data this year. The US economy grew by 4.2% annualised in the second quarter and 3.5% in the third quarter, the strongest rates in a number of years. Meanwhile, the unemployment rate has fallen to 3.7%, its lowest level since 1969. Widening interest rate differentials and bond spreads in favour of the dollar have also helped the currency as the Fed continues to steadily tighten policy.

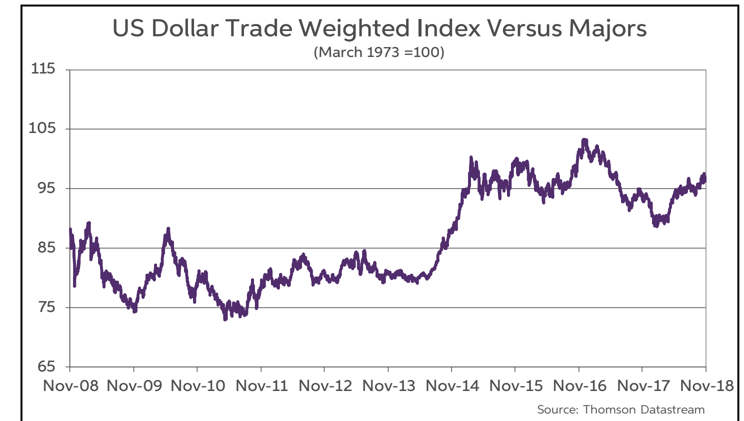
Rising risk aversion in markets has also been supportive of the highly liquid US currency this year. Escalating tensions over global trade, difficulties in emerging markets and geopolitical concerns have all sparked flights-to-quality in to safe-haven currencies like the dollar. It has also have benefitted from a big jump in the repatriation of funds by US companies this year to take advantage of cuts in US corporate taxes. All these factors have seen an unwinding of the extreme short positions built up against the dollar in late 2017 and early 2018, propelling the currency higher.

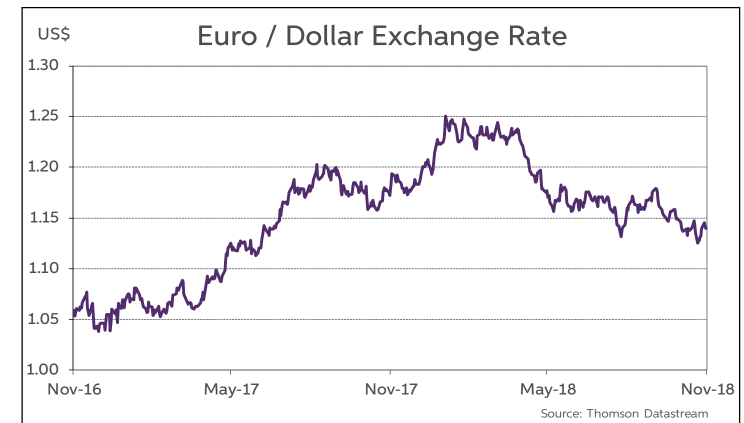
However, the US currency has found it difficult to continue to make gains over the autumn. This may be partly due to the fact that FX positioning has turned very long the dollar. Furthermore, the dollar is now at quite elevated levels against a range of currencies, which may be limiting further upside potential. While still some way below the levels reached in 2015-16, the dollar is close to 20% higher on a trade-weighted basis than during most of the period 2006-2014. There are also doubts about the extent to which the Fed will continue to hike rates next year given the loss of momentum by the world economy.

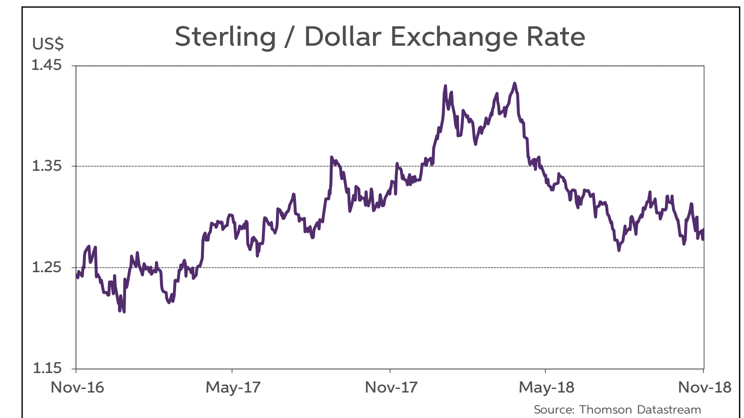
In the short term, the relative strength of the US economy, wide interest rate differentials, tensions over global trade, continuing stress in some large emerging markets and geopolitical uncertainties are all supportive of the US currency. Meanwhile, the on-going political uncertainties in the Eurozone are likely to remain a headwind for the euro. A general rise in euro-scepticism is weighing on the single currency, as has the weaker performance of the Eurozone economy this year. There has been strong support for the euro, though, at the $1.12-1.13 level in recent months. Even if the euro falls below this level, there is further strong support for it in the $1.10 to $1.12 range. Overall, the euro is likely to remain pinned down below the $1.15 level in the near term.

We remain of the view that the US dollar is likely weaken over the medium to long term. Rising twin deficits (fiscal and BoP) could start to weigh on the currency next year. The marked jump in the repatriation of funds following the cuts in US corporate taxes earlier this year is likely to abate over the medium term, lessening demand for the currency. Finally, the US economy could also slow sharply once the fiscal stimulus fades and higher US rates start to impact on activity, again undermining the currency.

On the other hand, there should be potential for the euro to rise over the medium term as the ECB begins to hike interest rates. The euro could move up towards the $1.20 level next year as the ECB prepares the markets for a tightening of policy. It could move above $1.20 at the end of 2019 if the ECB raises interest rates by then. For now, though, with the US economy still performing strongly, the dollar holds the upper hand.







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Forex Market Outlook

Large moves by sterling possible as Brexit saga enters critical final phase

Sterling fell sharply in the aftermath of the Brexit referendum vote in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. The Brexit vote also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

Sterling managed to move off its lows and regain some ground in the latter stages of 2017 and early part of 2018. It has largely traded in an 87-91p range against the euro since September 2017, as markets await clarity on what shape Brexit will take next year. Against a weaker dollar, sterling rose above the $1.40 level in Q1 2018 and in mid-April reached a new post-referendum high of $1.437. However, cable dropped back again when the dollar strengthened once more over the summer. Sterling has traded at around the $1.30 level in H2 2018.

The UK and EU have finalised a Withdrawal Agreement that provides for a soft Brexit, as it includes a transition period to last until at least end 2020. This will keep the current trading arrangements in place over this time. It will be very difficult for Theresa May to be able to get the Withdrawal Agreement through parliament, given the strong opposition to the deal from sections of her party as well the DUP. Indeed, the Withdrawal Bill is likely to be voted down if, as expected, it is put to a vote in the House of Commons before the Christmas break.

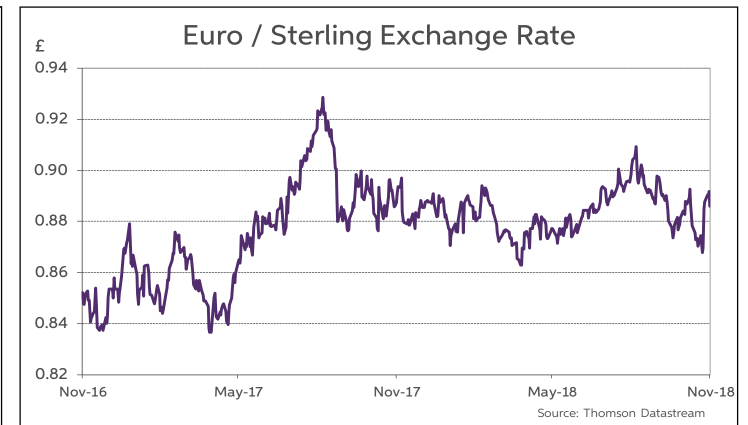
There is a real risk that we could see a parliamentary logjam in the UK, whereby no Brexit option -Withdrawal Agreement, No-Deal or Remain- can command majority support. Two options would seem to arise in this event: request the EU to push out the date for Brexit by a number of months and/or go back to the people for another referendum on the issue. With a range of outcomes now possible in relation to Brexit, sterling is entering a period of increased volatility, as we have seen over the past couple of weeks.

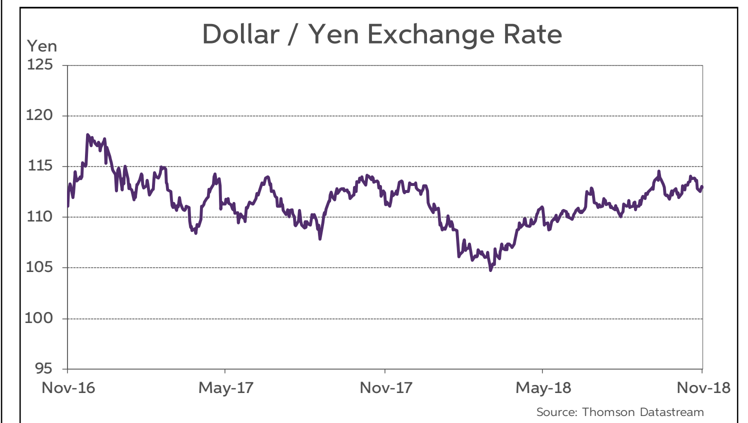
If market fears over a no-deal hard Brexit scenario escalate, EUR/GBP is likely to rise up towards the 93p level hit in summer 2017. It could reach the 95p mark that was last seen in 2009. EUR/GBP may even hit parity where the UK crashes out of the EU with no deal in a very disorderly, chaotic Brexit.

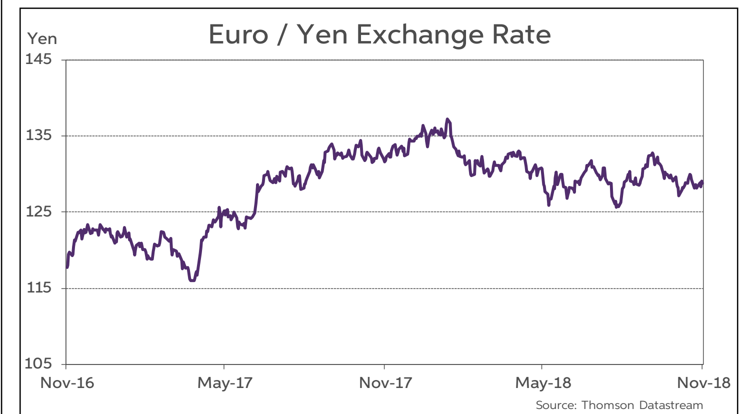
Even if the UK leaves with a deal, it will not be that clear what the long term EU-UK trading relationship will be for a number of years. Further difficult negotiations with the EU on trade will lie ahead for the UK. As a result, the upside for sterling may be limited and EUR/GBP may move down to 85-86p in such circumstances.

What has been lost sight of in the past couple of weeks is that the probability of the UK staying in the EU has risen, given that the matter could now go to another referendum. Sterling should make significant gains if the UK remains in the EU. EUR/GBP could move back down towards the 80p level in such a scenario, especially with UK interest rates likely to rise next year in this situation.

Our base remains that the Withdrawal Agreement will eventually get through the UK parliament. Those who oppose it in the Tory party and the DUP would risk a general election or a second referendum by scuppering the deal. Most MPs also want to avoid a hard Brexit. However, it is likely to take more than one vote and some time to get the Bill through parliament. Overall, we are entering the end game for the Brexit process but there is still considerable uncertainty about the final outcome, with large moves by sterling possible in either direction.







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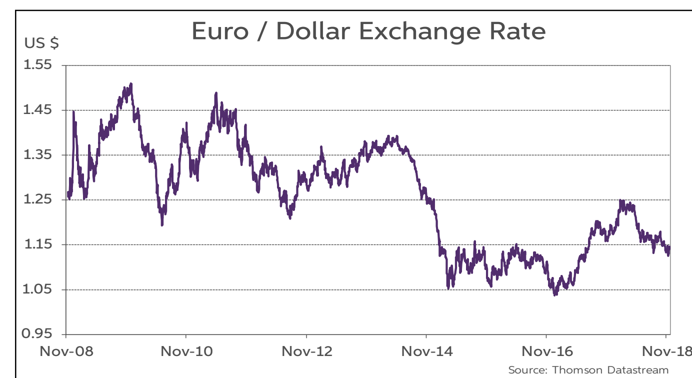
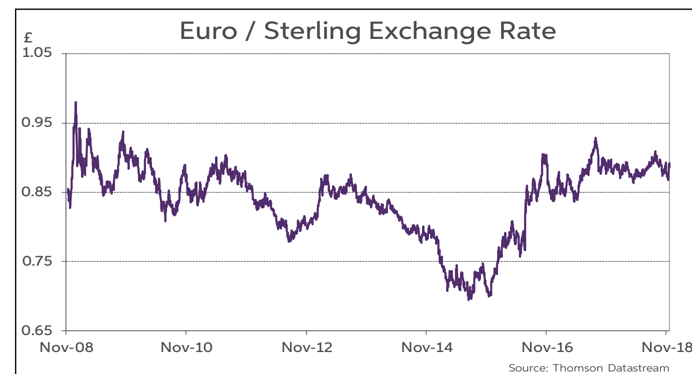
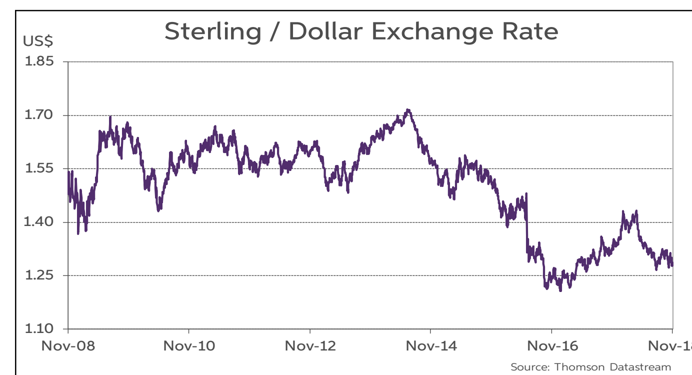
Summary of Exchange Rate Forecasts

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

Euro Versus	**Current**	**Q4-2018**	**Q1-2019**	**Q2-2019**	**Q3-2019**
USD	1.137	1.11-1.17	1.12-1.18	1.14-1.20	1.16-1.22
GBP	0.885	0.85-0.91	0.84-0.90	0.83-0.89	0.83-0.89
JPY	128.70	126-132	126-132	127-133	127-133
CHF	1.13	1.13	1.14	1.15	1.16
US Dollar Versus					
JPY	113.21	110-116	109-115	108-114	106-112
GBP	1.285	1.27-1.33	1.29-1.35	1.33-1.39	1.35-1.41
CAD	1.32	1.32	1.31	1.29	1.27
AUD	0.73	0.73	0.73	0.74	0.75
NZD	0.68	0.68	0.68	0.69	0.70
CNY	6.94	6.95	6.90	6.85	6.80
Sterling Versus					
JPY	145	147	148	151	150
CAD	1.70	1.71	1.73	1.76	1.76
AUD	1.77	1.78	1.81	1.84	1.84
NZD	1.89	1.91	1.94	1.97	1.97







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