Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

AIB

29th August 2023

- Economic data, especially on labour markets, have generally surprised to the upside to date in 2023. Global economy, though, still facing considerable headwinds, with risks to the downside
- Central banks appear to be nearing the end of their hiking cycles. Fed and ECB may raise rates by a further 25bps, though 50-75bps more tightening expected from the BoE
- With core inflation elevated and proving sticky, and labour markets remaining tight, monetary policy is seen as staying tight in the next few years, with a limited amount of rate cuts
- Dollar quite range bound at an elevated level to date in 2023. Supported by high rates and strong US economy. Yen remains under pressure from very low Japanese rates
- Sterling firmer in 2023 on more resilient economy and as UK rates rise to a high level. However, it remains well within the 83-90p trading range versus euro evident since the start of 2021

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Global Economic Outlook

Real economic data hold up better than expected, but risks are still to the downside

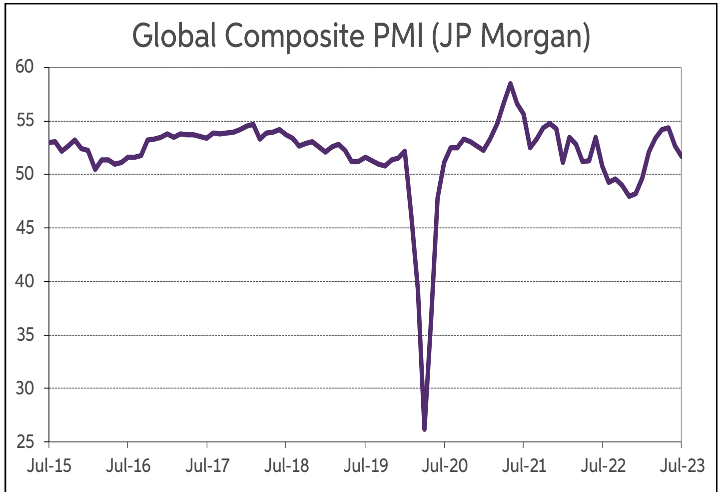
Surging inflation combined with a marked tightening of monetary policy, amid an environment of weakening confidence levels and heightened geo-political tensions, especially in relation to the war in Ukraine, saw the world economy slow sharply during 2022. However, concerns that advanced economies could be facing a recession in 2023 have largely abated. While survey data have been weak, especially on manufacturing, real economic data have generally printed ahead of expectations this year, most notably in the US, UK and Japan. Lower commodity prices, declining headline inflation and continuing strong labour markets have all supported economic activity, which was reflected in better than forecast GDP data for Q2 in all the main developed economies. Indeed, 2023 GDP forecasts for the US, UK and Japan have all been revised higher over the summer.

Nonetheless, risks remain to the economic outlook. The lagged effects of the sharp increases in interest rates in 2022-23 have yet to fully impact economies, especially in relation to the refinancing of maturing term debt at much higher rates. The OECD and IMF continue to warn that higher interest rates could yet expose underlying financial vulnerabilities with potential for rising loan defaults, most notably in weaker low-income countries, where signs of debt distress are already evident. CRE markets remain under pressure which could lead to rising bad debts, putting stress on those lenders with significant exposure to the sector. More generally, if inflation proves more persistent than expected, it could lead to even higher interest rates than is currently priced into markets, putting further downward pressure on financial and real estate asset prices. Meanwhile, China's expected economic rebound this year has underwhelmed, amid ongoing problems in the real estate sector, private sector deleveraging and concerns about the stability of the banking sector.

Thus, it is still too early to conclude the global economy will emerge largely unscathed from the substantial tightening of monetary policy seen in the past couple of years. The weakening trend in business surveys, in particular PMIs, which tend to be a good leading indicator of activity, is a concern. The flash PMIs for the major economies in August were particularly weak, especially in Europe. The OECD and IMF remain cautious about next year's growth prospects for advanced economies. Subdued growth of around 1% may be the best that the main economies achieve, despite much lower inflation, with the risks to activity still very much tilted to the downside.

In terms of inflation, falling commodity prices have seen headline CPI rates decline this year, led by the energy sector. Furthermore, economic activity remains subdued, with clear signs of a marked easing in inflationary pressures in the manufacturing sector. The falls in headline inflation rates have been impressive, with the US CPI rate now down to 3%, the Eurozone HICP at 5.3% and UK CPI running at 6.8%. However, price pressures have become more broad-based, most notably in the services sector, meaning core inflation rates are proving to be quite sticky and are now above headline rates and the 2% target level for inflation.

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, amid signs of more "persistent" underlying inflationary pressures. Overall, though, inflation is generally still expected to continue to decline, albeit more slowly than previously anticipated, with sticky core inflation delaying the return to the 2% target. The latest IMF inflation forecasts are for headline CPI rates in advanced economies to decline from 7.3% last year to 4.7% in 2023 and 2.8% in 2024. The headline rate is still seen at 2.5% in Q4 2024, implying it will be 2025 at the earliest before inflation falls back to the 2% target.



Source: Refinitiv

GDP (Vol % Change)

	2021	2022	2023 (f)	2024 (f)
World	6.3	3.5	3.0	3.0
Advanced Economies	5.4	2.7	1.5	1.4
US	5.9	2.1	1.8	1.0
Eurozone	5.3	3.5	0.9	1.5
UK	7.6	4.1	0.4	1.0
Japan	2.2	1.1	1.4	1.0
Emerging Economies	6.8	4.0	4.0	4.1
China	8.4	3.0	5.2	4.5
India	9.1	7.2	6.1	6.3
World Trade Growth (%)	10.7	5.2	2.0	3.7
Inflation -CPI				
Advanced Economies (%)	3.1	7.3	4.7	2.8

Sources: IMF World Economic Update July 2023

Interest Rate Outlook

Markets expect that rates will remain high in coming years

After an 18 month period, characterised by aggressive monetary policy tightening, most central banks appear to be nearing the end of their rate increasing cycles. This period of rapid rate hikes was against the backdrop of inflation rising to 10% or above in many economies last year and labour markets remaining tight. More recently, though, headline inflation has been on a downward trajectory. Monetary policy has also moved to a restrictive stance. Central banks are no longer giving clear signals that further rate hikes are in store and instead have moved to a "data-dependent" mode in terms of future monetary policy decisions. However, they have been dampening expectations of early rate cuts, while also indicating that policy will need to be kept tight for a considerable period to restore price stability given signs of more persistent inflationary pressures. Markets have taken note and have scaled back their expectations for near-term rate cuts, especially in the US. Rates are expected to settle in a 3.0-4.5% range over the medium term in the main markets, far above the levels that pertained from 2008-2022.

The Fed raised US rates by 25bps to a 5.25-5.50% range at its July FOMC meeting, having left them unchanged in June. The median projection in the Fed's last interest rate dot-plot in June shows that most participants anticipated that rates would have to be raised to a 5.50-5.75% range before end year, implying one further 25bps rate increase in the coming months. The Fed indicated at its July meeting it would take a "data-dependent approach" to future rate decisions. The market initially concluded that the Fed had completed its rate hiking cycle. However, more recently on the back of continuing strong US data, it has started to move towards pricing in one final 25bps rate increase at the Fed's November meeting. Meanwhile, the market has greatly scaled back its expectations for rate cuts in 2024-25. Futures contracts point to rates being cut to 4.5% by end 2024 and to around 4% by end 2025. In early summer, it was expected that rates would fall back to 3%.

The BoE raised rates by 25bps in August following a 50bps hike in June, which brought the Bank rate up to 5.25%. The UK central bank has had to continue with an aggressive tightening of policy in the face of persistently high core inflation and elevated and rising wage inflation. It indicated a willingness to hike rates further at its August meeting if there is evidence of continuing persistent inflationary pressures. With the core CPI rate stuck at around 7% in recent months and average weekly earnings growth rising sharply to above 8%, markets anticipate that the BoE will hike rates by a further 50-75bps by early next year—the Bank rate is currently seen peaking at 5.875%. There has been considerable volatility, though, around UK rate expectations over the summer, with the peak in rates seen at close to 6.5% in early July. Meanwhile, rates are expected to remain high over the medium term in the UK, ending 2024 at 5.375%, before falling to 4.75% at end 2025 and around 4.5% by end 2026.

Meantime, the ECB hiked rates by a further 25bps at its July meeting, which brought the Deposit rate up to 3.75%. It too has now moved to a data-dependent mode in terms of future policy decisions, with considerable weight also given to its assessment of the inflation outlook. Headline inflation has declined in the Eurozone, but core inflation is proving sticky and has only edged down slightly. Futures contracts are pricing that the ECB will deliver one final 25bps hike later this year, with rates peaking at 4% and remaining at this level until near the middle of 2024. The Deposit rate is seen ending next year back down at around 3.25%, implying 75bps of easing in 2024, before falling to 3% in 2025 and possibly 2.75% in 2026-27. Given the ECB's focus on bringing inflation under control and maintaining a restrictive policy for as long as required amid sticky core inflation, rate cuts may be slower to materialise 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	5.375	5.67	5.86	5.18	4.43
Sept'23	5.375	5.70	5.90	5.20	4.45
Dec'23	5.625	5.85	6.05	5.30	4.50
Mar'24	5.625	5.80	6.00	5.25	4.45

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	3.75	3.77	3.91	3.71	3.24
Sept'23	4.00	4.05	4.10	3.80	3.30
Dec'23	4.00	4.05	4.10	3.80	3.30
Mar'24	4.00	4.05	4.05	3.75	3.25

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	5.25	5.58	6.04	5.82	5.19
Sept'23	5.50	5.80	6.20	5.95	5.30
Dec'23	5.75	6.05	6.40	6.10	5.40
Mar'24	5.75	6.00	6.30	6.00	5.25

** Swap Forecasts Beyond 1 Year*

Expectations of continuing high US rates help underpin strong dollar

Although the US dollar has retreated from last year's peaks, which saw it reach its highest level on a trade-weighted basis in 20 years, it has remained at elevated levels to date in 2023. EUR/USD has moved in a $1.05-1.12 range so far this year and in a narrower $1.07-1.12 corridor since the end of March. Meantime, sterling has traded in a $1.23-1.31 range versus the dollar over the past five months. These are low ranges for both currencies against the dollar in the context of their trading levels for most of the last twenty years. Similarly, the Australian, New Zealand and Canadian dollars are trading at relatively weak levels against the US currency, while both the yen and Chinese yuan are back trading at very low levels against the dollar in recent months.

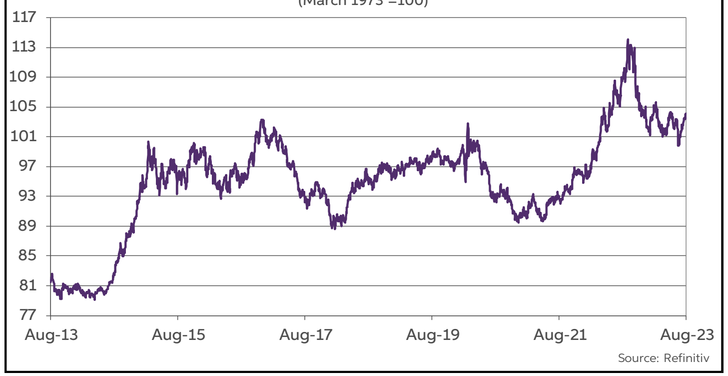
The continuing strength of the dollar can be very much linked to the ongoing impressive performance of the US economy and associated elevated level of US interest rates. US data have generally surprised to the upside in 2023. The anticipated slowdown in the economy has not materialised to date. Indeed, GDP growth this year is now likely to be broadly on a par with the 2.1% rate recorded in 2022. Meantime, the labour market remains very tight, with the jobless rate close to fifty year lows at 3.5% amid strong growth in employment. Although headline inflation has fallen back, core inflation remains well above its 2% target, adding weight to the case for a restrictive monetary policy stance.

Against this backdrop, the Fed has hiked rates by 525bps to a 5.25-5.5% range, with markets moving recently to price in one final 25bps rate increase before the end of the year. More importantly, the Fed is guiding that it will need to maintain a tight monetary policy for an extended period of time to return inflation to its 2% target. In short, US rates will need to remain higher for longer. This has seen markets scale back their expectations for US rate cuts in 2024-2025. Futures contracts now point to rates being cut to 4.5% by end 2024 and to around 4% by end 2025. In early summer, it was expected that US rates would fall back to 3%. This hardening of interest rate expectations has put upward pressure on US bond yields in recent months. Two year Treasury yields have climbed to over 5%, with ten year yields testing 15 years highs at above 4.3%. This high US rate environment has provided considerable support for the dollar in 2023, helping sustain it at elevated levels on forex markets.

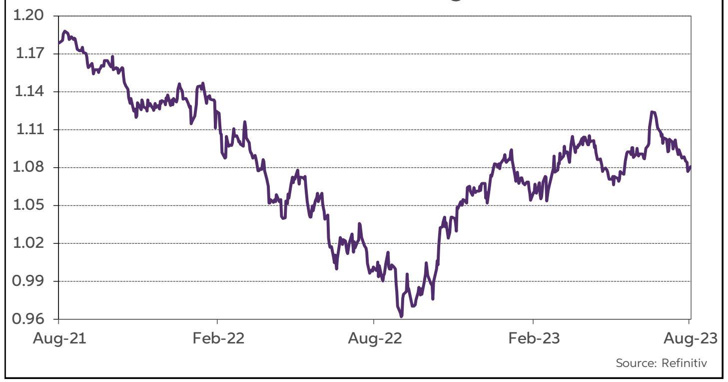
In contrast to the US, both the Eurozone and UK economies have struggled over the past year, narrowly avoiding recession. Indeed, while US GDP grew 2.6% year-on-year in Q2, growth in the Eurozone and UK was running at circa 0.5% year-on-year. Thus, Eurozone interest rates are expected to peak at 4%, well below those in the US, while it is very high inflation in the UK that has seen the BoE move broadly in tandem with Fed hikes.

In terms of the euro, the ECB continues to attach a very high importance to getting inflation back down to its 2% target. It has warned of signs of persistent inflationary pressures and thus a need to keep monetary policy tight for a considerable time to ensure a return to price stability. Thus, any policy easing is likely to be slow to materialise in the Eurozone which should be supportive of the euro. Overall, the likelihood is that the euro will remain quite range bound against the dollar, with monetary policy expected to go on hold in both the US and Eurozone before the end of the year. The performance of EUR/USD in 2024 will likely be heavily influenced by the timing and scale of any monetary policy easing in either jurisdiction. In particular, the dollar would be likely to lose ground against the euro next year should there be Fed easing that saw a narrowing of the current interest rate spread between the two currencies. Right now, though, that looks a considerable way off, so EUR/USD is likely to remain within the trading range evident to date in 2023 for some time.

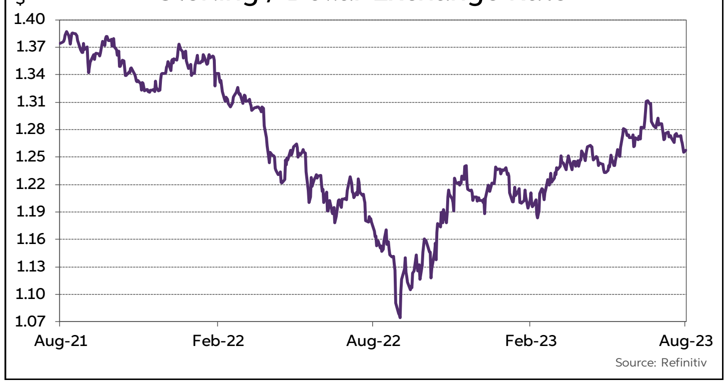
US Dollar Trade Weighted Index Versus Majors



Euro / Dollar Exchange Rate



Sterling / Dollar Exchange Rate



Forex Market Outlook

Sterling supported by high and rising UK rates and better than expected UK data

Sterling endured a difficult 2022 largely owing to concerns about the UK economy. Against a buoyant dollar, sterling fell sharply to a record low below $1.04 last September, following a badly received expansionary 'mini-budget', while EUR/GBP briefly moved above the 90p level. Sterling, though, has regained significant ground in the past year, aided by better than expected UK data, with the economy avoiding the recession that had been widely predicted to occur this year. At the same time, the rise in BoE rates to 5.25%, with expectations of further hikes to come, has also supported the currency.

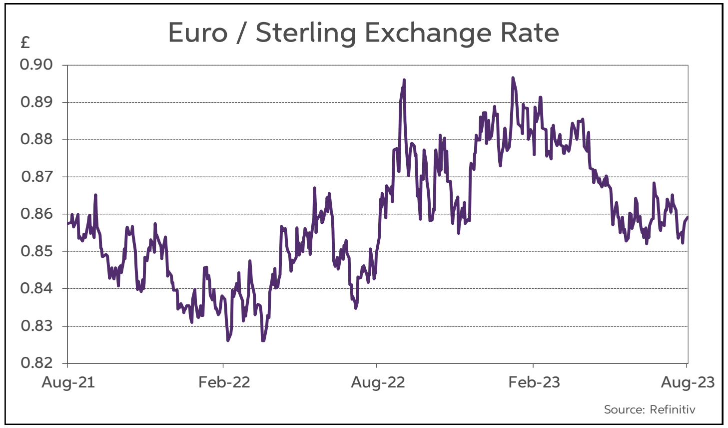
Cable has risen from $1.20 at the start of this year, to generally trade in a $1.24-1.31 range since the spring. Meanwhile, as sterling recovered, EUR/GBP has edged downwards from the 87-89p range it occupied in the opening months of the year, to trade in a 85-87p corridor over the summer. As already mentioned, BoE policy tightening has been providing support for sterling. However, the currency has lost some ground recently, especially versus the dollar, on a scaling back of rate hike expectations in the UK. Rates are now seen peaking at around 5.875% compared to close to 6.5% back in early July. This has seen sterling fall back against a strong dollar to $1.26 from $1.31 at mid-July and fail to make any further headway against the euro.

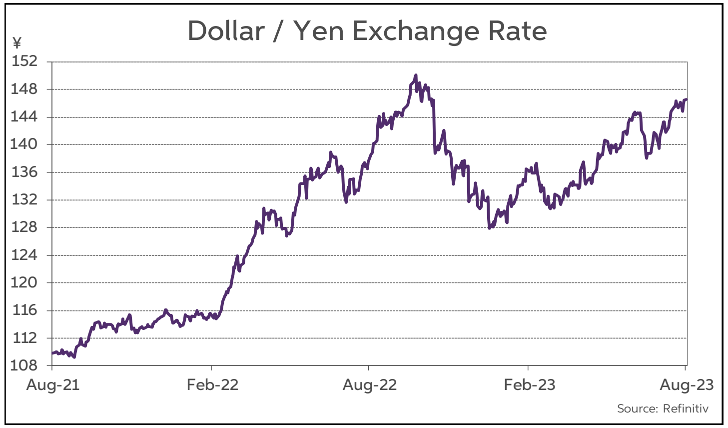
Rates are expected to be hiked by at least another 50bps in the UK and remain at a high level over the next couple of years, which should be supportive of the currency. The Bank rate is seen at 5.75% at end 2023, 5.4% at end 2024 and 4.75% by end 2025. As a result, two year gilt yields have risen to 5.25%, with ten year yields at 4.5%. However, the latest positioning data shows the market is now stretched long the pound. Thus, sterling could lose some ground if this starts to unwind, despite the rate tightening expected in the months ahead. We may see the euro test the 87p level before the end of the year, while sterling could weaken towards the $1.24 support level against the dollar. Further out, moves in interest rates are likely to be the key factor impacting sterling in 2024. The BoE is predicting a sharp fall in inflation over the next two years to below 2%. If this saw it cut rates to a greater extent than priced in by markets to support the weak economy, then sterling would likely lose ground.

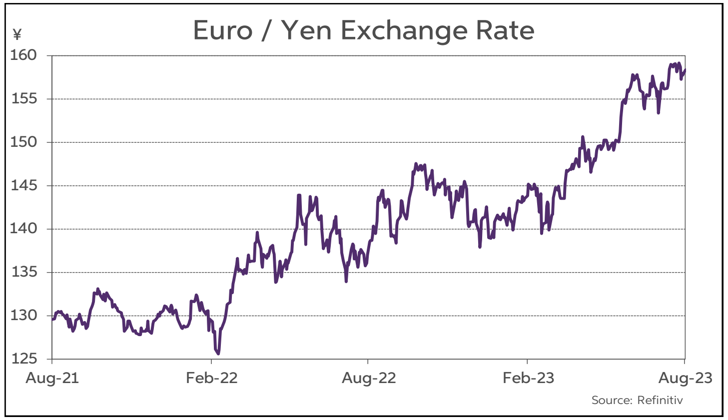
Continuing dovish policy stance by BoJ weighing on yen

In marked contrast to other central banks, the BoJ has continued with its very accommodative monetary policy. This resulted in the yen falling to a 30-year low against the US currency last autumn, with the dollar rising above the ¥150 level. The yen moved off its lows late last 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 as markets anticipated a shift away for a very accommodative monetary policy.

However, the BoJ under its new Governor, Ueda, continues to espouse a dovish outlook on policy. This has resulted in renewed yen weakness in 2023. The dollar has risen back up to ¥146 recently, while the euro has risen to fifteen year highs, near the ¥160 level, even though the BoJ permitted a further rise in the cap on ten year yields in July. Overall, though, BoJ monetary policy remains very loose and is thus continuing to act as a major headwind for the currency. A major shift in policy, such as the abolition of the yield control corridor or a hike in the official interest rate which is still in negative territory, does not seem imminent. Until BoJ monetary policy is altered or rates are cut elsewhere, the yen is likely to remain a very weak currency.







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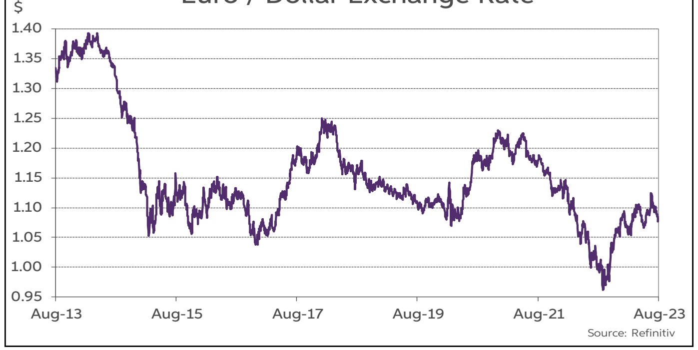
Summary of Exchange Rate Forecasts

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

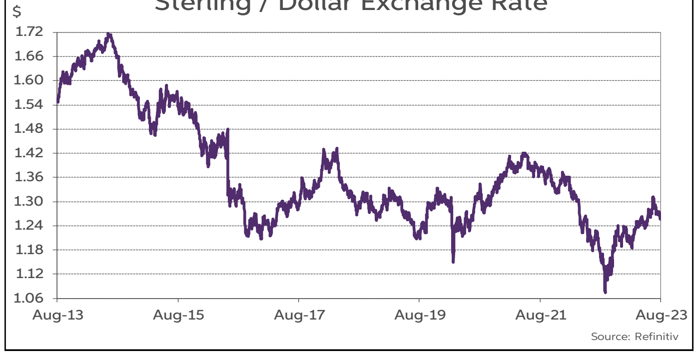
	Current	Q3-2023	Q4-2023	Q1-2024	Q2-2024
Euro Versus					
USD	1.081	1.05-1.11	1.06-1.12	1.07-1.13	1.08-1.14
GBP	0.857	0.83-0.89	0.84-0.90	0.84-0.90	0.84-0.90
JPY	158.49	156-162	156-162	155-161	155-161
CHF	0.96	0.96	0.96	0.97	0.98
US Dollar Versus					
JPY	146.57	144-150	143-149	141-147	139-145
GBP	1.262	1.23-1.29	1.22-1.28	1.23-1.29	1.25-1.31
CAD	1.36	1.36	1.35	1.34	1.32
AUD	0.65	0.64	0.64	0.65	0.66
NZD	0.59	0.59	0.59	0.60	0.61
CNY	7.29	7.30	7.30	7.30	7.20
Sterling Versus					
JPY	185	185	183	181	182
CAD	1.72	1.71	1.69	1.69	1.68
AUD	1.96	1.97	1.95	1.94	1.94
NZD	2.13	2.14	2.12	2.10	2.10

Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate

Sterling / Dollar Exchange Rate



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