Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Further wave to coronavirus has seen governments re-impose restrictions and lockdowns, depressing activity in early 2021 as economies struggle to recover from deep 2020 recession

- However, positive news on vaccines, which have started to be rolled out in numerous countries, is a major boost to recovery hopes. Growth is expected to rebound as the year progresses

- Rates futures contracts firm, especially in US and UK where BoE squashes negative rate talk. Central banks, though, still promising to keep policy very accommodative for a prolonged period

- Dollar stabilises, helped by rise in US yields and the fact market is very short the currency

- Sterling makes gains, as fast roll-out of vaccines by UK boosts its prospects of economic recovery

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Global Economic Outlook

Growing optimism about prospects for global growth with vaccine roll out underway

Large parts of the world economy were put into lockdown in the spring of last year to control the spread of the coronavirus, triggering a very deep global recession in the first half of 2020. Activity rebounded strongly over the summer as lockdown restrictions were lifted. The recovery, though, lost momentum over the autumn and winter, with the number of new cases of the virus surging again, triggering fresh restrictions on activity and new lockdowns in many developed economies. Activity, though, held up better than expected in Q4 2020.

The recession experienced by the world economy in 2020 was the deepest since the Great Depression of the early 1930s. Nevertheless, the stronger than expected recovery in H2 2020 has seen the IMF revise up its GDP forecasts in the latest World Economic Update. It has scaled back the estimated size of the contraction in the world economy in 2020 to 3.5% from 4.4% previously.

However, many countries have started 2021 under tighter Covid restrictions, including fresh lockdowns in some cases. As a result, economic activity has weakened in the opening months of the year, most notably in Europe. Here, GDP looks set to contract in Q1 2021, while in other regions growth is likely to be quite modest.

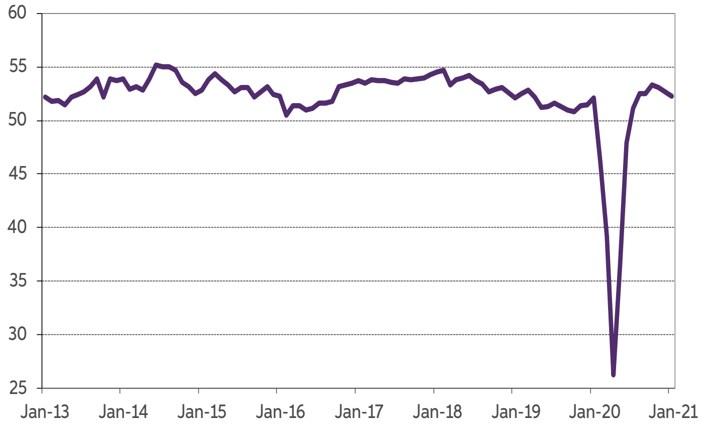
However, the IMF believes that this softening in activity in early 2021 will give way to an acceleration in growth from the second quarter as vaccines and therapies become more readily available. The sharp decline in the number of new cases of Covid-19 in many countries during the past month suggests that restrictions can start to be eased later in the spring, allowing activity to pick up pace again. We saw in the third quarter of last year that economies can rebound rapidly when restrictions are relaxed.

Beyond this though, the key determinant of growth remains the roll-out of vaccines and the extent to which they suppress the virus. In this regard, the recent news that two more pharma companies have had positive results in clinical trials is a very welcome development. Other companies are also conducting clinical trials, which hopefully will have positive outcomes too. A growing list of approved manufacturers should lead to what the IMF calls "a vaccine-powered strengthening of activity" later in 2021 and form the basis for a robust and sustained recovery by the global economy. Indeed, the IMF has upped its growth forecast for the world economy in 2021 from 5.2% to 5.5% and is forecasting further strong growth of 4.2% in 2022.

The IMF, though, does acknowledge that the surging infections in the past couple of months, including from new variants of the virus, renewed lockdowns, vaccine production constraints and logistical problems with their distribution, as well as uncertainty about take-up, are important counterpoints to the more favourable outlook. Economic confidence is also fragile and scarring effects such as rising business failures and bankruptcies, increasing bad debts, permanent job losses, lower labour force participation and inefficient resource allocation could weigh on the pace of recovery as well.

There are other negative economic impacts from the very deep COVID-19 recession. World trade volumes are estimated to have declined by almost 10% in 2020. We have also seen a sharp deterioration in public finances owing to government spending measures to mitigate the economic shock and declines in tax revenues. Meanwhile, unemployment could yet move much higher in 2021 as government labour market support schemes are wound down. Meantime, the fall in inflation in 2020 is likely to prove transitory - oil prices are recovering.

Global Composite PMI (JP Morgan)



Source: Refinitiv

GDP (Vol % Change)

	2019	2020 (f)	2021 (f)	2022 (f)
World	2.8	-3.5	5.5	4.2
Advanced Economies	1.6	-4.9	4.3	3.1
US	2.2	-3.4	5.1	2.5
Eurozone	1.3	-7.2	4.2	3.6
UK	1.4	-10.0	4.5	5.0
Japan	0.3	-5.1	3.1	2.4
Emerging Economies	3.6	-2.4	6.3	5.0
China	6.0	2.3	8.1	5.6
India	4.2	-8.0	11.5	6.8
World Trade Growth (%)	1.0	-9.6	8.1	6.3
Inflation -CPI				
Advanced Economies (%)	1.4	0.7	1.3	1.5

Source: IMF World Economic Outlook Update, January 2021

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Interest Rate Outlook

Rate contracts firm on view vaccines can lay ground for strong economic recovery

Central banks globally pulled out all the stops last year to try and ameliorate the most severe impacts of the COVID-19 pandemic on their economies and financial systems which were hit by a sudden and very deep recession. Interest rates were cut sharply to 0.125% and 0.1% in the US and UK, respectively in 2020. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and to ease funding pressures, notably in regard to the dollar.

The message from central banks has been that they are prepared to do whatever is necessary to help economies recover from the very severe recession that struck in 2020. They have also indicated that they are in this for the long haul. Central banks have been very clear and forceful in their communications that monetary policy will remain exceptionally loose over the next number of years. They have also indicated that if required, they can implement further loosening measures to restore economies to a strong footing.

It would seem, though, that we have reached the lower bound for interest rates in most economies. The ECB and BoJ do not seem overly keen to move interest rates even deeper into negative territory, having focused to date in this crisis on using other non-standard policy measures, in particular expanding QE. The Fed continues to show a clear reluctance to move rates into the negative domain. The BoE has also shown a lack of appetite for such a move, and recently indicated that it would be at least another six months before the banking system was in a position to adapt to such a change.

The BoE and ECB responded to the renewed weakening in activity last autumn by introducing additional QE and liquidity measures. The MPC announced a £150bn increase in government bond purchases in November, bringing the total stock of all purchases to £895bn. Meanwhile, the ECB increased the size of its PEPP by €500bn to €1,850bn in December, as well as announcing enhanced special liquidity measures. Meantime, the Fed is maintaining its open-ended QE bond buying programme. The recent meetings of the main central banks in early 2021 all gave the impression that policy is now on hold, with vaccination programmes underway that could well lay the basis for a sustained and strong economic recovery to take hold as the year progresses.

Markets are no longer pricing in that rates will be lowered further in the Eurozone and UK – in particular they no longer see UK rates moving into negative territory. The message from central banks, though, remains that rates are set to remain at their current very low levels for a considerable time. In this regard, the Fed recalibrated its monetary policy framework last autumn to put more weight on boosting the labour market and less emphasis on inflation, with the intention of keeping the fed funds rate at its current very low level for a prolonged period, even should inflation move moderately above 2%.

Futures contracts, though, have firmed in recent weeks. However, they still see rates remaining at their current very low levels for the next couple of years. Official US rates are not seen as increasing until mid-2023. Although beyond that, there has been a considerable hardening of US rate expectations recently, with three month money rates expected to rise to 1% by end 2024 and reach 1.5% in early 2026. Futures contracts also see the first hike in the BoE bank rate from 0.1% to 0.25% occurring around mid-2023. Rates, though, are expected to rise very slowly thereafter, with three month rates seen at 0.6% by H2 2025. The first 10bps hike in the ECB deposit rate to –0.4% is seen occurring in H2 2024, but three month rates are still seen as remaining negative out until end 2026.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.20	0.30	0.20	0.57
Mar'21	0.125	0.21	0.32	0.22	0.60
June'21	0.125	0.23	0.33	0.26	0.65
Sept'21	0.125	0.25	0.35	0.30	0.70

** 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	-0.55	-0.50	-0.52	-0.41
Mar'21	-0.50	-0.55	-0.49	-0.51	-0.38
June'21	-0.50	-0.55	-0.48	-0.50	-0.35
Sept'21	-0.50	-0.53	-0.45	-0.45	-0.30

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.10	0.05	0.12	0.16	0.39
Mar'21	0.10	0.05	0.13	0.18	0.42
June'21	0.10	0.05	0.14	0.20	0.45
Sept'21	0.10	0.07	0.15	0.25	0.50

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Dollar steadies as US rates firm, but downside risks remain

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade. However, it moved steadily lower in the final three quarters of last year, having reached very lofty heights in March when the growing Covid-19 pandemic triggered carnage in financial markets and a stampede into the safe-haven US currency. It lost 12% against the other major currencies over the period, though it remained at a fairly high level historically. It was a steady move down as risk appetite returned to markets and safe haven flows unwound, helped by positive news on vaccines in the closing months of the year.

The euro was a notable beneficiary of the news on vaccines, climbing to above $1.23 by the start of 2021 from $1.165 two months earlier. This is only the second spell above $1.20 by the euro since 2014. The previous move occurred at the start of 2018 and saw the EUR/USD rate rise to a high of $1.25. However, this was not sustained as the dollar regained strength, with the euro dropping back below $1.20 within a number of months. The euro continued to move lower subsequently, before bottoming out at $1.07 in the spring of last year.

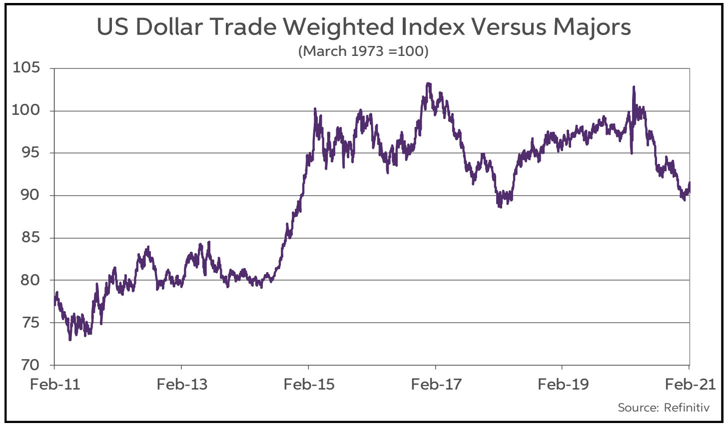
On this occasion, though, the general decline of the dollar could prove more sustained. The economic and policy landscape is changing. Vaccines for Covid-19 are now expected to become widely available over the course of 2021. This should lay the basis for a period of sustained, robust growth by the global economy over the next couple of years, with the US economy no longer an outperformer. This would increase the attractiveness of non-US assets, as well as lessen the appeal of safe-haven currencies like the dollar.

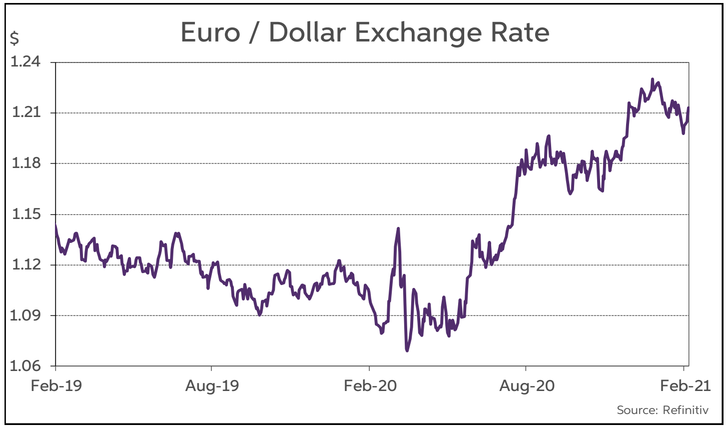
The dollar was also supported for much of the last decade by significantly higher interest rates in the US than elsewhere, most notably when compared to the negative interest rates prevailing in the Eurozone and Japan. However, the latter two have not cut rates over the past year, whereas US rates have been slashed to virtually zero. As a result, the US dollar's large interest rate spread vis-à-vis other key currencies has been much reduced.

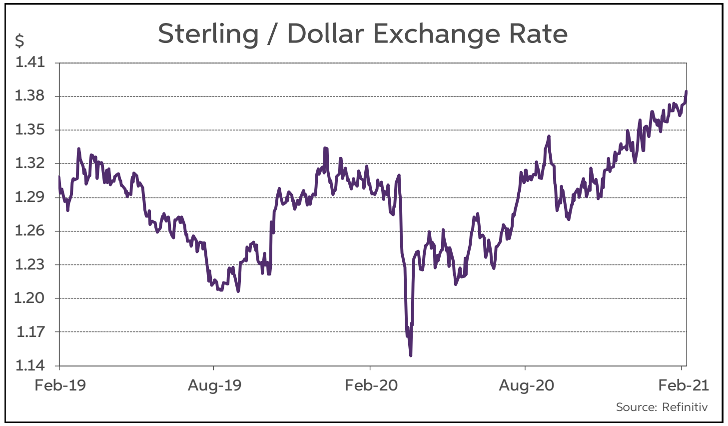
A further headwind for the dollar may be that the US seems likely to continue running a large budget deficit under the new Biden Administration. Traditionally, this would weigh on a currency, especially in an economy with low interest rates and a sizeable balance of payments deficit, like the US.

The dollar, though, has stabilised over the past month. EUR/USD has fallen back towards the $1.20 level, with long euro positions being scaled back. More generally, the dollar has been supported by rising US bond yields and a firming of US interest rate futures. The US economy is also continuing to outperform other advanced economies in early 2021, with vaccines being rolled out relatively quickly there too. The market is still very short the dollar, which could continue to be an aid to the US currency in the near-term. For the euro, though, there is considerable support at $1.20 and in the $1.16-1.18 range, so its downside may be limited.

Although the dollar may remain underpinned in the near-term, the currency could come under renewed downward pressure if a sustained, robust global economic recovery takes root later in the year. Having overcome the $1.20 level, the next major hurdle for the euro to surmount is $1.25, the peak rate for EUR/USD over the past seven years. This is likely to be a very challenging task, so the EUR/USD pair may trade in a $1.18-1.25 range in the months ahead. However, we would expect the euro to test the $1.25 level later in the year, if as anticipated, a strong global recovery gets underway, dampening the appeal safe haven currencies.







Forex Market Outlook

Sterling gains ground as UK makes good progress on vaccine roll out

After a volatile year in 2019, sterling saw further sharp movements in the early months of 2020. However, since last May it has been quite range bound against the euro, with most of trading in the pair confined to a relatively narrow 88-92p corridor. Meanwhile, like many other currencies, sterling has been on a rising path against the dollar since early last summer, with cable rising from $1.23 at mid-2020 to above $1.38 in recent days.

The EU-UK trade deal that was finally agreed on Christmas Eve, had only a limited impact on sterling. One reason is that an agreement was expected by the markets. Furthermore, it is a very limited trade deal which does not include services and is far inferior to the EU Single Market. It can hardly be classed as a major positive development for the economy, although it avoided a much worse outcome in the form of a no-deal Hard Brexit.

Sterling, though, has made some ground in the past couple of weeks. This seems to be largely due to growing optimism that the rapid roll out of Covid vaccines in the UK will allow restrictions on activity there to be eased considerably in the months ahead, leading to a sharp rebound in activity. Ten million people in the UK have already been vaccinated, or 15% of the population, which is well ahead of elsewhere.

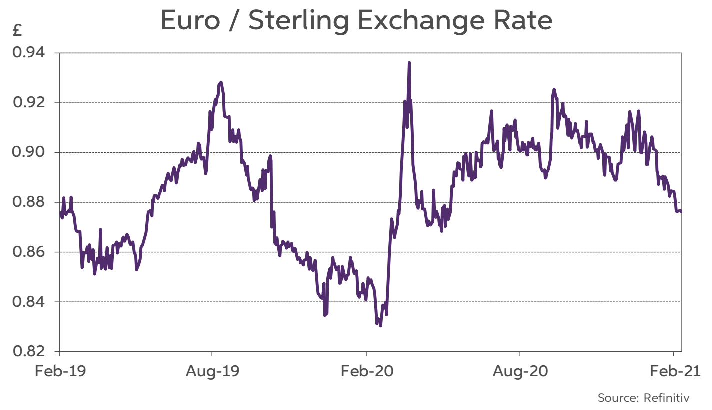
A relatively upbeat Monetary Policy Report was published by the Bank of England this month. The Bank sees UK GDP growth picking up to 5% in 2021 and 7.25% in 2022, following the estimated 10% fall in output last year. Furthermore, the Bank is not sounding like it will loosen monetary policy any further, especially in terms of lowering rates. Thus, markets are no longer pricing in a move to negative interest rates in the UK.

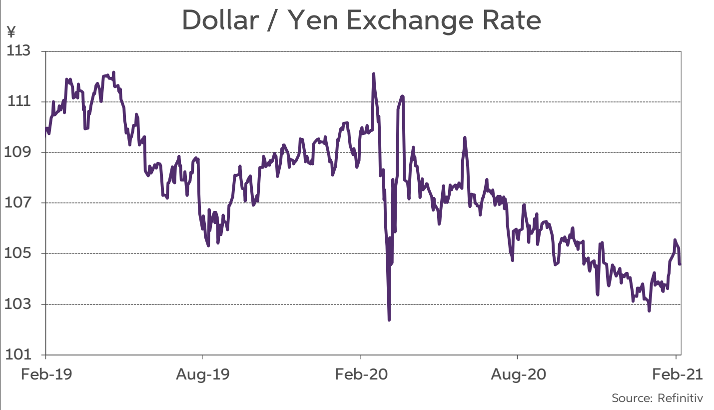
EUR/GBP fell below the 88p level in the aftermath of the BoE report, for the first time since May. However, there is strong support for EUR/GBP in the 86-87p range, which could make it difficult for sterling to make large additional gains against the single currency. Indeed, downside risks remain for sterling. One concern is that the very deep recession in the UK has seen the budget deficit soar to close on 20% of GDP in FY2020/21, much higher than in other countries. Downside risks from Brexit in terms of its negative impact on UK trade and investment are also likely to become more apparent over time, and act as a headwind for the currency.

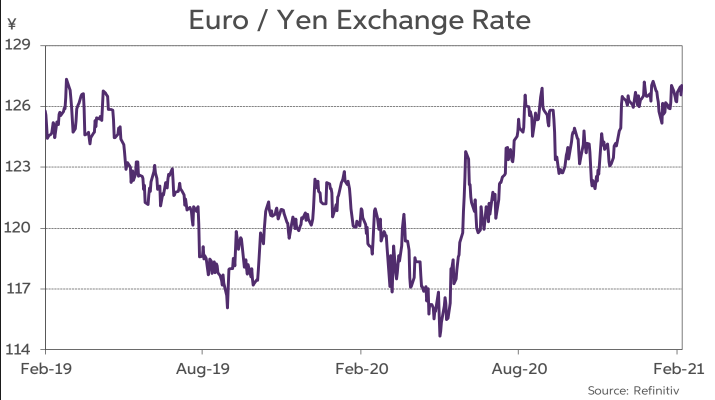
Taking all the factors into consideration, sterling could make some further modest gains in the near-term, with EUR/GBP edging down to 86-87p. However, it could well return to an 88-90p range against the euro later in the year. Meanwhile, cable could move somewhat higher to around $1.40. It is worth noting, though, that sterling hardly ever traded below $1.40 throughout the whole period from the mid-1980s up until its collapse after the Brexit Referendum in 2016. Thus, it remains a weak currency in the aftermath of the EU-UK trade deal.

Yen remains a strong currency

The yen has been trending higher against the US currency over the past five years, with the dollar falling to a ¥103 –105 range in the past three months. It was trading at ¥118 back in 2016. The yen benefits from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency. A re-emergence of downward pressure on the dollar could see it edge lower against the yen later in 2021, although it has good support at ¥103 and seems unlikely to fall below the key ¥100 support level. Meantime, the yen may largely range trade against the euro this year around the ¥126-128 level.





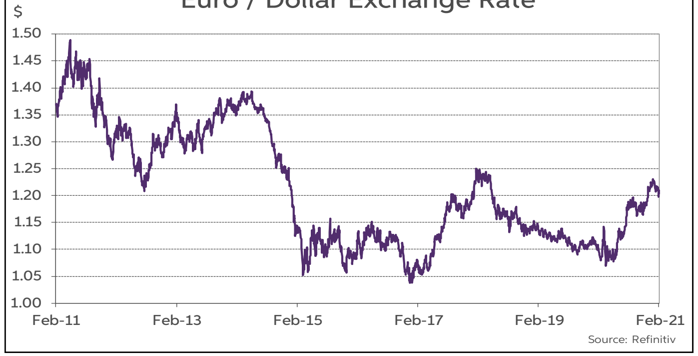


Summary of Exchange Rate Forecasts

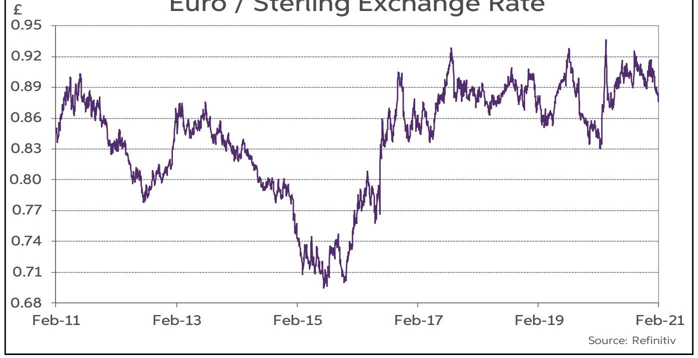
("Spot" Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

	Current	Q1-2021	Q2-2021	Q3-2021	Q4-2021
Euro Versus					
USD	1.210	1.17-1.23	1.19-1.25	1.21-1.27	1.23-1.29
GBP	0.878	0.84-0.90	0.85-0.91	0.86-0.92	0.87-0.93
JPY	127.09	123-129	124-130	125-131	125-131
CHF	1.08	1.08	1.08	1.09	1.09
US Dollar Versus					
JPY	105.02	102-108	101-107	100-106	99-105
GBP	1.379	1.35-1.41	1.36-1.42	1.36-1.42	1.37-1.43
CAD	1.27	1.27	1.26	1.25	1.23
AUD	0.77	0.77	0.78	0.79	0.80
NZD	0.72	0.72	0.73	0.74	0.75
CNY	6.45	6.45	6.40	6.35	6.30
Sterling Versus					
JPY	145	145	145	143	143
CAD	1.76	1.75	1.75	1.74	1.72
AUD	1.78	1.79	1.78	1.76	1.75
NZD	1.92	1.92	1.90	1.88	1.87

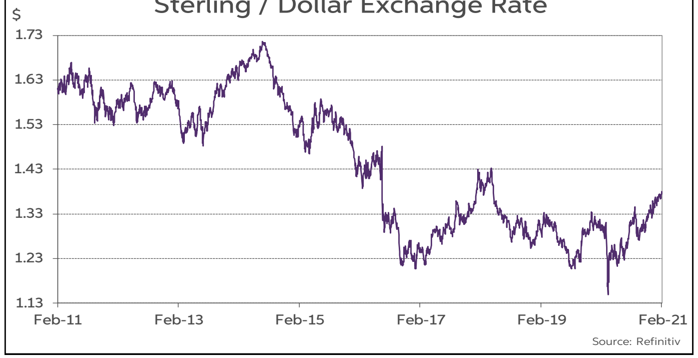
Euro / Dollar Exchange Rate



Euro / Sterling Exchange Rate



Sterling / Dollar Exchange Rate



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