Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- Coronavirus pandemic causes very deep recession in wold economy in H1 2020. Activity now starting to pick up again as restrictions are eased, but likely to be a long road to a full recovery
- Sharp declines of up to 10% in GDP predicted for many economies in 2020. Strong growth forecast for 2021, but recovery may be constrained by scarring effects or further waves to virus
- Central banks everywhere ease policy aggressively with rate cuts, large QE programmes and enhanced liquidity measures. Monetary policy to remain very loose over next few years
- Main currency pairs remain quite range bound despite economic instability and volatile markets
- Sterling softer in H1 2020 on numerous factors, including renewed Brexit uncertainty and talk of negative UK rates. Should regain some ground if EU-UK trade deal is agreed later in the year

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Global Economic Outlook

Forecasters see a long road to recovery post very deep COVID-19 recession

Economic forecasting in the unprecedented COVID-19 recessionary environment is very difficult. Large parts of the world economy were put into lockdown to control the spread of the virus, triggering a very deep global recession in H1 2020. Lockdown restrictions have now started to be eased. Without knowing the duration of the virus outbreak, the extent of further outbreaks, how long it will take countries to successfully exit lockdowns, developments in regard to treatments and a vaccine as well as the speed and strength of the recovery in economic activity, a wide range of outcomes are possible for GDP over the period 2020-2022.

What is clear is that the world economy has experienced a very deep recession in H1 2020 that commenced in March in most countries. The recession is unique in terms of its suddenness and severity. The OECD and IMF expect that this year will see the biggest fall in global GDP since the Great Depression of the 1930s. In many countries, though, the hit to the labour market has been mitigated by various government funded furlough and income support schemes. Furthermore, while the recession will be deep, it is widely anticipated that it will be of short duration, with growth rebounding in H2 2020 as most of the containment measures under the lockdowns are unwound. Indeed, activity has already started to pick up in May and June, most notably consumer spending. However, very large falls in GDP are still in store for both Q2 and 2020 as a whole.

The most recent set of comprehensive economic forecasts have come from the OECD in its semi-annual Economic Outlook, June 2020. Reflecting the exceptionally uncertain economic outlook, it has published forecasts for two equally likely scenarios, depending on whether or not there is second widespread coronavirus outbreak towards the end of the year. In the single outbreak scenario, world GDP falls by 6% this year and rebounds by 5.2% next year. However, for the OECD area where lockdowns have been most prevalent, GDP falls by 7.5% in 2020 and then recovers by just 4.8% next year. It would require growth of 3% in 2022 to return GDP to its pre-crisis level.

In its 'double-hit' virus scenario, the OECD sees world GDP contracting by 7.6% this year and recovering by just 2.8% in 2021, leaving it well short of its pre-crisis level by the end of next year. This is even more so the case for the OECD region, with output falling by 9.3% this year and growing by only 2.2% in 2021. It would require growth of 8% in 2022 to return GDP to its pre-crisis level. However, the OECD does see the region growing by 8.4% yoy by Q4 2021, so there is strong momentum entering 2022 and robust GDP growth is likely for that year.

There are other obvious impacts on economies from the very deep COVID-19 recession. World trade volumes are seen falling by at least 10% in 2020. Despite furlough schemes, which are preventing unemployment reaching very high levels, the jobless rate in the OECD area is still expected to rise to 9-10% in 2020-21 from 5.4% in 2019. There is also marked downward pressure on inflation, aided by the large drop in oil prices. The annual PCE rate is projected at circa 1% on average this year in the OECD region, down from just below 2% in 2019.

We are also seeing a sharp deterioration in public finances owing to government spending measures to mitigate the economic shock and declines in tax revenues due to the severe recession. Governments in virtually all economies are set to record very large budget deficits this year and a corresponding jump in public debt. Fiscal deficits in the OECD area are seen rising to 11-13% of GDP from circa 3% in the past couple of years. The deficits will start to decline in 2021 as tax receipts begin to recover and emergency spending measures are scaled down.

GDP (Vol % Change)

	2018	2019	2020 (f)	2021 (f)
World	3.4	2.7	-6.0	5.2
Advanced Economies	2.3	1.7	-7.5	4.8
US	2.9	2.3	-7.3	4.1
Eurozone	1.9	1.2	-9.1	6.5
UK	1.3	1.4	-11.5	9.0
Japan	0.3	0.7	-6.0	2.1
Emerging Economies	4.4	3.5	-4.6	5.6
China	6.6	6.1	-2.6	6.8
India	6.8	4.2	-3.7	7.9
World Trade Growth (%)	3.9	1.1	-9.5	6.0
World Inflation (Private Consumption Deflator %)	2.4	1.9	1.1	1.3

Source: OECD Economic Outlook, June 2020

Interest Rate Outlook

Central banks in for the long haul in terms of maintaining ultra-loose policies

Central banks globally have been pulling out all the stops to try and ameliorate the most severe impacts of the COVID-19 recession on their economies and financial systems and lay the groundwork for a recovery in activity as containment measures are lifted. Thus, rates have been cut sharply to 0.125% and 0.1% in the US and UK, respectively, enormous QE bond purchase programmes have been put in place and measures adopted to enhance the supply of liquidity to the economy and ease funding pressures, notably in regard to the dollar.

The message from central banks and, indeed, governments, is that they are prepared to do whatever it takes to prevent the sudden, severe contraction in economic activity morphing into a prolonged depression. The other message is that they are in this for the long halt. Central banks, in particular, have been very clear and forceful in their communications that monetary policy will remain exceptionally loose over the next couple of years and further measures will be adopted if required to restore economies to a strong footing.

Any additional easing by the main central banks is likely to be in the form of further QE as it would appear that we have reached the lower bound in 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. Markets see at most a further 10bps rate reduction over the coming year, taking the central point of the target range for the Fed funds rate down to virtually zero at 0.025%.

The BoE had been toying with the idea of a move to negative rates, with the Governor saying it is under active consideration. However, any such policy shift does not appear imminent and the BoE remains to be convinced about the merits of negative rates. There was no reference to negative rates in the minutes of the June MPC meeting when the BoE opted to further increase the size of its QE programme. Markets see UK rates being cut by 10bps at most in the coming year, which would take the bank rate down to zero. Meanwhile, markets see a very slight 5bps reduction the ECB deposit rate to –0.55%. Thus, it would appear that we are at or very close to the bottom of the interest rate cycle.

All the main central banks, though, are emphasising that rates will remain at these very low levels for an extended period of time. This is reflected in the pricing of futures contracts which don't see rates rising for a number of years. The first 10bps hike in the ECB deposit rate from its current level of –0.5% is not priced in until 2024, with rates still at –0.2% by 2026. In the UK, short-sterling contracts would suggest that the Bank rate is unlikely to be increased back up to 0.25% until 2025. Futures contracts in the US would appear to be looking for a 0.125% rise in the funds rate to 0.25% around mid-2023, with rates rising to 0.5% by end 2024.

The main central banks retain a clear bias towards maintaining very loose monetary conditions. Both the ECB and BoE announced large increases to their QE bond purchases at their June policy meetings. The ECB also indicated that net purchases under its programme would run until at least June 2021. Meanwhile, the Fed is already engaged in unlimited asset purchases. Chair Powell has commented that the Fed is "strongly committed to using our tools to do whatever we can and for as long as it takes" to help the economy recover. In this regard, there is some speculation that the Fed could move to implement yield curve control i.e. targeting bond yield levels. Ultra-loose monetary policy is here to stay for quite a long time.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.125	0.30	0.57	0.24	0.35
Sept'20	0.125	0.30	0.55	0.25	0.35
Dec'20	0.125	0.30	0.55	0.25	0.40
Mar'21	0.125	0.25	0.50	0.30	0.45

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.50	-0.41	-0.19	-0.37	-0.35
Sept'20	-0.50	-0.40	-0.20	-0.37	-0.35
Dec'20	-0.50	-0.40	-0.20	-0.35	-0.30
Mar'21	-0.50	-0.40	-0.20	-0.30	-0.25

** 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	0.18	0.49	0.20	0.25
Sept'20	0.10	0.19	0.50	0.20	0.25
Dec'20	0.10	0.20	0.50	0.20	0.30
Mar'21	0.10	0.20	0.50	0.25	0.35

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Main FX rates remain in narrow ranges despite unprecedented uncertainty

The euro-dollar rate has been confined to a very narrow eight cent corridor of $1.07-1.15 since the autumn of 2018. This is an exceptionally tight range for such a prolonged period of time. The narrow trading range to date in 2020 is remarkable in particular, given we have witnessed the advent of the deepest global recession since the Great Depression, incredible volatility on financial markets and central banks loosening monetary policy to an unprecedented degree, while the economic outlook remains highly uncertain.

There have been ebbs and flows recently in the EUR/USD rate, but within this tight trading range. The euro gained some ground in late May and early June, rising from $1.08 to $1.14 on improving risk appetite in markets but without ever threatening a break out of its narrow range against the dollar. The euro has dropped back to $1.12 in the past week. It is not just the euro which has been range bound against the dollar in recent times. The other big major currency, the yen, has traded in a tight ¥105-112 range versus the greenback since the end of 2018, with the exception of one short period at the height of market turbulence earlier this year when the rate briefly moved below ¥105.

The bigger picture is that the dollar has been at elevated levels against a broad range of currencies since 2015. It benefitted initially from the strong US economy and relatively high US interest rates. This year, it has been supported by its safe-haven status and associated market flows at a time of elevated uncertainty. Two other strongly performing currencies in recent times, the yen and Swiss franc, are also viewed as safe havens.

Technical levels are obviously important in currency trading in an environment where narrow ranges dominate. In regard to EUR/USD, a move down below this year's low of $1.07 would be a signal of renewed upward pressure on the US currency. This could see EUR/USD test the lows of $1.04-1.05 hit in the 2015-2017 period. A breach of these levels would open a move down towards parity. We view this as unlikely as the dollar is already at very high levels and it might trigger market intervention by central banks.

Meantime, the euro has not traded above $1.15 since late 2018. It is going to be hard for the single currency to breach this level. Money market rates in the Eurozone are now expected to remain negative well into the second half of this decade, thereby continuing to act as a headwind for the currency.

It is hard to call the next big move in FX markets. It is going to take a major event to shake the EUR/USD rate out of the narrow corridor of $1.07-1.15 that it has occupied since the autumn of 2018. A return to heightened risk aversion on markets, possibly on fresh concerns over the economic outlook, would likely trigger a flight into the dollar. This would probably see the euro quickly drop below $1.10 and possibly test support at the $1.07 level. On the other hand, if a sustained strong global recovery takes hold in the second half of the year, the dollar could start to descend from its current high levels. However, as noted already, it may be difficult for the euro to rise above $1.15. A move above $1.20 would certainly be a tall order as it has not been above this level since 2014 when the ECB first moved to negative interest rates, except for a brief period in the first half of 2018.

Overall, we think that as in 2019, EUR/USD could continue to trade in a narrow range over the second half of the year, with most of the action contained in a $1.10 to $1.15 corridor. It is likely to be a similar story for the yen/dollar pair, with movement contained in the ¥105-110 range.

Forex Market Outlook

Sterling out of favour for now

After a volatile year in 2019, sterling has continued to see some very sharp movements in the first half of 2020. This was especially so in the spring when markets went into free fall as the coronavirus took hold. Cable fell rapidly from $1.32 in early March to $1.15 by the middle of the month, its lowest level since the mid-1980s. Meantime, the euro rose from 84p to 95p, with some very big intra-day price movements.

The UK currency, though, staged a strong recovery soon after. It had clearly become oversold given that it had fallen sharply in a matter of days to historically low levels. However, it did not regain all the ground lost in the early March sell-off. The euro had fallen back to 87p by end April, but it has been on a slow but steady uptrend against sterling over the past two months, rising back above the 90p level in mid-June. Meanwhile, against the dollar, sterling recovered to the $1.28 level in early June, before moving back down to around $1.24.

Two factors in particular seem to have weighed on the UK currency in the past couple of months. The first has been the lack of progress to date this year in the EU-UK trade negotiations, given that these are supposed to conclude with a trade deal being agreed before the end of the year. The UK has ruled out any extension to the transition period which expires at end 2020 that would allow the negotiations to extend into next year. Thus, markets have been concerned that we could be heading for another cliff-edge Brexit date in December.

The second factor which has weighed on sterling has been speculation, led by the Bank of England itself, that negative interest rates could be on the cards in the UK. The BoE Governor indicated that negative interest rates were under active consideration, with futures contracts beginning to price in that rates may turn negative.

Both these risks, though, would appear to have receded somewhat is the past couple of weeks. However, there has been no obvious benefit for sterling, which has remained on the back foot. Both the EU and UK have turned more conciliatory in the latest phase of Brexit talks and have committed to try and reach a trade deal by the autumn. The EU has given some grounds on State aid rules, while the UK now seems to be more prepared to agree to minimum standards in regard to common regulations. It may be only a limited trade deal that is agreed which avoids the imposition of tariffs and quotas on goods. However, this would be far better than no deal and moving to trade under WTO rules from the start of next year.

Meantime, the risk of a move to negative rates would appear to have abated, with the UK economy regaining momentum at a quicker than expected pace. There was no mention of negative rates being discussed in the minutes of the June MPC meeting. Markets are now discounting that the bank rate could be lowered to zero at most. The extreme volatility of March highlights the difficulties in making sterling forecasts in this very uncertain environment. The UK's large current account deficit also leaves sterling vulnerable to shifts in market flows.

Sterling could find itself in the line of fire again if markets once more become convulsed by the coronavirus. It also would be vulnerable if the EU-UK trade talks run into fresh difficulties. Overall, though, the UK currency is at relatively low levels and thus should not continue to drift lower unless the risks of a no-deal Brexit start to rise again or market instability re-emerges. Indeed, we would expect EUR/GBP rate to move back down to 87-88p, if even only a limited trade deal is agreed later in the year.

Summary of Exchange Rate Forecasts

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

	Current	Q3-2020	Q4-2020	Q1-2021	Q2-2021
Euro Versus					
USD	1.126	1.09-1.15	1.10-1.16	1.11-1.17	1.12-1.18
GBP	0.905	0.88-0.94	0.85-0.91	0.85-0.91	0.85-0.91
JPY	120.26	117-123	119-125	121-127	123-129
CHF	1.07	1.07	1.07	1.08	0.98
US Dollar Versus					
JPY	106.83	104-110	105-111	106-112	107-113
GBP	1.244	1.20-1.26	1.25-1.31	1.27-1.33	1.28-1.34
CAD	1.35	1.35	1.34	1.33	1.31
AUD	0.69	0.69	0.69	0.70	0.71
NZD	0.65	0.65	0.65	0.66	0.67
CNY	7.07	7.05	7.00	6.95	6.90
Sterling Versus					
JPY	133	132	138	142	144
CAD	1.69	1.66	1.72	1.66	1.71
AUD	1.80	1.78	1.86	1.86	1.85
NZD	1.92	1.89	1.97	1.97	1.96

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