

# Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Advanced economies have re-opened as vaccine rollout gathers momentum, resulting in a marked pick-up in activity. Robust growth of circa 6% forecast for global economy in 2021
- Strong global growth of 4.5-5.0% expected for next year also, but virus is proving difficult to suppress. Meanwhile, inflation has risen sharply, stoking some concerns about price stability
- Futures contracts, though, still point to just very modest rate rises in US and UK in H2 2022 and 2023. No rate hikes expected in the Eurozone until 2024
- Market focus is now on expected Fed tapering plans, which seems likely to begin before end year
- Main currency pairs continue to trade within quite narrow ranges. Euro has lost some ground over the summer and could struggle if rates start rising elsewhere in 2022

Oliver Mangan  
Chief Economist

John Fahey  
Senior Economist

Daniel Noonan  
Economist

<https://aib.ie/investorrelations/economic-research-unit>

## Strong growth forecast for global economy; inflation rise expected to be temporary

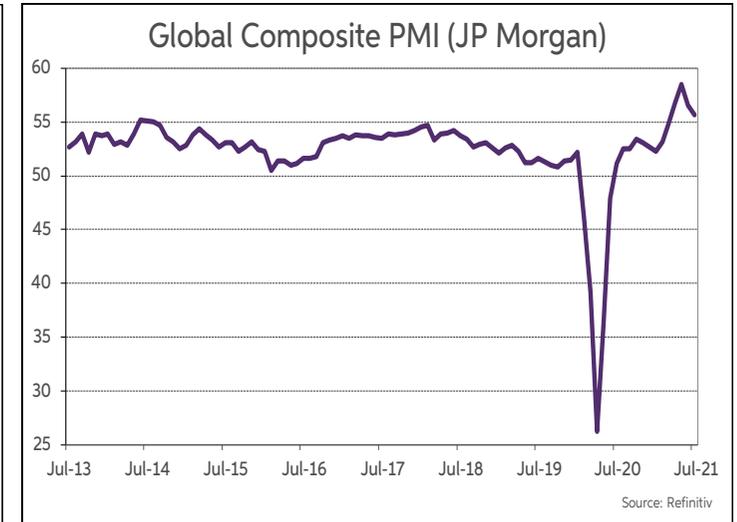
Growth forecasts for the global economy have been upped quite considerably this year. This is on the back of the relatively successful vaccine rollout programmes, economies being better able to cope with restrictions and high Covid case numbers, as well as the additional fiscal supports announced earlier in the year. The OECD is forecasting that the global economy will grow by 5.8% this year and 4.4% in 2022, while the IMF is projecting growth of 6% and 4.9% for the two years. Meanwhile, world trade is recovering strongly after contracting by 8.3% last year. A rise of 9.7% is being pencilled in for trade this year by the IMF, followed by growth of 7% in 2022.

The OECD and IMF, though, have pointed out the marked differences in the economic recovery across countries. They note that in many emerging-market economies, the slow deployment of vaccinations, further Covid infection outbreaks, associated containment measures and reduced capacity for policy supports will continue to act as a headwind on activity for quite some time. The one notable exception to this is China, where output is expected to remain on a robust growth path in H2 2021 and into 2022, after a strong rebound during the past year.

Meanwhile, in advanced economies, the on-going progress of the various vaccination rollouts has allowed many of the sectors that were severely curtailed by containment measures to gradually re-open. At the same time, additional fiscal stimulus this year is helping to boost demand, reduce spare capacity and lower the risks of the long-term scarring from the pandemic restrictions. A large accumulation of private sector savings over the eighteen months, combined with improved confidence and fewer public health restrictions should encourage strong growth in consumer spending. GDP in the OECD area is forecast to rise by 5.3% in 2021, led by a strong upturn in the US economy. Growth is seen easing to 3.8% in 2022.

The IMF and OECD note that there are significant upside and downside risks to their forecasts. The key downside risk relates to the vaccine rollout not being fast enough to stop the spread of the virus or prevent the emergence of new variants. In such instances, confidence and private sector spending would fall, especially if restrictions need to be introduced. The virus is proving persistent and difficult to surpass, even where vaccination rates are high. On the upside, the OECD references the extent to which household savings are normalised and excess savings are rundown at a quicker than expected pace. It also notes the potential for greater than envisaged longer term benefits from policy supports. The OECD judges the risks to its forecasts as broadly balanced, but the IMF believes they are tilted to the downside. Meantime, although the rise in unemployment has been modest to date, it could move higher later in 2021 as government labour market support schemes are wound down.

On inflation, the OECD and IMF, as well as the main central banks, acknowledge the upward pressure on input costs this year and marked pick up in inflation. However, they believe that sizeable spare capacity in the global economy should prevent a sustained rise in underlying inflation. The upturn in inflation this year reflects the recovery of oil and other commodity prices, a surge in shipping costs, the normalization of prices in hard-hit sectors and an unwinding of indirect tax cuts. These factors are expected to prove temporary. The OECD sees inflation in advanced economies at 3.1% in Q4 2021, easing back to 2.4% in Q4 2022, with the IMF forecasting inflation will fall to 1.9% by the end of next year. The biggest inflation risk could be the labour market, if a shortage of workers emerges, putting upward pressure on wages. US data are being closely watched in this regard, as job vacancies there have risen to historically high levels, while the jobless rate is declining at a rapid pace.



## GDP (Vol % Change)

|                        | <u>2019</u> | <u>2020</u> | <u>2021 (f)</u> | <u>2022 (f)</u> |
|------------------------|-------------|-------------|-----------------|-----------------|
| World                  | 2.8         | -3.2        | 6.0             | 4.9             |
| Advanced Economies     | 1.6         | -4.6        | 5.6             | 4.4             |
| US                     | 2.2         | -3.5        | 7.0             | 4.9             |
| Eurozone               | 1.3         | -6.5        | 4.6             | 4.3             |
| UK                     | 1.4         | -9.8        | 7.0             | 4.8             |
| Japan                  | 0.0         | -4.7        | 2.8             | 3.0             |
| Emerging Economies     | 3.7         | -2.1        | 6.3             | 5.2             |
| China                  | 6.0         | 2.3         | 8.1             | 5.7             |
| India                  | 4.0         | -7.3        | 9.5             | 8.5             |
| World Trade Growth (%) | 0.9         | -8.3        | 9.7             | 7.0             |
| Inflation -CPI         |             |             |                 |                 |
| Advanced Economies (%) | 1.4         | 0.7         | 2.4             | 2.1             |

Source: IMF World Economic Update, July 2021

## *Fed turns more hawkish, but markets believe central banks will be slow to tighten*

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. Enormous QE bond purchase programmes were put in place and measures adopted to enhance the supply of liquidity to businesses, and ease funding pressures in markets.

Central banks actions this year have been largely confined to tweaking their QE programmes. The ECB announced in March that it was increasing the pace of asset purchases to prevent a tightening of financial conditions as upward pressure emerged on bond yields. Both the Canadian and UK central banks, however, have scaled back the size of their weekly asset purchases. Overall, though, central banks have been very clear in their communications that monetary policy will need to remain supportive of activity for quite some time.

Over the summer, though, some central banks turned a bit more hawkish on monetary policy. At the June FOMC meeting, there was a significant shift in its interest rate projections by Fed policymakers. Eleven of the 18 FOMC members indicated they expected interest rates would start to rise in 2023, compared to in 2024, previously. The median projection was for two 25bps hikes in 2023. The other key aspect from the June FOMC meeting was that the conversation about slowing down its rate of monthly asset purchases (i.e. QE tapering) began.

This has progressed over the summer to where, in the past couple of weeks, there have been soundings from several top Fed policymakers that the conditions to begin tapering could soon be met. Fed officials have indicated that its inflation goal has been achieved and that another couple of months of strong jobs growth could see its' employment goal accomplished also, suggesting that policy tightening could be coming before too long. We would not be surprised to see the Fed start to taper QE in the final quarter of this year.

The Fed is likely to provide clarity on the timeline for tapering in the coming weeks. Markets, though, still believe that any Fed rate hikes are quite a way off and will be modest. Futures contracts are pricing in a small 0.125% rise in December 2022, taking the funds rate up to 0.25%, with a further 50bps of rate increases priced in for 2023.

The Bank of England has also turned a bit more hawkish, with the MPC meeting in August concluding that "some modest tightening of monetary policy" was likely over the next couple of years. Its current asset purchase programme is set to conclude around the end of the year. Markets are pricing in that UK rates could be hiked by 15bps to 0.25% next summer and then rise by another 25bps by late 2023.

Rate hike expectations are even less pronounced in other markets, most notably in the Eurozone and Japan. Markets do not expect the ECB deposit rate to be increased from its current level of -0.5% until well into 2024, and then to be raised very slowly thereafter, with rates still in negative territory at end 2026. The ECB altered its policy framework over the summer and now has a symmetric 2% inflation target. It has indicated that rates would not be raised until the target is met. ECB forecasts show it does not foresee the inflation target being achieved anytime soon, with the HICP rate in 2023 projected at 1.4%. Thus rates hikes look years away in the Eurozone, while the ECB is expected to maintain substantial asset purchases even after the current PEPP is wound down.

### US Interest Rate Forecasts (to end quarter)

|         | Fed Funds | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---------|-----------|-------|--------|----------|----------|
| Current | 0.125     | 0.13  | 0.24   | 0.30     | 0.84     |
| Sept'21 | 0.125     | 0.14  | 0.25   | 0.31     | 0.85     |
| Dec'21  | 0.125     | 0.15  | 0.28   | 0.35     | 0.90     |
| Mar'22  | 0.125     | 0.17  | 0.32   | 0.40     | 1.00     |

\* 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        | -0.56 | -0.50  | -0.50    | -0.38    |
| Sept'21 | -0.50        | -0.55 | -0.50  | -0.49    | -0.37    |
| Dec'21  | -0.50        | -0.55 | -0.49  | -0.48    | -0.35    |
| Mar'22  | -0.50        | -0.55 | -0.48  | -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      | 0.07  | 0.21   | 0.48     | 0.69     |
| Sept'21 | 0.10      | 0.08  | 0.22   | 0.50     | 0.70     |
| Dec'21  | 0.10      | 0.09  | 0.25   | 0.55     | 0.75     |
| Mar'22  | 0.10      | 0.10  | 0.30   | 0.60     | 0.85     |

\* Swap Forecasts Beyond 1 Year

## Dollar may have some upside potential, in contrast to euro

The dollar appreciated very sharply in the period 2014 to 2016 and remained at elevated levels over the rest of the decade, underpinned by relatively high US interest rates. However, it moved steadily lower in the final three quarters of last year, losing 12% against the other major currencies, as US rates were cut to virtually zero. The euro was one notable beneficiary of the dollar weakness as the ECB kept rates on hold, climbing to circa \$1.23 by the start of 2021 from around \$1.08 early in 2020. This was only the second time that the euro has risen above \$1.20 since the ECB moved to negative rates back in 2014.

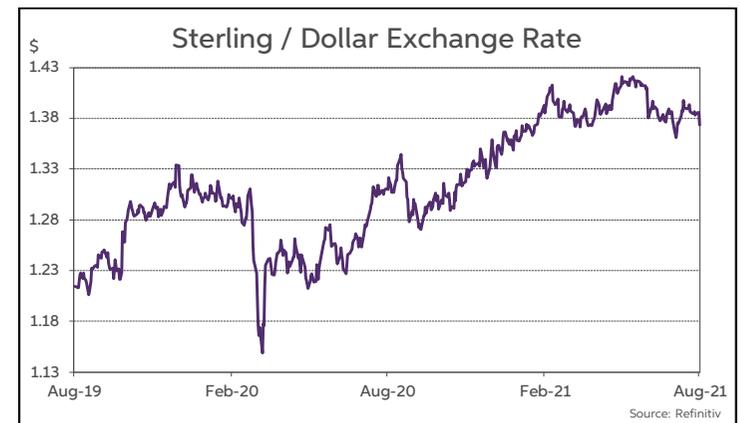
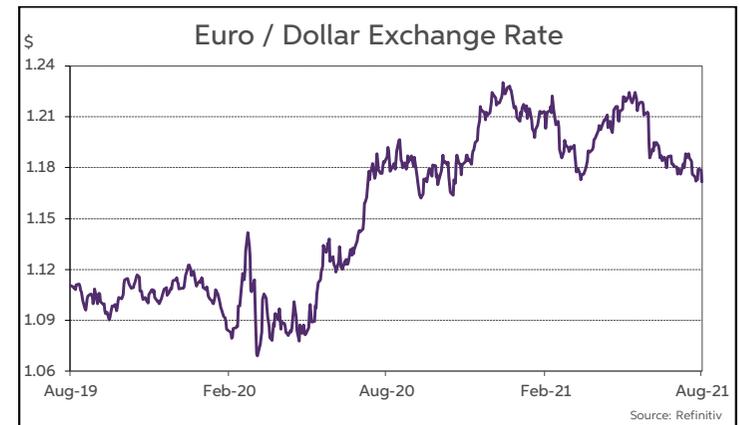
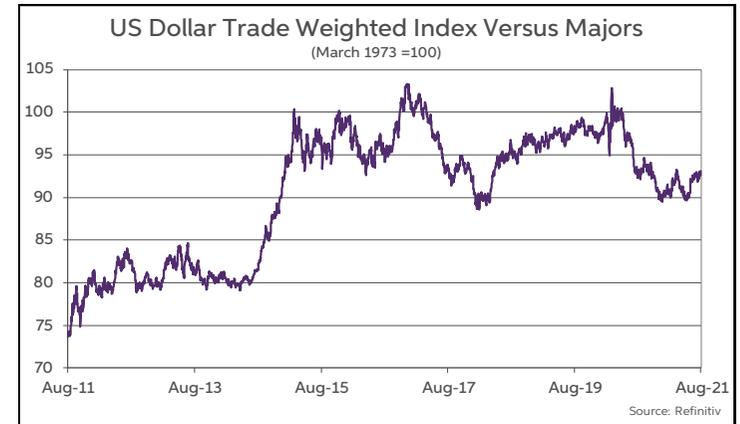
The dollar, though, has recovered some ground against most currencies this year, helped by a firming of US interest rate future contracts on the back of big upgrades to US growth forecasts for 2021/22. The market was also very short the US currency at the start of 2021, which helped the dollar make gains as some of these positions were closed out, including against the euro.

We have seen the euro-dollar exchange rate trade in a very tight \$1.17-1.19 corridor since mid-year. Looking further back and though somewhat volatile at times, the euro-dollar pair has been confined to a narrow \$1.17-1.23 channel for over a year now. There is very strong support for the single currency in the \$1.16-1.18 range, which held in the spring when the euro came under pressure, and again in the late summer. Meanwhile, the dollar has strong support in the \$1.23-1.25 region. Indeed, the single currency has failed to rise above this level since 2014 when ECB rates turned negative.

However, at some stage, this very tight trading range will break down and we will get some significant moves in the euro-dollar rate. Interest rates are an important driver of forex markets, and their stability has been key to the narrow trading ranges for the pair over the past year. Rate hikes are quite possible in the US next year, while Eurozone rates look set to stay on hold for a long time and thus remain deeply negative. A widening of interest rate differentials, if it were to materialise next year, should be supportive of the dollar. In the shorter term, the dollar may be supported by the tapering of asset purchases that is expected by the Fed later this year, given that the ECB is expected to continue with the large scale buying of bonds for the next couple of years.

One fly in the ointment for the dollar could be a sustained rise in US inflation relative to elsewhere. Though US rates would have to rise, high inflation is usually a harbinger for currency weakness. Another possible headwind for the dollar may be if vaccine hesitancy results in continuing high Covid case numbers and hospitalisations in the US, restraining the pace of recovery and delaying hikes in interest rates. The marked fall in US bond yields over the summer, despite strong economic data and a sharp rise in inflation, suggest markets have some doubts about whether the robust recovery in activity will be sustained and rate tightening will be implemented over the next couple of years. Such doubts could limit the upside for the dollar in the near term.

Meantime, we find it hard to think of what could drive the euro higher, given the outlook for Eurozone interest rates. Indeed, Germany and France are facing potentially difficult elections this year and next, which may weigh on the currency. Thus, while range trading seem likely to remain the order of the day, the balance of risk points to some upside potential for the dollar against the euro. Indeed, the trend over the summer has been for the euro to edge lower against all the major currencies, given the prospects that interest rates will remain decidedly negative in the Eurozone over the next few years under the new ECB's policy framework.



## Solid sterling

The EU-UK trade deal that was finally agreed at the end of last year had no immediate impact on sterling as the outcome of the negotiations was largely in line with market expectations. The currency, though, appreciated steadily during the opening quarter of 2021, most notably versus the euro. The rapid rollout of Covid vaccines in the UK was supportive of the currency. It allowed restrictions on activity to be eased considerably and growth forecasts for the UK economy in 2021 were revised sharply higher.

This includes the Bank of England, which now sees UK GDP growth picking up to 7.25% in 2021, despite the economy being in lockdown in the opening months of the year, with further strong growth of 6% projected for 2022. The Bank sees output returning to its pre-Covid levels by the end of this year, much earlier than had been initially expected. As a result, markets have moved from, at the start of the year pricing in a move to negative interest rates, to now expecting that UK rates will start to rise over the course of next year. This has seen short-dated Gilt yields turn positive in 2021, with long-term yields rising also.

EUR/GBP fell steadily from around 90p at the start of 2021 to the 85p level by end March. Cable climbed to a high near \$1.42 in Q1, before moving back down below \$1.40. The EUR/GBP rate was largely confined to a very tight 85-87p range between April and July. However, it has tested the lower bound of this range during the past couple of weeks, dipping to as low as 84.5p on general euro weakness at one stage, before rising back above the 85p level. Meanwhile, cable remains stuck below the \$1.40 level.

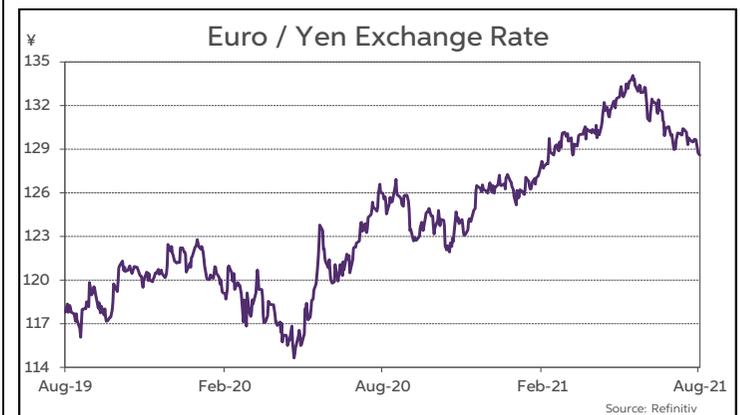
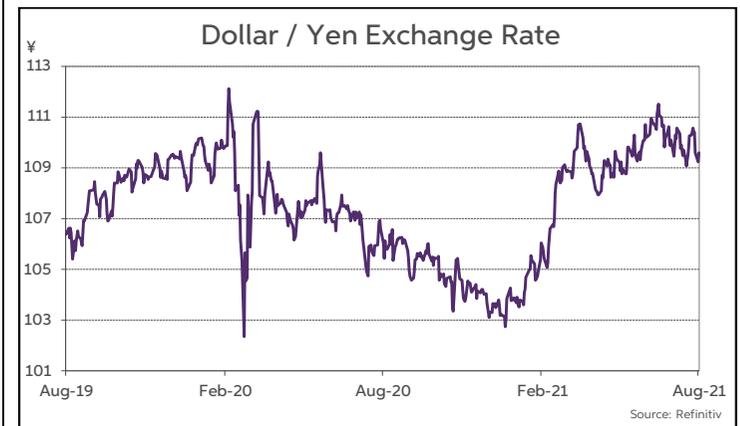
It is hard to call the next major move in the UK currency. Market positioning is relatively neutral. The economy is performing quite well suggesting the currency should remain well underpinned after its very solid performance in recent months. Further out, if rate hikes materialise in the UK next year as markets expect, it could provide a fillip for sterling, especially against currencies with zero or negative interest rates like the euro.

## Yen stabilises after declining earlier in the year

The yen has performed strongly in recent years, registering significant gains up until early this year, with the dollar falling to around ¥103 by the start of 2021 from a peak of ¥125 back in 2015. Meanwhile, the euro fell from a high of ¥140 in 2015 to a trough of ¥115 in mid-2020, before recovering. The yen benefitted from its safe-haven status, a big trade surplus and large overseas holdings of foreign assets that generate flows back into the currency.

The yen, though, has lost ground this year, with the dollar climbing from ¥103 to around the ¥110 level and the euro rising from ¥126 in January to a high of ¥134 by early summer. There was hardly any rise in long term interest rates in Japan earlier this year, in marked contrast to what happened in Europe and the US. This weighed on the yen as investors moved into higher yielding currencies. Upgrades to global growth forecasts, the rollout of vaccines and improving risk appetite on markets also lessened the safe haven appeal of the yen.

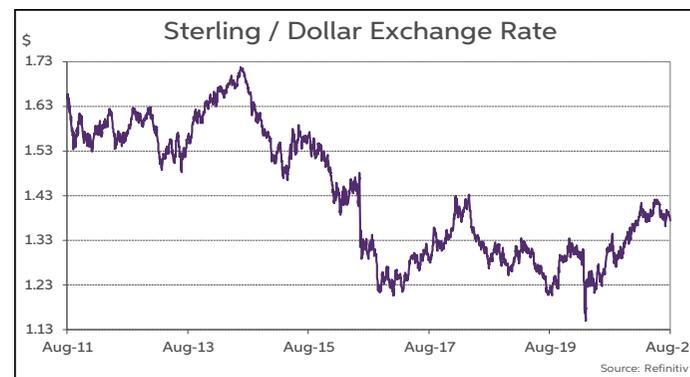
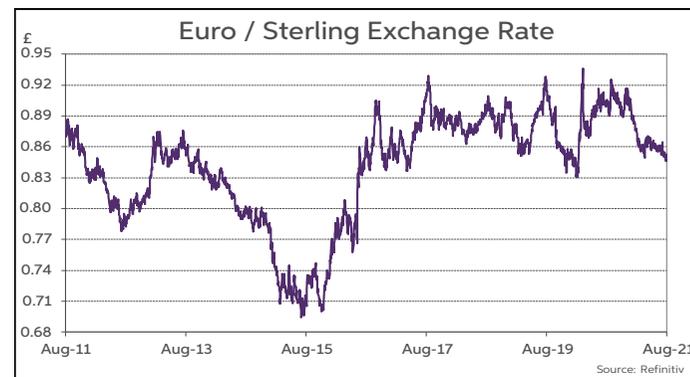
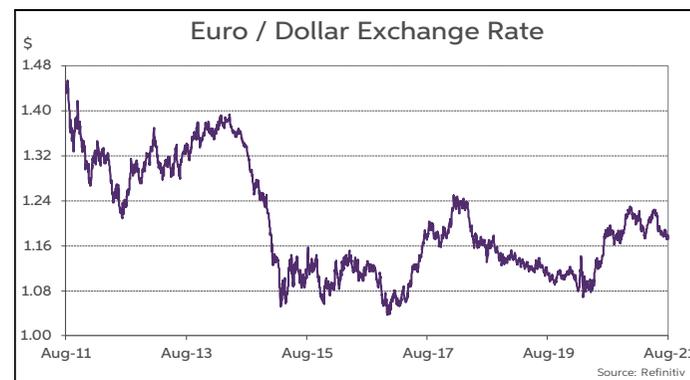
Global bond yields have fallen over the summer which has helped the yen to stabilise against the dollar and recover some ground against the euro, with the single currency dropping back below ¥130. Market positioning is now relatively short the yen. Thus, the currency may remain quite stable over the rest of the year. However, it could be vulnerable to some further falls in 2022 if interest rates and bond yields rise elsewhere next year.



# Summary of Exchange Rate Forecasts

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

|                         | Current | Q3-2021   | Q4-2021   | Q1-2022   | Q2-2022   |
|-------------------------|---------|-----------|-----------|-----------|-----------|
| <b>Euro Versus</b>      |         |           |           |           |           |
| USD                     | 1.172   | 1.14-1.20 | 1.13-1.19 | 1.13-1.19 | 1.12-1.18 |
| GBP                     | 0.852   | 0.82-0.88 | 0.81-0.87 | 0.81-0.87 | 0.80-0.86 |
| JPY                     | 128.47  | 125-131   | 125-131   | 125-131   | 125-131   |
| CHF                     | 1.07    | 1.07      | 1.07      | 1.06      | 1.06      |
| <b>US Dollar Versus</b> |         |           |           |           |           |
| JPY                     | 109.64  | 106-112   | 107-113   | 107-113   | 108-114   |
| GBP                     | 1.375   | 1.35-1.41 | 1.35-1.41 | 1.35-1.41 | 1.36-1.42 |
| CAD                     | 1.26    | 1.26      | 1.27      | 1.27      | 1.28      |
| AUD                     | 0.73    | 0.73      | 0.72      | 0.72      | 0.71      |
| NZD                     | 0.69    | 0.69      | 0.68      | 0.68      | 0.67      |
| CNY                     | 6.48    | 6.50      | 6.45      | 6.40      | 6.40      |
| <b>Sterling Versus</b>  |         |           |           |           |           |
| JPY                     | 151     | 150       | 152       | 152       | 154       |
| CAD                     | 1.74    | 1.73      | 1.75      | 1.76      | 1.98      |
| AUD                     | 1.90    | 1.89      | 1.92      | 1.92      | 1.96      |
| NZD                     | 1.99    | 2.00      | 2.03      | 2.03      | 2.07      |



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