Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

11th January 2024

- World economy grew at a very modest pace in 2023. Subdued growth expected again in 2024, with continuing weak performance by most advanced economies in particular

- Inflation fell sharply last year and further moderation in price pressures anticipated in 2024

- With inflation in marked decline and activity subdued, markets look for significant rate cuts, starting in Q2 2024. Central banks, though, remain cautious on timing and scale of policy easing

- Main currency pairs quite range bound last year, as central banks pursued broadly the same rate tightening policies. Exception was BoJ which refrained from rate hikes, weighing heavily on yen

- Dollar remains at elevated level, though well below peak. It could lose some ground if US rates are cut appreciably in 2024. Yen has significant upside potential should BoJ start to tighten policy

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Global Economic Outlook

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Growth expected to remain subdued in 2024, with inflation easing further

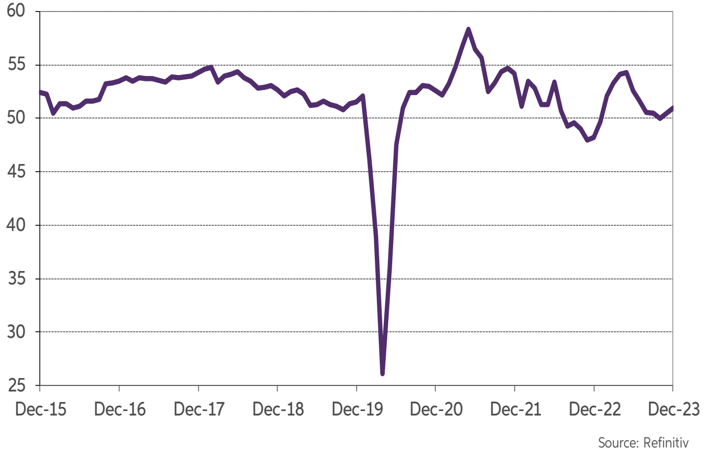
The latest updates from the OECD and IMF, published in the closing months of last year, remained cautious on the outlook for the global economy. They note that the impact of tighter monetary policy is becoming increasingly visible, business and consumer confidence have turned down, and the rebound in China faded rather quickly. The world economy grew at a subdued pace of circa 3% in 2023. Global growth is projected to remain sub-par by the IMF and OECD in 2024-2025 in a 2.7-3.0% range. The OECD comments that the primary reason for the subdued global growth outlook is the substantial monetary policy tightening that has been required to rein in inflation. Furthermore, although rate cuts are expected in the next two years, central banks have been guiding that monetary policy will need to remain restrictive for a considerable period of time to bring inflation under control.

However, it is not just a restrictive monetary policy stance that is weighing on global growth prospects. The IMF says other factors are also at work, including the impact of some large emerging economies, such as China and South Korea, moving to a more moderate growth phase of their development cycle. Labour markets are also tight, with many advanced economies at full employment. Meanwhile, the OECD notes increasing geo-economic fragmentation, and growing protectionism with rising trade barriers, is contributing to a slowdown in international trade, which is impacting negatively on the world's highly integrated supply chains. Governments are also faced with growing budgetary pressures from rising debt burdens and ageing populations. Geo-political risks are also still elevated. Although inflation is coming down, cost-of-living pressures remain a constraint on households. It all adds up to a challenging macro-economic environment.

The US is the one economy that continues to defy expectations of a slowdown in activity. GDP growth last year is estimated at close to 2.5%, exceeding the 2.1% rate recorded in 2022. Forecasters, though, expect the pace of US growth to slow this year under the weight of much higher interest rates, with some signs recently the economy is starting to lose momentum. Meanwhile, growth in both the Eurozone and UK was very weak last year, with GDP increasing by around 0.5% in both economies. Growth is expected to pick up only modestly in 2024.

That said, central banks may be on the verge of pulling off a soft landing for the world economy in 2024. The surge in inflation over the past three years, with CPI rates rising to around 10%, and the aggressive tightening of monetary policy in 2022-23 which has seen interest rate hikes totalling 450-500bps in many countries, would normally be a recipe for recession. It will be unusual if economies come through this period without a downturn in activity and significant rise in unemployment. Based on the forecasts for the coming year, although growth will remain weak, especially in Europe, a recession is not foreseen and economies are expected to remain close to full employment. The return of inflation to its 2% target also looks to be coming into sight.

Official forecasters, including central banks, though, remain cautious and warn it is still too early to conclude that the battle to restore price stability has been won or that a recession will be avoided. Their view remains that the balance of risks to the economic outlook are tilted to the downside. Geo-political risks remain elevated in particular, as highlighted by the associated disruption to global trade routes in the Middle East in the past couple of weeks. Over the past three years, the world economy has had to cope with the COVID-19 global pandemic, a war in Europe, cost-of-living crises and the most severe tightening of monetary policy in decades. These shocks have left it in a weakened state. It is unlikely that economies would come through another major shock in 2024, without being hit by a recession. Thus, the risks to the economic outlook bear close watching.



GDP (Vol % Change)

	2022	2023 (f)	2024 (f)	2025 (f)
World	3.3	2.9	2.7	3.0
OECD Economies	2.9	1.7	1.4	1.8
US	1.9	2.4	1.5	1.7
Eurozone	3.4	0.6	0.9	1.5
UK	4.1	0.3	0.8	0.8
Japan	0.9	1.7	1.0	1.2
Non-OECD Economies	3.6	4.0	3.8	4.0
China	3.0	5.2	4.7	4.2
India	7.2	6.3	6.1	6.5
World Trade Growth (%)	5.2	1.1	2.7	3.3
Inflation -CPI OECD Economies (%)	9.3	7.4	5.3	3.9

Sources: OECD Economic Outlook November 2023

Interest Rate Outlook

Markets look for central banks to cut rates aggressively in 2024

After a two year period characterised by aggressive monetary tightening, the main central banks have kept rates on hold since late summer/early autumn, and moved to a "data-dependent" mode in terms of monetary policy decisions. Central banks indicated that policy will need to be kept restrictive for a considerable period to ensure a return to price stability over the medium term. Markets, though, are taking note that headline inflation has been on a marked downward trajectory over the past year, getting close to 2% in some economies, while core inflation has been in decline since the summer. Meanwhile, economic activity is subdued in most economies, bar the US. Hence, futures contracts are pricing in significant rate cuts by central banks, beginning in Q2 2024.

The Fed raised US rates by 25bps to a 5.25-5.50% range at the July FOMC meeting, a 22-year high. It has kept rates unchanged since then, though with Chair Powell commenting in December that the question of rate cuts is coming into view. The Fed's December dot-plot showed the median projection of FOMC members is that rates would be cut by 75bps this year and a further 100bps in 2025. The market, though, has moved to price in more aggressive easing in 2024. Futures contracts look for rate cuts of 140bps in 2024, beginning in May, which would take rates down to 4.0% by December. A further 60-65bps of rate cuts are priced in for 2025, bringing rates down to a 3.25-3.5% range. The Fed dot-plot sees rates getting to 3.5-3.75% by end 2025.

The BoE raised rates by 25bps in early August which brought the Bank rate up to 5.25%. The UK central bank has kept rates unchanged at its subsequent meetings, but on a split vote. The majority cited a much bigger than expected fall in inflation as the reason to leave policy on hold. Others wanted to raise rates somewhat further. The MPC has indicated a willingness to hike rates again if there is evidence of continuing persistent inflationary pressures. Markets, though, are no longer pricing in further rate increases. Instead, rates are expected to begin to be cut, starting possibly as early as May, which would appear contrary to BoE guidance. Futures contracts see rates falling by 125bps by end year and a further 60bps in 2025, taking them down to a 3.25-3.5% range.

The ECB has kept policy on hold since it last rate hike of 25bps at its September meeting, that brought the Deposit rate up to 4%. Headline inflation declined sharply in the Eurozone last year, while core inflation has eased since the summer. The ECB has been indicating that rates will need to be kept sufficiently restrictive for a sufficiently long period of time to ensure a return to price stability. Futures contracts, though, are pricing that the ECB will start lowering rates in April, with 140bps of cuts priced in for 2024, which the ECB cautioned at its December press conference is not in line with its thinking. A further 40bps in cuts are anticipated in 2025, taking the deposit rate down to 2.0-2.25%. In our view, it may be June before the ECB starts lowering rates.

Further significant declines in headline and core inflation look to be in store this spring. Meanwhile, economic activity remains very weak in Europe and appears to be starting to slow in the US. Overall, it is likely that rates will be cut this year. There is a risk, though, that they may not be cut as quickly as markets expect, especially in the Eurozone. Headline inflation has been quite volatile in recent months and central banks will want to see a clear downtrend re-emerge. Labour markets remain tight, with strong growth in wage earnings and unit labour costs. Core inflation is also still quite some way above target, especially in the UK. Central banks will want to be sure that inflation is on a clear path to 2% on a sustained basis before embarking on rate cuts. Thus, inflation data in the spring will be critical and need to show that price stability is coming into view. Headline inflation should fall to circa 2% or below, with core rates within sight of this level. Such outturns are needed for rates to be cut in Q2'24.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	5.375	5.59	5.11	4.43	3.93
Mar'24	5.375	5.55	5.05	4.40	3.90
June'24	4.875	5.05	4.50	4.05	3.60
Sept'24	4.375	4.55	4.00	3.70	3.30

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	4.00	3.93	3.44	2.99	2.60
Mar'24	4.00	3.90	3.45	3.00	2.60
June'24	3.75	3.65	3.00	2.70	2.45
Sept'24	3.25	3.15	2.70	2.50	2.30

** 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	5.32	5.06	4.46	3.87
Mar'24	5.25	5.30	5.05	4.45	3.85
June'24	5.00	5.00	4.75	4.20	3.70
Sept'24	4.50	4.50	4.35	3.90	3.50

** Swap Forecasts Beyond 1 Year*

Forex Market Outlook

Most currencies could continue to trade within narrow ranges in 2024

Although the US dollar has retreated from its 2022 peak, which saw it reach its highest point on a trade-weighted basis in 20 years, it still remains at quite elevated levels. The continuing strength of the dollar is very much linked to the ongoing impressive performance of the US economy and associated high level of US interest rates. US data generally surprised to the upside in 2023. The anticipated slowdown in the economy did not materialise and GDP growth last year is estimated at close to 2.5%, up from 2.1% in 2022. Meantime, the labour market remains very tight, with the jobless rate still close to fifty year lows at below 4%, amid continuing strong growth in employment. Against this backdrop, the Fed hiked rates to a 5.25-5.5% range July and kept them there over the second half of the year, helping to underpin the currency.

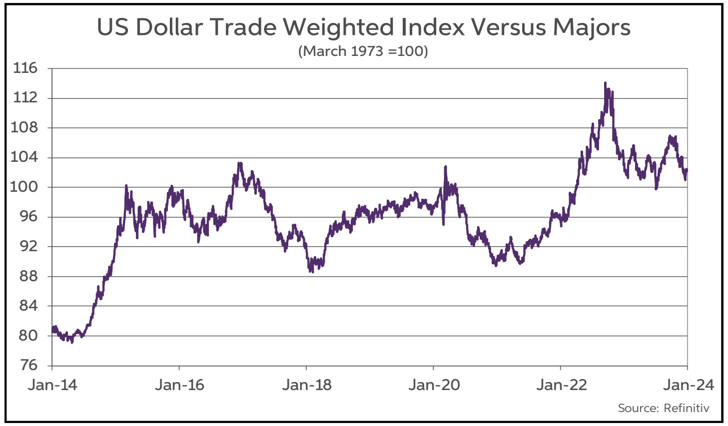
In contrast to the US, both the Eurozone and UK economies struggled last year, narrowly avoiding recession. Both economies are estimated to have grown by around 0.5% in 2023, a much lower growth rate than the US. Meanwhile, Eurozone interest rates looked to have reached a peak at 4%, well below those in the US, while there was a marked scaling back of rate hike expectations in the UK in the second half of last year.

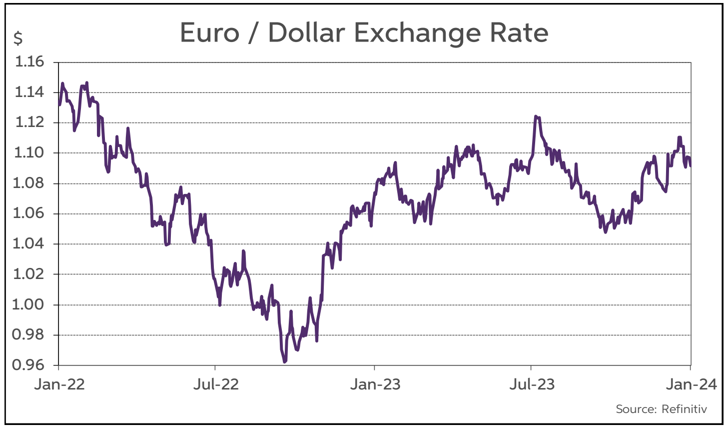
Overall, the most notable feature of the main currency markets last year was the predominance of narrow trading ranges, with the exception of the yen. EUR/USD was confined to a $1.04-1.12 corridor in 2023, with most of the action in a $1.06-1.11 range. Meantime, sterling has traded in a $1.20-1.31 band versus the dollar since last March. Similarly, the Australian, New Zealand and Canadian dollars also traded in narrow ranges versus the US currency last year, in particular since March. Thus, after large dollar gains in 2021-22, forex markets were more settled in 2023 and confined to quite narrow trading ranges, bar the weak yen. The question is will this pattern continue in 2024?

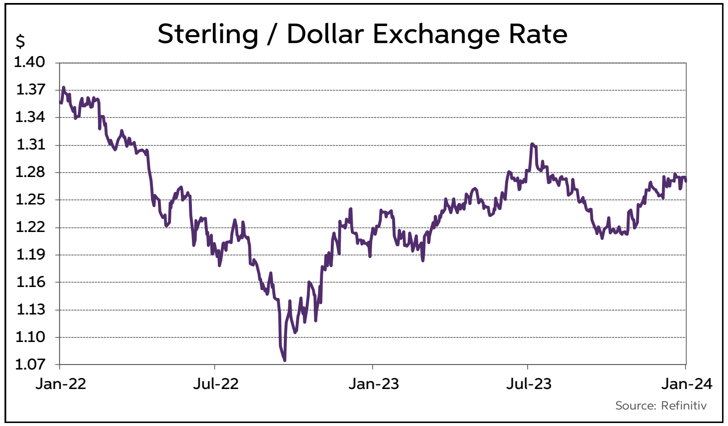
Monetary policy has been a crucial driver of forex markets in the past three years. The main central banks have kept policy unchanged in the past few months and are guiding that policy will need to remain restrictive for a period of time to get inflation back to its 2% target. Significant rate cuts are expected in the main economies this year, starting in the second quarter, with markets pricing in 120-140bps of policy easing in the UK, US and Eurozone in 2024. This suggests that the main currency markets could continue to range trade for much of the year.

The euro and sterling made gains during the final quarter of last year, while the dollar lost some ground. The EUR/USD rate rose from $1.05 at the start of October to around the $1.09-1.10 level more recently. Meanwhile, sterling has risen from $1.21 to $1.27 in the past three months. Rates are at higher levels in the US than most other economies so there is more capacity to loosen policy there once central banks move on to an easing path. The dollar is also still at an elevated level and so it has greater scope to fall than most other currencies.

This suggests we could see the dollar losing some ground in 2024 as the Fed begins to lower rates, especially if it is an early mover. However, the fall may be limited. Significant rate cuts are expected elsewhere too, including in the Eurozone and UK. Geo-political risks are also likely to remain elevated, with elections due in more than 70 countries covering about half the global adult population. Meanwhile, market positioning at the start of the year was relatively short the dollar and long the euro and sterling, though not excessively so. Overall, currencies may make just modest gains against the dollar this year, with the euro rising towards $1.15 by end 2024.







High BoE rates and more stable UK backdrop supportive of sterling

Sterling gained some ground in 2023 and was generally much more stable than in recent years. It was aided by better-than-expected UK data, with the economy avoiding the recession that had been widely predicted to occur last year. At the same time, the rise in BoE rates to 5.25% was also supportive of the currency as was the more stable political backdrop. EUR/GBP edged downwards from the 87-89p range it occupied in the opening months of last year, to trade in a narrow 85.0-87.5p corridor since May 2023. Meanwhile, sterling moved up from lows below $1.20 early in 2023 to trade in a $1.20 to $1.31 band against the dollar since last March. It is currently around the middle of this range. Overall, then, the UK currency was much more stable in the past year.

Inflation proved more sticky in the UK than elsewhere in 2023, with strong wage inflation evident also. UK rates have been raised to 5.25% as a result, and markets expect UK rates to be lowered at a slightly slower pace this year than in the US and Eurozone, which could be supportive of the currency. The Bank rate is seen falling to 4% by end 2024 and 3.25-3.5% by end 2025. Meantime, the latest positioning data shows the market is somewhat long on the pound, though not 'stretched' long. Overall, sterling could remain stable in 2024, especially if market expectations that rates in the UK will be cut slightly less than elsewhere prove correct. Some BoE modelling, though, suggests there could be scope for a sharp fall in inflation to below 2% in the next two years. If this proved to be the case, it could see the BoE cut rates to a greater extent than priced in by markets to support the weak economy. Sterling would likely lose some ground in such circumstances. We don't see the pending UK general election impacting the currency much as a change of government is widely anticipated.

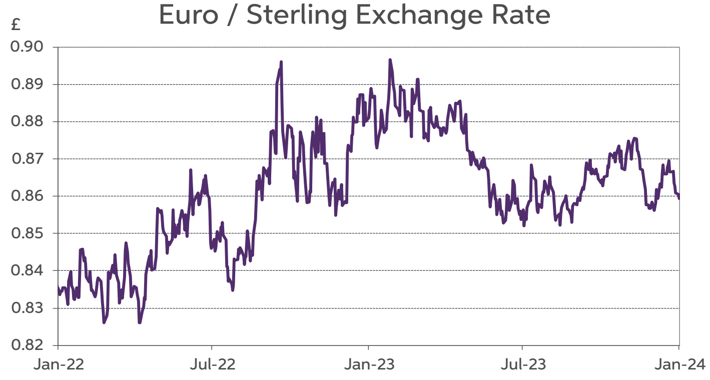
Should be scope for yen to recover some ground in 2024

In marked contrast to other central banks, the BoJ has continued with its very accommodative monetary policy, maintaining its key official interest rate in negative territory. The BoJ, under a new Governor, Ueda, continued to pursue this dovish policy stance last year. As a result, a large interest spread opened up between bond yields in Japan and the other major markets. All this has seen the yen hitting 30-year lows against the US currency in the past two years. Indeed, the dollar hit new 30 year highs above ¥150 late last year, with the euro rising to fifteen year highs, near the ¥165 level.

Thus, the very loose BoJ monetary policy stance has acted as a major deadweight for the currency over the past two years. A significant shift in policy, such as the abolition of the bond yield control corridor or a hike in the official interest rate, or else big cuts in interest rates elsewhere, would seem necessary for the yen to recover lost ground. There is certainly scope for the yen to rebound in 2024 if there is a change in policy or rates are lowered elsewhere, given the extent of the currency's sharp fall in 2022-23.

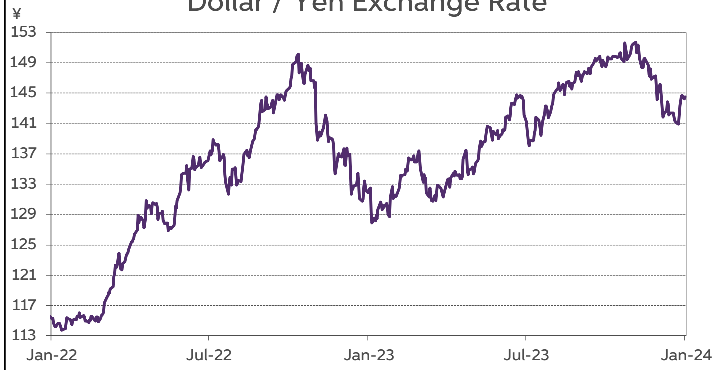
Inflation has picked up in Japan in the past couple of years, with the CPI rate running at around 3% for much of 2023. This has led to speculation that we could see some tightening of BoJ policy in 2024. This could occur at the same time as rates start to be cut elsewhere, possibly in Q2. The process, though, is likely to be slow. Large BoJ rate hikes seem unlikely as inflation is expected to fall back again in Japan in 2024. Nevertheless, even a modest policy shift at a time of rate cuts elsewhere should form the basis for a rebound by the yen this year. Indeed, the currency has recovered some ground in the past two months, though it remains at a very low level.

Euro / Sterling Exchange Rate



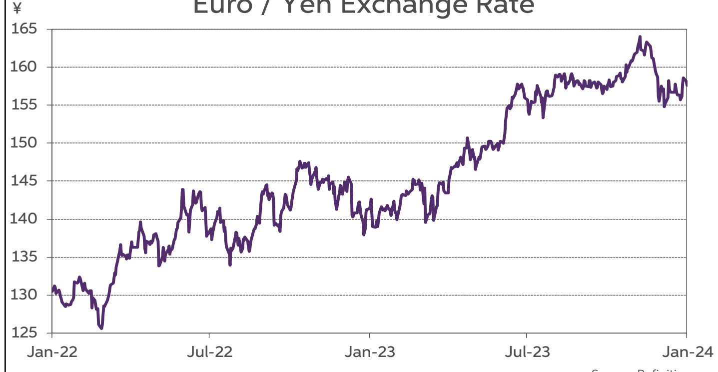
Source: Refinitiv

Dollar / Yen Exchange Rate



Source: Refinitiv

Euro / Yen Exchange Rate



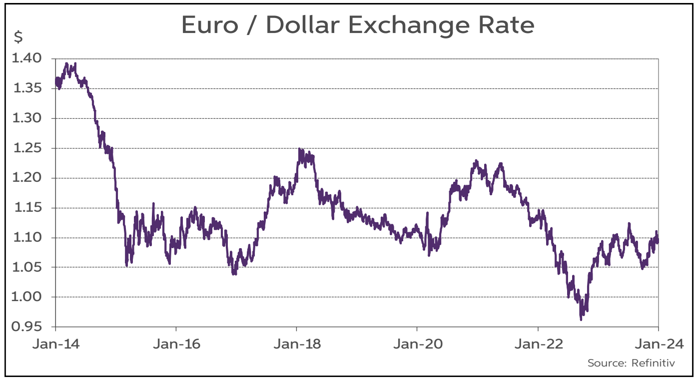
Source: Refinitiv

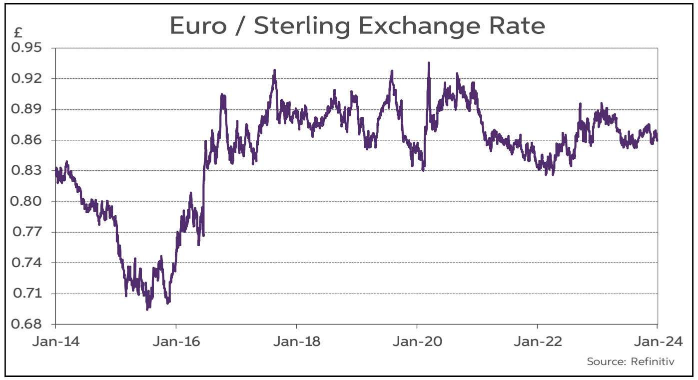
AIB Treasury Economic Research Unit

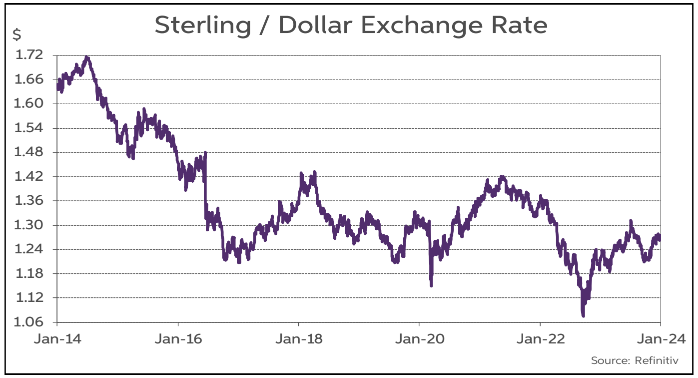
Summary of Exchange Rate Forecasts

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

	Current	Q1-2024	Q2-2024	Q3-2024	Q4-2024
Euro Versus					
USD	1.093	1.07-1.13	1.08-1.14	1.09-1.15	1.11-1.17
GBP	0.861	0.83-0.89	0.83-0.89	0.84-0.90	0.84-0.90
JPY	160.02	155-161	152-158	149-155	147-153
CHF	0.93	0.93	0.94	0.95	0.96
US Dollar Versus					
JPY	146.35	141-147	137-143	133-139	129-135
GBP	1.271	1.25-1.31	1.26-1.32	1.26-1.32	1.28-1.34
CAD	1.34	1.34	1.32	1.31	1.29
AUD	0.67	0.67	0.68	0.69	0.70
NZD	0.62	0.62	0.63	0.64	0.65
CNY	7.16	7.15	7.10	7.00	6.90
Sterling Versus					
JPY	186	184	181	175	173
CAD	1.70	1.71	1.70	1.69	1.69
AUD	1.91	1.91	1.90	1.87	1.87
NZD	2.05	2.06	2.05	2.02	2.02







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