# Forex and Interest Rate Outlook

## AIB Treasury Economic Research Unit

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- The economic rebound has lost momentum since mid-year due to a rise in Covid cases and supply bottlenecks, including labour shortages
- Inflation continues on an upward trajectory amid supply shortages and rising energy prices. Inflation not now expected to show signs of easing till the mid-point of 2022
- BoE surprises markets by failing to follow through on its hawkish rhetoric, leaving rates unchanged. Rate hikes, though, still seem likely sooner rather than later
- Fed, as expected, starts to taper QE, but emphasises it will be patient on rate hikes. Meanwhile, ECB tells 'hawkish' markets that rate hikes are very unlikely next year
- Dollar regains the upper hand on FX markets amid rising US inflation. Hawkish BoE supportive of sterling. Euro weakens as bigger rate hikes expected elsewhere

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# Global Economic Outlook

AIB Treasury Economic Research Unit

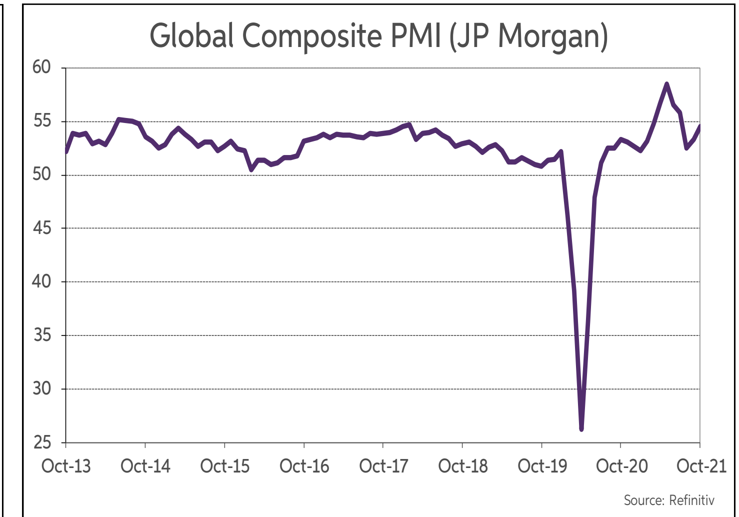
## *Recovery loses momentum, inflation remains on upward trajectory*

The performance of the global economy in the first half of 2021 was better than had been anticipated at the turn of the year. This was mainly on the back of the relatively successful vaccine rollout programmes, as well as economies being better able to cope with restrictions and high Covid case numbers, and because of additional fiscal supports being provided by governments. As a result, global growth forecasts were revised higher during the opening six months of the year. Autumn updates on the outlook for the world economy by both the IMF and OECD show very little change for the 2021-22 period compared to their mid-year projections. In this regard, global growth is forecast to expand by around 6% this year and between 4.5-5% next year.

However, the recent updates from the IMF and OECD depict a more cautious tone regarding the macro outlook. This is against the backdrop of economic data tending to print below expectations since mid year. This has included a raft of survey data, including the PMIs as well as hard data such as retail sales. More recently the first estimates of Q3 GDP data from the US and UK confirm that the economic rebound has lost momentum in these economies. Meantime, while the pace of the Eurozone recovery was maintained in Q3, growth is expected to slow sharply in Q4. There have been downgrades to 2021 growth forecasts for the US and UK. The IMF's October edition of its World Economic Outlook saw this year's US GDP forecast lowered from 7% to 6%. The OECD and US Fed made a broadly similar downward revision to their 2021 projections. Meanwhile, the IMF reduced its UK 2021 GDP forecast to 6.8% (from 7%), while the OECD lowered it by 0.5% to 6.7%.

There are two key factors behind the loss of momentum in the recovery. While vaccinations have proved effective at helping to reduce the risks in relation to Covid-19, the much more transmissible Delta variant has seen a fresh surge in infection numbers over recent months. This is of particular concern in countries where vaccination rates are low or there is considerable vaccine hesitancy. It is weighing on confidence and consumer behaviour. Secondly, supply bottlenecks are becoming more acute in some sectors, with shortages of raw materials, key inputs and workers, as well as capacity difficulties in transportation, resulting in delays and rising supplier delivery times. This is holding back output growth in some industries, most notably the auto sector. In brief, the supply side of economies is struggling to keep pace with the surge in demand.

The combination of these supply shortfalls alongside the release of pent-up demand and a rebound in commodity prices, especially in the energy sector, have caused inflation to surge this year. Some policy developments have also contributed, such as the expiration of the German VAT cut. The CPI rate has risen to above 6% in the US and inflation is above 4% in the Eurozone. In the UK, inflation is currently at around 3% and remains on an upward trajectory. The IMF, OECD, and the main central banks, retain their view that the recent spike higher in inflation will prove temporary. However, they note the increased level of uncertainty regarding this assumption as well as the fact the spike will persist for longer than previously envisaged. They now expect an easing in supply chain disruptions to emerge around the midpoint of 2022, allowing inflation to fall back in the second half of next year. The biggest inflation risk could be the labour market, if a shortage of workers puts sustained 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. Overall, the rise in inflation now seems likely that it will take somewhat longer for it to fall back to target or below. However, once the mismatches between supply and demand start to ease, inflation should start to come down in the second half of 2022. Meanwhile, more stable energy prices next year should also play a key role in helping to reduce the rate of headline inflation.




*GDP (Vol % Change)*

| | 2019 | 2020 | 2021 (f) | 2022 (f) |
|---|---|---|---|---|
| World | 2.8 | -3.1 | 5.9 | 4.9 |
| Advanced Economies | 1.6 | -4.5 | 5.2 | 4.5 |
| US | 2.2 | -3.4 | 6.0 | 5.2 |
| Eurozone | 1.3 | -6.3 | 5.0 | 4.3 |
| UK | 1.4 | -9.8 | 6.8 | 5.0 |
| Japan | 0.0 | -4.6 | 2.4 | 3.2 |
| Emerging Economies | 3.7 | -2.1 | 6.4 | 5.1 |
| China | 6.0 | 2.3 | 8.0 | 5.6 |
| India | 4.0 | -7.3 | 9.5 | 8.5 |
| World Trade Growth (%) | 0.9 | -8.2 | 9.7 | 6.7 |
| Inflation -CPI | | | | |
| Advanced Economies (%) | 1.4 | 0.7 | 2.8 | 2.3 |

*Source: IMF World Economic Outlook, October 2021*

# Interest Rate Outlook

## *Central banks patient on rate hikes, but markets look for tightening in 2022*

When the Covid-19 pandemic triggered a very sudden and deep recession last year, central banks globally pulled out all the stops to try and ameliorate the most severe impacts of the virus and associated restrictions on their economies and financial systems. This included sharp cuts to interest rates, enormous QE bond purchase programmes and liquidity supports to businesses, and to ease funding pressures in markets. As a result, monetary conditions have been exceptionally loose over the past eighteen months. Over the course of this year, economies have rebounded at a much quicker than anticipated pace. This has seen a marked upward revisions to 2021 growth forecasts. The rise in inflation has also been much greater than expected this year also. Meanwhile, labour markets are also tightening more quickly than expected, with few enough signs to date of scarring from the recession. Central banks though remain of the view that the surge in inflation will not be sustained, although they have pushed out the timeframe for when inflation should start to ease to around mid-2022.

Central bank's policy deliberations have been centred over the last few months on rowing back on some of the extraordinary monetary stimulus. However, these discussions have been complicated by the fact that while inflation continues to rise, recent macro data suggest that the economic recovery has lost momentum and the downside risks to growth have increased. This has heightened the risk of significant policy errors in determining the appropriate stance of monetary policy. In this context, the recent meetings from most of the main central banks show them espouse a generally patient approach to raising rates. However, market expectations have turned noticeably more hawkish recently on the rate outlook amid the persistence of elevated inflation.

The November FOMC, as expected saw it follow through on the guidance it gave in September by announcing a start to tapering QE. Initially, they will reduce purchases by $15bn per month, leaving a new monthly purchases total of $105bn. It also stated that it will implement a further $15bn reduction in December. While tapering it not a form of policy tightening, it does still represent an important step in the Fed adjusting its policy settings. However, Chair Powell emphasised that the Fed will be patient on rate hikes. Its projections (from Sept) showed that half of the FOMC expect a rate hike next year, with the fund rate at 0.25% by end-2022. It is projecting rates at 1% by end 2023. Futures contracts are pricing in a more aggressive pace of tightening for the period 2022-23. The market envisages US rates at 0.625% by end 2022 and near to 1.375% by end-2023

The BoE November meeting provided a surprise to markets, leading to volatility in UK rates and sterling. The BoE failed to follow through on its hawkish signalling and left the Bank rate at 0.1%. However, it did state that if incoming data were in line with expectations, rate hikes could be expected sooner rather than later. It noted that a 1% Bank Rate would be consistent with it reaching its 2% inflation target. A rate hike could still occur in December and the market still see rates getting to 1.2% by end-2022.

Meanwhile, the ECB is in the process of lowering the monthly pace of monthly asset purchases, though QE purchases are likely to continue next year, albeit at a more modest level. However, President Lagarde has emphasised that despite the current inflation surge, the outlook for inflation over the medium term remains subdued, and conditions for rate hikes in the Eurozone are very unlikely to be satisfied next year. Despite this guidance, markets are still pricing in a 15bps rate hike by late next year and a further 25bps in 2023.

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

| | Fed Funds | 3 Mth | 1 Year | 2 Year * | 5 Year * |
|---|---|---|---|---|---|
| Current | 0.125 | 0.16 | 0.39 | 0.75 | 1.33 |
| Dec'21 | 0.125 | 0.16 | 0.40 | 0.78 | 1.35 |
| Mar'22 | 0.125 | 0.17 | 0.45 | 0.85 | 1.40 |
| June'22 | 0.125 | 0.20 | 0.50 | 0.90 | 1.50 |

** 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 | -0.57 | -0.49 | -0.32 | -0.08 |
| Dec'21 | -0.50 | -0.57 | -0.49 | -0.32 | -0.06 |
| Mar'22 | -0.50 | -0.56 | -0.47 | -0.30 | -0.04 |
| June'22 | -0.50 | -0.55 | -0.45 | -0.28 | -0.02 |

** 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 | 0.10 | 0.65 | 1.11 | 1.26 |
| Dec'21 | 0.10 | 0.20 | 0.70 | 1.15 | 1.30 |
| Mar'22 | 0.25 | 0.35 | 0.75 | 1.25 | 1.40 |
| June'22 | 0.50 | 0.55 | 0.85 | 1.30 | 1.45 |

** Swap Forecasts Beyond 1 Year*

# Forex Market Outlook



## *Dollar firms on rate hike expectations, euro under pressure*

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 dollar, though, has recovered ground this year, helped by a firming of US interest rates along the curve on the back of big upgrades to US growth and inflation forecasts,.

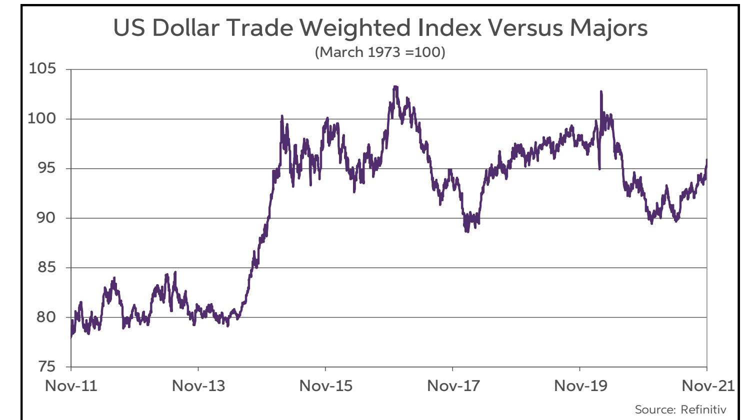
The EUR/USD rate generally traded within a relatively narrow range of $1.17-1.23 from July last year up to the end of September of this year, with the $1.16-1.17 area offering good technical support. The dollar has held a stronger tone since mid-2021 against a broad range of currencies. This occurred in the context of the Fed preparing the ground for a QE tapering as well as the central bank turning more hawkish in its projections on interest rates. This saw the market increasingly test the $1.16-1.17 support for the euro, over the autumn.

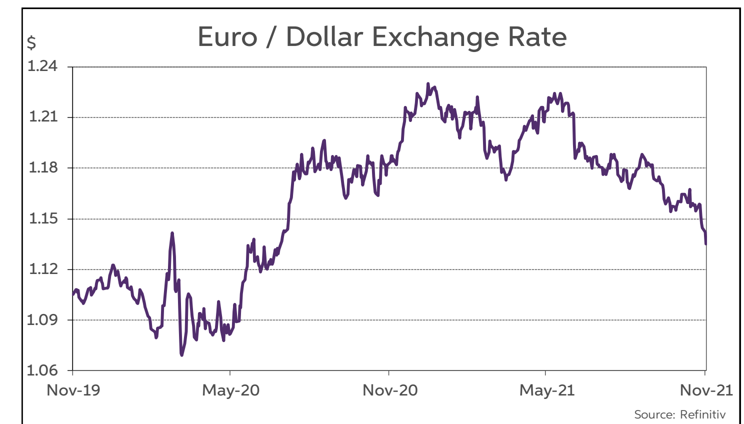
The EUR/USD rate moved below the $1.16 threshold in October, to its lowest level in 15 months in the lead up the Fed meeting in early November, as the dollar edged higher against a broad range of currencies. The aforementioned FOMC meeting in early November passed off without much immediate reaction from the dollar, as the Fed had well signaled to the market that a tapering announcement was on the cards. However, the EUR/USD has tended to trade sub-$1.16 since the November meeting. Indeed, it fell to a new year-to-date low, below the $1.15 level, following much higher than expected US inflation data for October. Over the last two weeks, we have seen increasing speculation of US rate hikes next year, which has further boosted the dollar. This was evident in EUR/USD moving down to around $1.13.

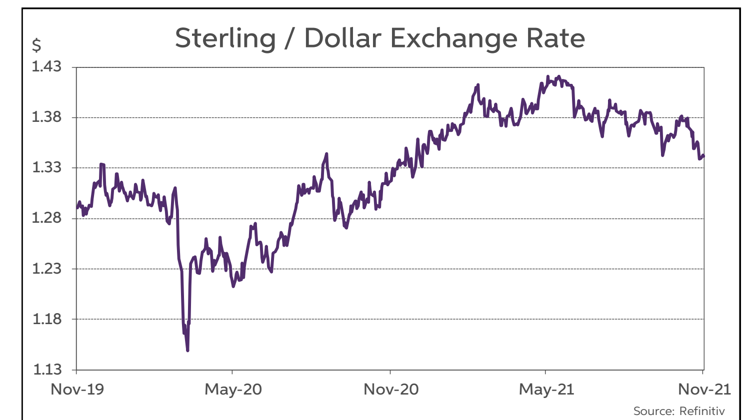
Looking ahead, there is the potential for increased levels of volatility on markets, including for currencies given the reality that it will be some time, possibly mid-2022, before it becomes clear whether or not the rise in inflation proves temporary. We have seen in recent years, interest rates are an important driver of forex markets. Rate hikes are quite possible in the US next year, while the ECB is guiding that Eurozone rates are unlikely to be increased in 2022. From a euro viewpoint, it is hard to highlight any obvious factor that could drive the currency higher, in light of the outlook for continuing negative Eurozone interest rates in the next couple of years. It is noteworthy that the euro has been pinned down below $1.25 ever since the ECB moved to negative interest rates in 2014.

Overall, the balance of risk points to some further upside potential for the dollar against the euro. However, there is considerable support for the euro in the $1.10-1.13 range. Beyond that, the $1.08 level offers very strong support, which most notably held in H1 2020. Indeed , one has to go back to 2015-2016 period for the last time the pair spent any time below the $1.08 level. Overall, as we move into next year and the Fed gets nearer to the point of hiking rates, this could bring further pressure to bear on the EUR/USD rate which could move down to $1.10-1.11.

One possible source of downside for the dollar could be a sustained rise in US inflation relative to elsewhere. While 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-19 case numbers and hospitalisations in the US, thereby restraining the pace of recovery and delaying hikes in US interest rates.



# Forex Market Outlook



## *Volatile sterling supported by BoE rate hike expectations*

The UK currency appreciated steadily during the opening quarter of 2021, most notably versus the euro. As well as the EU-UK Brexit trade deal lifting a cloud of uncertainty around sterling, the rapid rollout of Covid vaccines in the UK was also very supportive of the currency as the economy rebounded. This saw markets moving from, at the start of the year pricing in negative interest rates, to expecting that UK rates could rise from early 2022. Meanwhile, EUR/GBP traded in a very narrow corridor of 85-87p for much of the period since mid February up to the beginning of October. Cable was more volatile over this period, reflecting movements in the dollar. Sterling which had climbed to a high of $1.42 in early June, fell back towards the $1.35 by the early part of October.

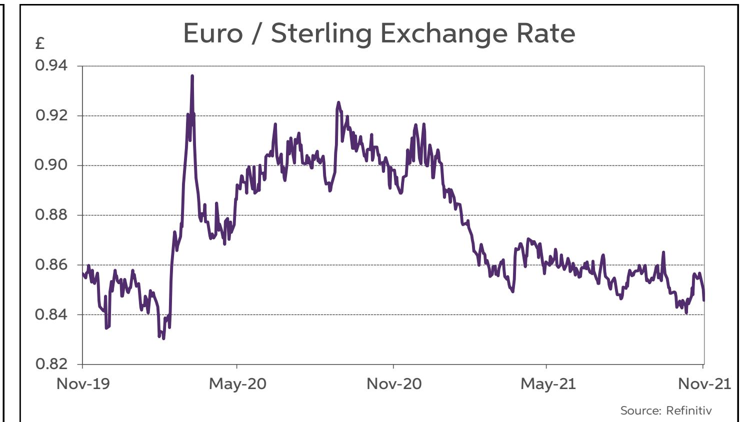
The BoE started to sound more hawkish during October and in essence teed up markets for a rate hike at its November meeting. On the back of this expectation, sterling gained ground against the euro and the dollar. However, when the BoE failed to follow through on its hawkish rhetoric, instead leaving the Bank Rate unchanged, the currency gave up some these gains. More recently, rate futures contracts have firmed again in the UK, with the BoE remaining hawkish on policy tightening. This has been evident in sterling movements in recent days with EUR/GBP moving down towards 84p

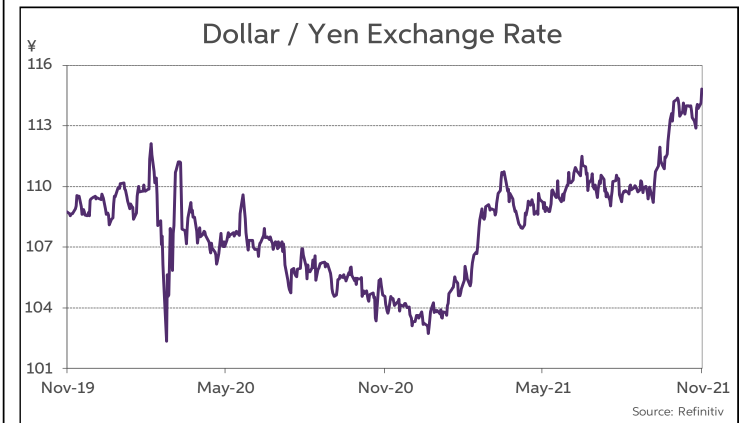
There is scope for further bouts of volatility in sterling in light of the uncertainty over the BoE's guidance as well as the fact that it will take some time before it becomes clear whether or not the rise in UK inflation is temporary and the knock-on consequences of this for BoE rate policy. If rate hikes materialise in the UK over the coming months, as markets expect, it could provide a fillip for sterling, especially against currencies with zero or negative interest rates like the euro and the yen.

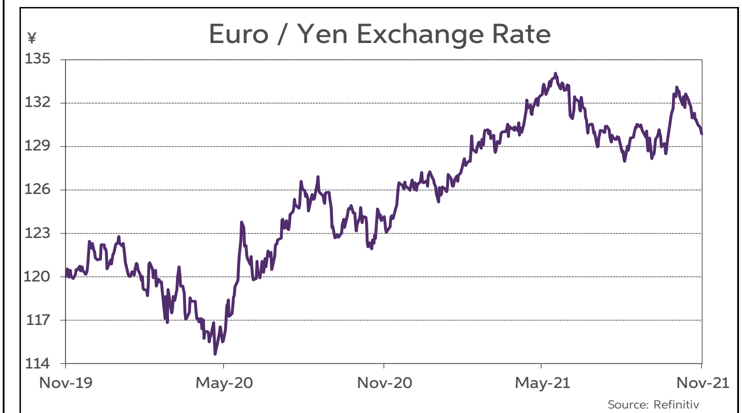
On the other hand, the recovery in the UK has lost a good deal of momentum since mid-year, as evident in the Q3 GDP data. There are concerns that global supply shortages in both goods and especially labour markets could be accentuated in the UK by the fact it is no longer in the Single Market or Customs Union. This may hold back the recovery in the economy and at the same time, add to inflationary pressures. Tightening monetary policy is usually supportive of a currency when an economy is experiencing relatively strong growth. However, this is not the case where rate rises are required to dampen down relatively high inflation.

Meanwhile, the specific risk of a 'hard-Brexit' has re-emerged. This is on the back of escalating tensions between the UK and EU regarding the Northern Ireland protocol in relation to customs requirements and the role of the ECJ. In a worst case scenario, these tensions could put at risk the FTA that was agreed in late 2020, which avoided a hard Brexit. At the very least, given that the current dispute is proving difficult to resolve, it provides a potential source of volatility for sterling. It is useful to note that during the period 2017-2020 when Brexit negotiations were on-going, EUR/GBP traded in an 88-92p range.

Overall, much uncertainty remains about the economic outlook in the UK. Thus, sterling could experience further volatility until a clearer picture emerges on the UK's economic and interest rates, as well as how the current UK/EU impasse over the NI protocol is resolved. Rate hikes, though, seem likely very soon in the UK, which should support sterling. The 83p level is a major level for the euro, which has not been overcome by sterling since the Brexit referendum in 2016. This support level may continue to hold, even with UK rate hikes.



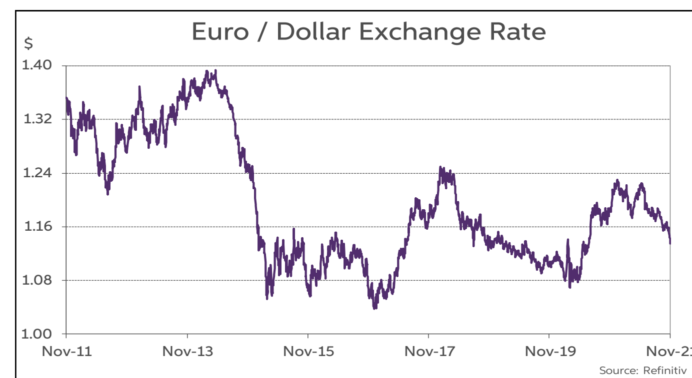



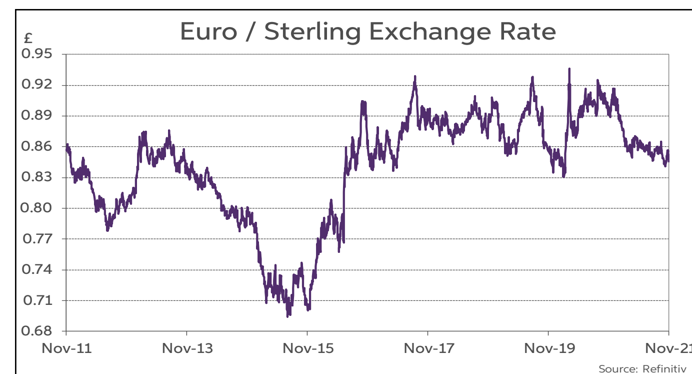



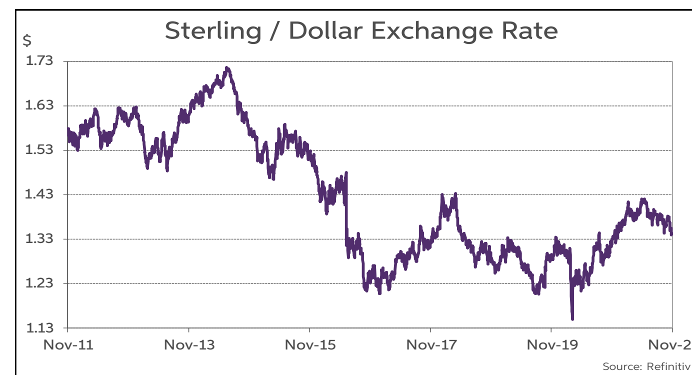
# Summary of Exchange Rate Forecasts

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

| Euro Versus | Current | Q4-2021 | Q1-2021 | Q2-2022 | Q3-2022 |
|---|---|---|---|---|---|
| USD | 1.131 | 1.09-1.15 | 1.08-1.14 | 1.08-1.14 | 1.08-1.14 |
| GBP | 0.839 | 0.81-0.87 | 0.80-0.86 | 0.80-0.86 | 0.80-0.86 |
| JPY | 129.43 | 126-132 | 126-132 | 127-133 | 127-133 |
| CHF | 1.05 | 1.05 | 1.05 | 1.04 | 1.04 |
| **US Dollar Versus** | | | | | |
| JPY | 114.47 | 112-118 | 113-119 | 114-120 | 114-120 |
| GBP | 1.347 | 1.30-1.36 | 1.31-1.37 | 1.31-1.37 | 1.31-1.37 |
| CAD | 1.26 | 1.27 | 1.28 | 1.28 | 1.28 |
| AUD | 0.73 | 0.72 | 0.71 | 0.71 | 0.71 |
| NZD | 0.70 | 0.69 | 0.68 | 0.68 | 0.68 |
| CNY | 6.38 | 6.35 | 6.30 | 6.30 | 6.30 |
| **Sterling Versus** | | | | | |
| JPY | 154 | 153 | 155 | 157 | 157 |
| CAD | 1.70 | 1.69 | 1.71 | 1.66 | 1.64 |
| AUD | 1.85 | 1.85 | 1.89 | 1.89 | 1.89 |
| NZD | 1.93 | 1.93 | 1.97 | 1.97 | 1.97 |

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