

# Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



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- Global economy appears to be losing momentum in the face of some considerable headwinds. US economy, though, continues to outperform, defying expectations of a slowdown
- Central banks seem to be at, or near the end of their hiking cycles. Both the Fed and BoE may raise rates by a further 25bps, while the ECB could well be done
- With inflation still well above the 2% target, and labour markets remaining tight, monetary policy is seen as staying restrictive in the next couple of years, with just limited rate cuts
- Dollar makes significant ground since mid-July against all currencies. Euro could see a breach of key €1.04 level in near term. Yen remains under pressure from very low Japanese rates
- Sterling loses some ground recently on a marked scaling back of UK rate hike expectations. However, it remains well within the 83-90p trading range versus euro evident since start of 2021

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## Sluggish growth forecast into 2024, with the risks to the downside

The latest quarterly update from the OECD on the outlook for the global economy was published in late September. In a downbeat assessment, it notes that the impact of tighter monetary policy is becoming increasingly visible, business and consumer confidence have turned down, and the rebound in China has faded. Thus, although there was a stronger than anticipated start to 2023, helped by lower energy prices, this is not expected to be sustained. GDP growth in 2023 and 2024 is projected to be sub-par, at 3.0% and 2.7%, respectively. Not only that, the OECD says the risks to the outlook remain tilted to the downside.

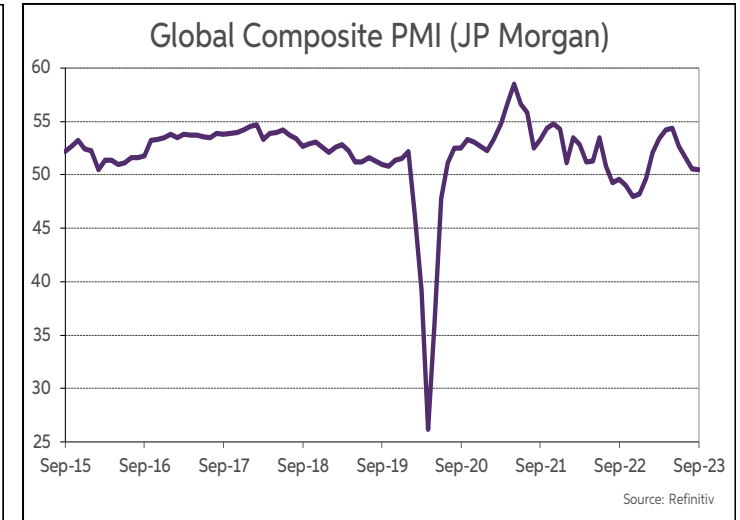
It comments that the primary reason for the subdued global growth outlook is the substantial monetary policy tightening that has been required to rein in inflation. The main message emanating from nearly all the policy meetings of the main central banks in the past few weeks has been, that while the tightening cycle may be close to, or at an end, interest rates are going to have to remain high for a considerable period of time to bring inflation back down to its 2% target. While headline CPI rates are declining, inflation pressures remain persistent in many economies, reflecting rising cost pressures and wages, as well as margin widening in some sectors.

However, it is not just a restrictive monetary policy stance and elevated inflation that are weighing on global growth prospects. Other factors are also at work, including the progress some large emerging economies, such as China and South Korea, have made in raising living standards, and thus are now moving into a more moderate growth phase of their development cycle. It also reflects weaker labour force growth, with many developed economies at full employment. Technological change is also slowing down.

Meanwhile, increasing geo-economic fragmentation, and growing protectionism with rising trade barriers, are 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. It all adds up to a challenging macro-economic environment. In addition, the lagged effects of the sharp increases in interest rates in 2022-23 have yet to fully impact economies, especially in relation to the refinancing of maturing term debt at much higher rates. The US is the one economy that continues to defy expectations of a slowdown in activity. GDP this year could well exceed the 2.1% rate recorded in 2022. Forecasters, though, continue to expect the US to slow next year under the weight of much higher interest rates.

Both the OECD and IMF have warned that higher interest rates could yet expose underlying financial vulnerabilities with potential for rising loan defaults, most notably in weaker low-income countries, where signs of debt distress are already evident. CRE markets remain under pressure which could lead to rising bad debts, putting stress on those lenders with significant exposure to the sector. More generally, if inflation proves more persistent than expected, it could lead to even higher interest rates than is currently priced into markets, putting further downward pressure on financial and real estate asset prices. Meanwhile, China's expected economic rebound this year has underwhelmed, amid ongoing problems in the real estate sector, private sector deleveraging and concerns about the stability of the banking sector.

Thus, it is still too early to conclude the global economy will emerge with little damage from the substantial tightening of monetary policy seen in the past couple of years and avoid a recession. The risks to the economic outlook remain to the downside so a close eye needs to be kept on leading indicators of activity.



GDP (Vol % Change)				
	2021	2022	2023 (f)	2024 (f)
World	6.3	3.3	3.0	2.7
Advanced Economies	5.4	2.7	1.5	1.4
US	5.9	2.1	2.2	1.3
Eurozone	5.3	3.4	0.6	1.1
UK	7.6	4.1	0.3	0.8
Japan	2.2	1.0	1.8	1.0
Emerging Economies	6.8	4.0	4.0	4.1
China	8.4	3.0	5.1	4.6
India	9.1	7.2	6.3	6.0
World Trade Growth (%)	10.7	5.2	2.0	3.7
Inflation -CPI				
Advanced Economies (%)	3.1	7.3	4.7	2.8

Sources: OECD Economic Outlook September 2023 & IMF World Economic Update July 2023

## Central banks guide that rates will need to remain high over next couple of years

After a near two year period characterised by aggressive monetary policy tightening, most central banks appear to be at or near the end of their rate hiking cycles. This period of rapid rate increases was against the backdrop of inflation rising to 10% or above in many economies last year and labour markets remaining tight. More recently, though, headline inflation has been on a downward trajectory. Monetary policy has also moved to a restrictive stance. Central banks are no longer giving clear signals that further rate hikes are in store and instead have moved to a “data-dependent” mode in terms of future monetary policy decisions. However, they have been dampening expectations of early rate cuts, while also indicating that policy will need to be kept tight for a considerable period to restore price stability given signs of more persistent inflationary pressures.

The Fed raised US rates by 25bps to a 5.25-5.50% range at the July FOMC meeting, and then as expected, left them unchanged at its September meeting. The median projection in the Fed’s September interest rate dot-plot shows that most FOMC members still anticipated that rates would have to be raised to a 5.50-5.75% range before end year, implying one further 25bps rate increase in the final quarter of 2023. The market has its doubts, though, and is only pricing in a 40% chance of a further hike in rates. Meanwhile, the market has greatly scaled back its expectations for rate cuts in 2024-25. Futures contracts point to rates being cut to 4.50-4.75% by end 2024 and to circa 4.0% by end 2025. In early summer, it was expected that rates would fall back to 3%. The September Fed dot-plot saw it raise its rate trajectory by 50bps for both 2024 and 2025 compared to June. It now sees rates remaining above 5% next year, before falling to just below 4% at end 2025. There has been a marked rise in US bond yields over the summer on the back of the hardening in US rate expectations.

The BoE raised rates by 25bps in early August following a 50bps hike in June, which brought the Bank rate up to 5.25%. The UK central bank then unexpectedly kept policy on hold at its September meeting in a tight 5-4 split vote, with the majority citing a much bigger than expected fall in inflation as the reason to leave rates unchanged. However, the MPC indicated a willingness to hike rates further if there is evidence of continuing persistent inflationary pressures. There has been a considerable softening in UK rate expectations over the summer, with the peak in rates seen at close to 6.5% in early July. Markets are assigning around a 60% probability that there will be one final rate hike over the winter that would take rates up to 5.5%. Meanwhile, rates are expected to remain high over the medium term in the UK. Futures contracts see rates falling only slightly next year, to around 5%, before declining by a further 50bps to 4.5% at end 2025 and then to around 4.25% by end 2026.

The ECB moved to a data-dependent mode in terms of future policy decisions during the summer, with considerable weight also given to its assessment of the inflation outlook. It hiked rates by a further 25bps at its September meeting, which brought the Deposit rate up to 4%. Headline inflation has declined sharply in the Eurozone, with core inflation now also beginning to decline. Thus, the ECB indicated at its September meeting that it believes that rates have now reached levels that if maintained for a sufficiently long period of time will have a substantial impact on inflation falling to its 2% target. Markets interpreted this as a signal that rates have most likely peaked. They are assigning only a 25% probability that rates will be hiked again. Further out, futures contracts are pricing that the ECB will cut rates by circa 75bps in 2024, most likely starting in July. A further 25bps cut is anticipated by mid-2025, taking the deposit rate down to 3.00%, with policy expected to be put on hold after that. Earlier in the summer, markets had priced in that rates would be cut to as low as 2.75% by 2026.

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

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	5.375	5.67	5.60	5.27	4.79
<b>Dec'23</b>	5.625	5.85	5.85	5.40	4.80
<b>Mar'24</b>	5.625	5.85	5.75	5.30	4.70
<b>June'24</b>	5.625	5.80	5.65	5.20	4.60

\* Swap Forecasts Beyond 1 Year

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

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	4.00	3.98	3.99	3.73	3.38
<b>Dec'23</b>	4.00	3.95	4.00	3.80	3.45
<b>Mar'24</b>	4.00	3.95	4.00	3.75	3.40
<b>June'24</b>	4.00	3.90	3.90	3.65	3.30

\* Swap Forecasts Beyond 1 Year

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

	Bank Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	5.25	5.41	5.60	5.32	4.90
<b>Dec'23</b>	5.50	5.60	5.80	5.50	4.95
<b>Mar'24</b>	5.50	5.60	5.75	5.45	4.90
<b>June'24</b>	5.50	5.55	5.65	5.35	4.80

\* Swap Forecasts Beyond 1 Year

## Renewed dollar strength as markets price in higher for longer US rates

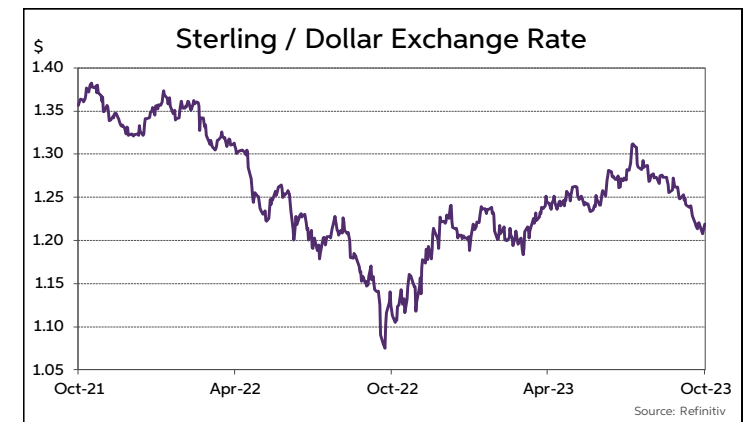
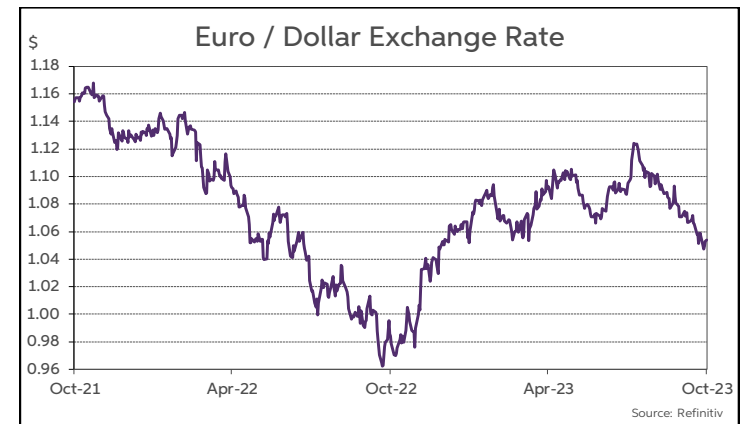
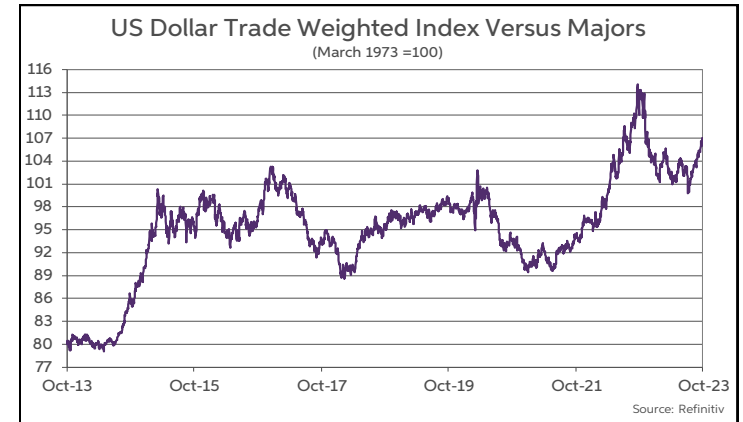
Although the US dollar has retreated from last year's peaks, which saw it reach its highest point on a trade-weighted basis in 20 years, it has remained at elevated levels in 2023. Indeed, it has made gains over the past three months, recovering the ground lost in the first half of the year. EUR/USD has largely moved in a \$1.05-1.12 corridor so far this year, but is now testing the lower bound of this trading range. Meantime, sterling has traded in a \$1.21-1.31 band versus the dollar since mid-March and is also testing the bottom of this range. The dollar is also testing its twelve month high of ¥150 against the Japanese currency. Thus, a number of key currencies are at crucial support levels against the dollar, which if they give way could open the path to a further significant rise in the greenback. It should be noted that these currencies are already at very low levels against the dollar in the context of their trading ranges for most of the last twenty years. Similarly, the Australian, New Zealand and Canadian dollars, as well as the Chinese yuan, are also trading at weak levels against the US currency,

The recent strengthening of the dollar is very much linked to the ongoing impressive performance of the US economy and associated elevated level of US interest rates. US data have generally surprised to the upside in 2023. The anticipated slowdown in the economy has not materialised to date. Indeed, GDP growth this year is on course surpass 2%. Meantime, the labour market remains very tight, with the jobless rate close to fifty year lows amid strong growth in employment. Against this backdrop, the Fed has hiked rates by 525bps to a 5.25-5.5% range, while indicating it could deliver a further 25bps rate increase before the end of the year.

More importantly, though, the Fed is guiding that it will need to maintain a tight monetary policy stance for an extended period of time to return inflation to its 2% target. The latest Fed dot-plot shows that it expects to keep rates at above 5% in 2024. Futures contracts show markets are now pricing in that rates will be cut to 4.75% by end 2024 and to around 4% by end 2025. In early summer, it was expected that US rates would fall back to 3%. This hardening of interest rate expectations has put significant upward pressure on US bond yields in recent months. Two-year Treasury yields have risen to over 5%, while ten-year yields have climbed by 100bps over the summer, hitting 4.88%, their highest level since 2007.

In contrast to the US, both the Eurozone and UK economies have struggled over the past year, narrowly avoiding recession. Indeed, while US GDP grew 2.6% year-on-year in Q2, growth in the Eurozone and UK was running at circa 0.5% year-on-year. Eurozone interest rates looked to have reached a peak at 4%, well below those in the US, while there has been a marked scaling back of rate hike expectations in the UK. It may well be that BoE rates could have already reached a peak at 5.25%, though markets are anticipating one further hike.

In terms of the euro, \$1.04 is a crucial support level for it against the dollar. When this has given way in the past, it has triggered a fall to below parity for EUR/USD. Further strong US data or a Fed rate hike before year end could result in a major test of this support level. Fed policy, though, would likely be put on hold after another rate rise. Furthermore, the market is no longer short the dollar. Thus, the dollar may not sustain a breach of \$1.04. Further out, the performance of EUR/USD in 2024 will likely be heavily influenced by the timing and scale of any monetary policy easing in either jurisdiction. In particular, the dollar is only likely to lose ground where there is Fed easing that results in a narrowing of the current wide interest rate spread between the two currencies. This looks a long way off at present, pointing to the dollar remaining at elevated levels in the early part of next year at least.



## *Sterling supported in 2023 by high BoE rates and improved UK data*

Sterling endured a difficult 2022 largely owing to concerns about the UK economy. Against a buoyant dollar, sterling fell sharply to a record low below \$1.04 last September, following a badly received expansionary ‘mini-budget’, while EUR/GBP briefly moved above the 90p level. Sterling, though, has regained significant ground in the past year, aided by better than expected UK data, with the economy avoiding the recession that had been widely predicted to occur this year. At the same time, the rise in BoE rates to 5.25%, has also supported the currency.

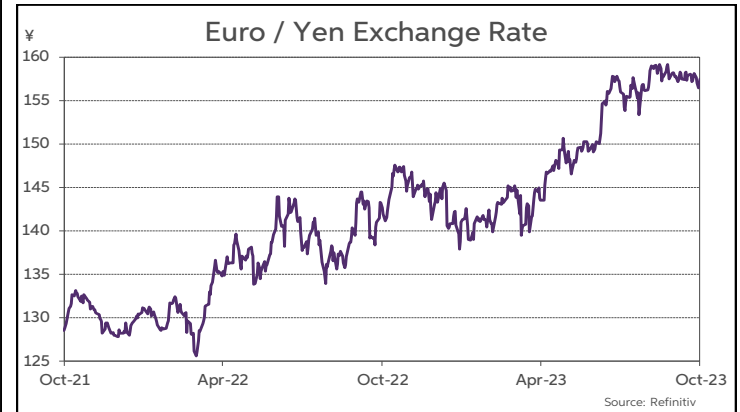
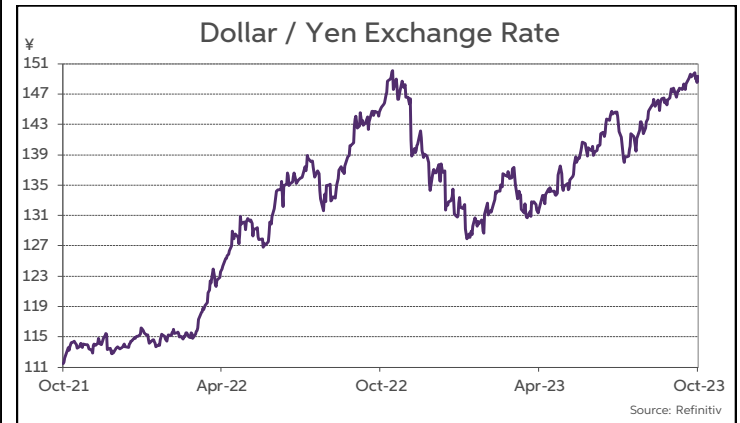
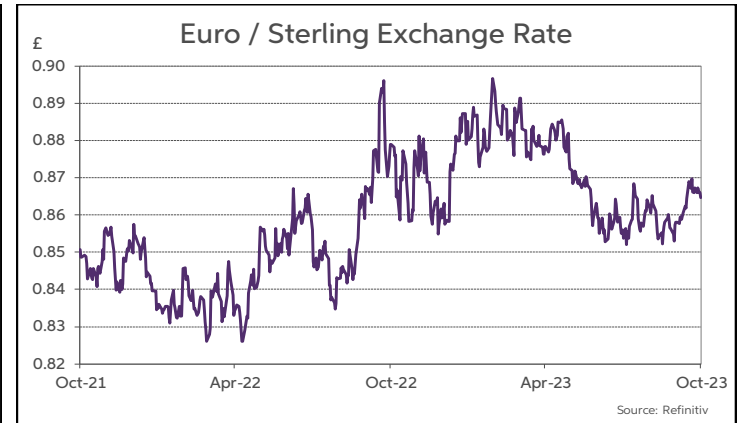
Sterling’s recovery has seen EUR/GBP edge downwards from the 87-89p range it occupied in the opening months of this year, to trade in a 85-87p corridor over the summer. As already mentioned, BoE policy tightening has been providing support for sterling. However, sterling has lost some ground to the euro in September on a significant scaling back of rate hike expectations in the UK. Rates are now seen as peaking at either 5.25% or 5.50% compared, to close to 6.50% back in July. Meanwhile, sterling has lost considerable ground to the buoyant dollar since July, with cable falling back below to near \$1.20 from \$1.31, its lowest level since March. There is strong support for sterling at both the \$1.20 and \$1.18 levels, which could be tested in the coming months.

Markets are assigning around a 60% probability that there could be one final 25bps hike from the BoE this winter, which would take rates up to 5.50%. UK rates are expected to remain at a high level over the next couple of years, which should be supportive of the currency. The Bank rate is seen at around 5.0% at end 2024 and 4.50% by end 2025. Meantime, the latest positioning data shows the market is no longer stretched long the pound. Thus, sterling could be steady in the next couple of months, especially if expectations for a further rate hike remain in place. Further out, moves in interest rates are likely to be the key factor impacting sterling in 2024. The BoE is predicting a sharp fall in inflation over the next two years to below 2%. If this saw it cut rates to a greater extent than priced in by markets to support the weak economy, then sterling would likely lose ground.

## *Continuing dovish policy stance by BoJ weighing on yen*

In marked contrast to other central banks, the BoJ has continued with its very accommodative monetary policy. This resulted in the yen falling to a 30-year low against the US currency last autumn, with the dollar rising above the ¥150 level. The yen moved off its lows late last year, helped by the BoJ unexpectedly widening the yield corridor for ten year JGBs in December, effectively allowing them to rise by 25bps. This saw the USD/JPY rate fall back below ¥130 by January as markets anticipated a shift away for a very accommodative monetary policy.

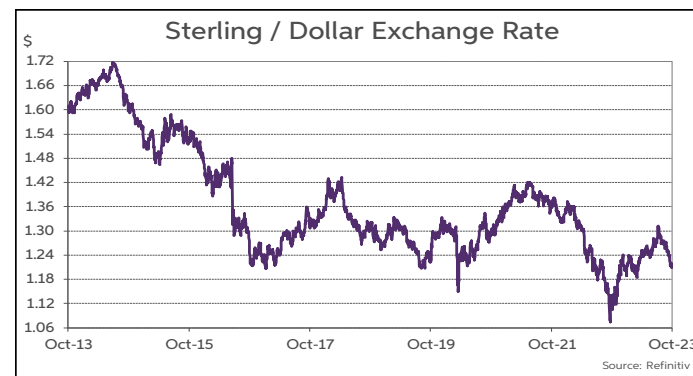
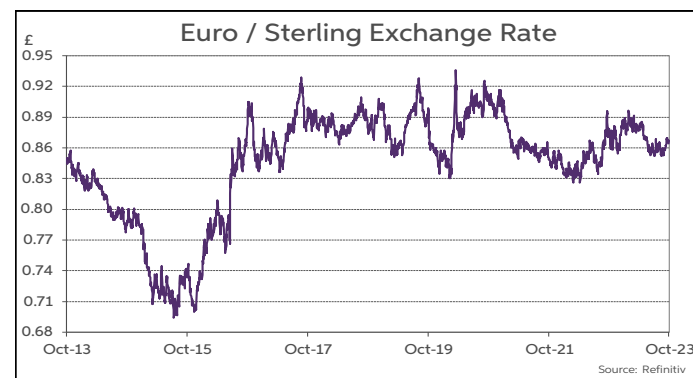
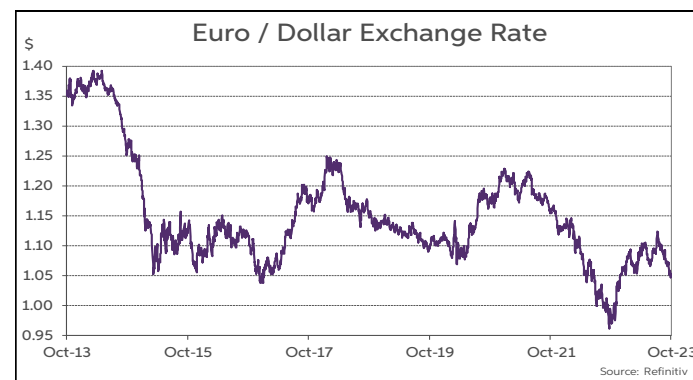
However, the BoJ under its new Governor, Ueda, continues to espouse a dovish outlook on policy. This has seen renewed yen weakness in 2023. The dollar has risen back up to ¥150 recently, while the euro is at fifteen year highs, near the ¥160 level, even though the BoJ permitted a further rise in the cap on ten year yields in July. Overall, though, BoJ monetary policy remains very loose and is thus continuing to act as a major headwind for the currency. A major shift in policy, such as the abolition of the yield control corridor or a hike in the official interest rate which is still in negative territory, does not seem imminent. Until BoJ monetary policy is altered or rates are cut elsewhere, the yen is likely to remain a very weak currency. However, we could see some tightening of BoJ policy in 2024 as well as rate cuts elsewhere, which would form the basis for a rebound by the yen next year.



# Summary of Exchange Rate Forecasts

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

	Current	Q4-2023	Q1-2024	Q2-2024	Q3-2024
<b>Euro Versus</b>					
<b>USD</b>	1.052	1.02-1.08	1.03-1.09	1.05-1.11	1.07-1.13
<b>GBP</b>	0.864	0.84-0.90	0.84-0.90	0.84-0.90	0.84-0.90
<b>JPY</b>	156.93	152-158	150-156	148-154	147-153
<b>CHF</b>	0.96	0.96	0.97	0.98	0.99
<b>US Dollar Versus</b>					
<b>JPY</b>	149.13	145-151	141-147	137-143	133-139
<b>GBP</b>	1.218	1.18-1.24	1.19-1.25	1.21-1.27	1.23-1.29
<b>CAD</b>	1.37	1.36	1.35	1.33	1.31
<b>AUD</b>	0.64	0.64	0.65	0.66	0.67
<b>NZD</b>	0.60	0.60	0.61	0.62	0.63
<b>CNY</b>	7.29	7.30	7.25	7.20	7.10
<b>Sterling Versus</b>					
<b>JPY</b>	182	179	176	174	171
<b>CAD</b>	1.66	1.64	1.64	1.65	1.66
<b>AUD</b>	1.91	1.89	1.88	1.88	1.88
<b>NZD</b>	2.04	2.02	2.00	2.00	2.00



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