

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



20th April 2026

- Economic outlook thrown into uncertainty with escalation of war in Iran. Temporary disruption will dent growth and boost inflation, with risk of more prolonged and damaging conflict
- US economy more insulated to shocks, with Eurozone and UK exposed to global energy volatility
- Central banks held in March and delivered hawkish rhetoric. Market has repriced for higher rates, but central bankers have been sounding more dovish of late, and we expect hold/cuts in near term.
- Geopolitics temporarily supporting dollar, but Fed policy, AI and labour markets will return to the fore post conflict
- Further modest upside for the euro, while sterling could remain on the defensive amid geopolitical uncertainty

David McNamara
Chief Economist

John Fahey
Senior Economist

Daniel Noonan
Economist

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

Economic outlook highly uncertain amid Middle East conflict

The current energy shock is focused on oil, 2022 was centred on gas supply

While there are clear parallels today with the energy crisis of 2022, that shock was centred on supply from a single country, Russia, which is a smaller player in global markets (<5% of global oil output) than the output from the Middle East (>20%). Nevertheless, Russia was the main supplier of gas to Europe prior to 2022, leading to a surge in consumer prices following the invasion of Ukraine. This has now been replaced by LNG, predominately from the US.

Oil prices have touched \$120 per barrel post the Iran war

The current oil price surge is similar to 2022, reaching a recent peak of \$120/barrel (2022 peak: \$130). However, European natural gas prices remain at a fraction of the peaks reached in 2022. Since the beginning of the war, gas prices have ranged between €40-60/kwh, compared to a peak of €350/kwh in 2022. This is one of the factors why inflation is unlikely to reach the double-digit ranges seen in 2022, alongside weaker second-round price pressures.

Risk of broader supply shock beyond energy

The shock is not confined to energy. More than 30% of global urea fertiliser moves through the Strait of Hormuz, along with about 20% of ammonia and phosphate. This creates risks for agriculture and food security. Additionally, the Gulf region produces around 8% of the global supply of aluminium, which is used in construction and manufacturing. Shortages in these and other commodities pose broader inflation risks.

Bond markets unlikely to stomach 2022-style Gov. spending pledges

In 2022-23, European Government spent 3% of GDP on energy supports

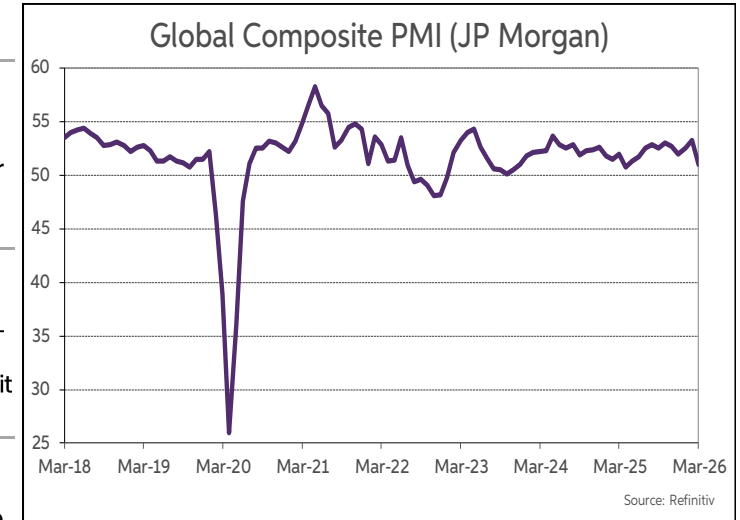
In 2022-23, analysis by the IMF showed European governments spent, on average, nearly 3% of GDP on energy supports. In the UK and Ireland, the figure was 4.5% of GDP/GNI*. According to the OECD, in the median G20 economy, government debt has risen by close to 40% of GDP since 2007, with a significant chunk of this debt built up since 2020. Other spending demands have also recently emerged, such as defence, and are now adding to fiscal pressures from longer-term trends, including ageing populations and climate change. These pressures are now crystallising in rising sovereign bond yields.

Higher rates and weak growth mean European governments will be unable to offset an inflation shock

With many European governments running substantial fiscal deficits and debt, most do not have the fiscal space to repeat the supports of 2022. Interest rates are structurally higher today, and growth is broadly weak. In particular, government bond yields have surged for countries with a combination of high public debt, and a heavy reliance on energy imports (France, UK, Italy).

Second-round effects are expected to be less than 2022 as the labour market is looser and wage growth weaker

We expect some modest second-round effects on non-energy inflation and wages, although our assumption is that these pressures will be more modest than occurred following the energy shock in 2022. This is primarily due to softer trends in the labour market, with less job vacancies and wage bargaining power at present in the economy. The economy is also in a relatively more balanced position than in 2022, when demand was surging post the re-opening of all sectors after the pandemic.



GDP (Vol % Change)

	2024	2025 (e)	2026 (f)	2027 (f)
World	3.3	3.4	3.1	3.2
Advanced Economies	1.8	1.9	1.8	1.7
US	2.8	2.1	2.3	2.1
Eurozone	0.9	1.4	1.1	1.2
UK	1.1	1.4	0.8	1.3
Japan	-0.2	1.2	0.7	0.6
Emerging Economies				
China	5.0	5.0	4.4	4.0
India	6.5	7.6	6.5	6.5
World Trade Growth (%)	3.6	5.1	2.8	3.8
Inflation -CPI				
Advanced Economies (%)	2.6	2.5	2.8	2.2

Sources: IMF Economic Outlook Update, April 2026

Interest Rate Outlook

Significant hawkish shift in market rate expectations

Inflation risks from Middle East conflict creates new complication for central banks.

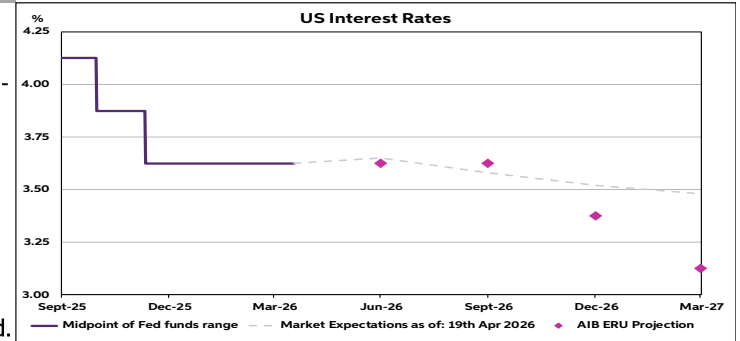
Most of the main Central Banks came into 2026 with a bias to cut rates further or to maintain rates at low levels. Central banks were already operating in a volatile global policy environment amid the trade-related uncertainty that developed over the course of 2025, as the new US administration overhauled their trade policy with the introduction of tariffs. Futures market were anticipating further rate cuts this year. However, the Middle East conflict and the potential inflationary shock arising from this, has had a significant impact on both market rate expectations and central bank's own mindset regarding potential policy changes. The outlook for rates is now very much linked to the duration/extent of the war.

	Interest Rate Forecasts				
	Current	End Q2	End Q3	End Q4	End Q1
		2026	2026	2026	2027
Fed Funds	3.625	3.625	3.625	3.375	3.125
ECB Deposit	2.00	2.00	2.00	2.00	2.00
BoE Repo	3.75	3.75	3.75	3.50	3.25

Current Rates Reuters, Forecasts AIB's ERU

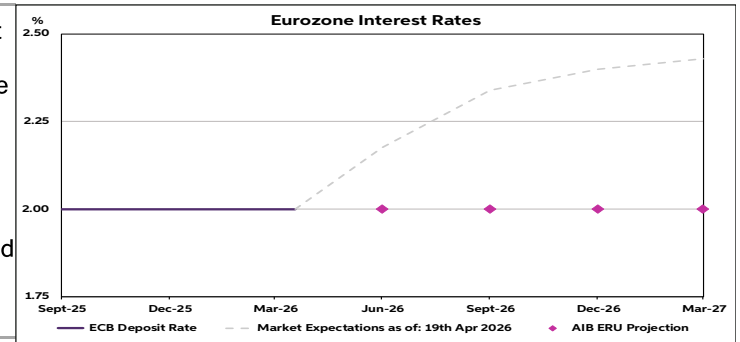
Fed retains an easing bias, but on hold for now amid war in the Middle East

The Fed left rates on hold in a 3.50-3.75% in March, as expected. The Fed has cut rates, so far, by a total of 175bps (most recent cut was Dec'25). Its updated dotplot continued to show just one rate cut for 2026 and 2027. At the press conference, Chair Powell refrained from offering any guidance on the future path of rates amid the conflict in the Middle East. However, subsequent to this, he did remark that inflation expectations remain well anchored, suggesting he is not contemplating any near term rate hikes. An additional issue to factor in for the Fed's outlook is the new Chair, Kevin Warsh, who could be in place by mid-year and favours lower rates. Our view is that the Fed is likely to remain on hold for now, awaiting developments in the Middle East. However, it could look to cut rates in the second half of the year, by at least 25bps, and potentially by more under a new, more dovish, Chair. Market is pricing in c.15bps of cuts by year end.



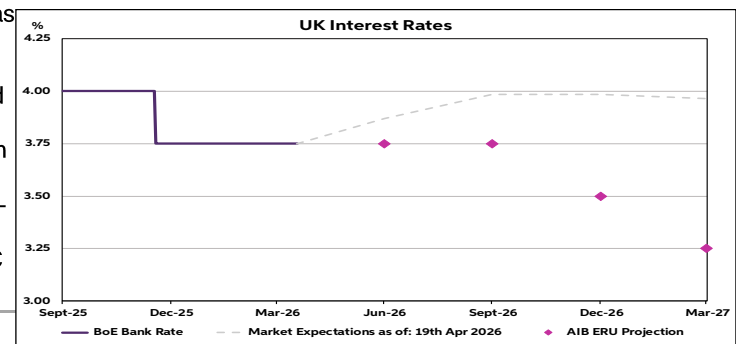
ECB has not ruled out rate hikes but no changes expected in April

The ECB has maintained the Depo rate at 2.00% for six consecutive meetings. It had cut rates by a total of 200bps during its easing cycle. President Lagarde comments indicate that the ECB is content to remain in a "wait and see" posture for now, while not ruling out some policy tightening if oil prices remain elevated. Futures contracts at one stage in March were pricing in an aggressive 75bps of hikes. They have since re-priced to around 45-50bps of tightening. Some more recent ECB speakers have sounded less hawkish on rates. We are leaning towards the ECB being able to hold off raising rates on the key assumption of a 'sooner- than-later' resolution to the Middle East war. If the conflict escalates and becomes more prolonged than the ECB could hike rates, but they are likely to wait until mid-year, before implementing such a policy.



BoE has tried to talk down market rate hike expectations

The BoE kept the Bank rate unaltered at 3.75% in March. For a change, there was unanimity within the MPC on its policy decision. It has so far cut rates by a total of 150bps. The March statement no longer referenced the possibility that "Bank rate is likely to be reduced further", while the minutes noted that the MPC would be alert to the "increase risk of domestic inflationary pressures through second round effects in wage and price setting". UK market rate expectations went from pricing in around 50bps of cuts to around 75bps of hikes. However, subsequent to the March meeting, Governor Bailey has twice tried to push back against market rate pricing. There is currently c.30bps of tightening priced-in. We see the BoE remaining on hold over the coming months and would not rule out the MPC cutting rates again before year end if inflationary pressures subside.



Dollar has benefited from higher energy prices

Dollar has benefitted from current conflict and energy price surge

The dollar has seen renewed gains since the Middle East conflict, with the trade-weighted DXY index gaining 3% by end-March. Against the euro, the dollar gained similar ground in March, but has given back most of these gains, as markets have begun to price in a near-term cessation of the conflict. While benefitting from the terms of trade boost of higher oil prices, it appears the 'safe-haven' flows to the greenback have been weaker than in previous cycles, reflected in higher Treasury yields post the conflict.

An enduring conflict could be a boost to dollar in near term..

While we factor into our forecasts the conflict de-escalating on the back of the ceasefire with Iran and Lebanon, there are clearly risks of a further bout of hostilities, while the Strait of Hormuz remains blockaded. A more adverse scenario of a sustained war and energy price shock, would likely be a boost for the dollar in the short term.

..but risks still to the downside for the greenback in the medium term

There remain obvious structural risks to the downside for the dollar, which should come back to the fore post the Middle East conflict. The policy trajectory of the Fed could be a key driver here, with a new dovish Chair expected in to be situ by mid-year. The strength of the US economy will be in focus, with clear signs of a slow down in the labour market, and growth becoming increasingly reliant on AI. Finally, the political noise from the White House could provide an unhelpful backdrop for the currency in the run up to US mid term elections. This could spur a more sustained break above \$1.20 vs. the euro, reflected in a top end of our range at \$1.23 for year-end.

Europe more exposed to energy shocks, ECB will be key for euro

Europe highly exposed to energy shock

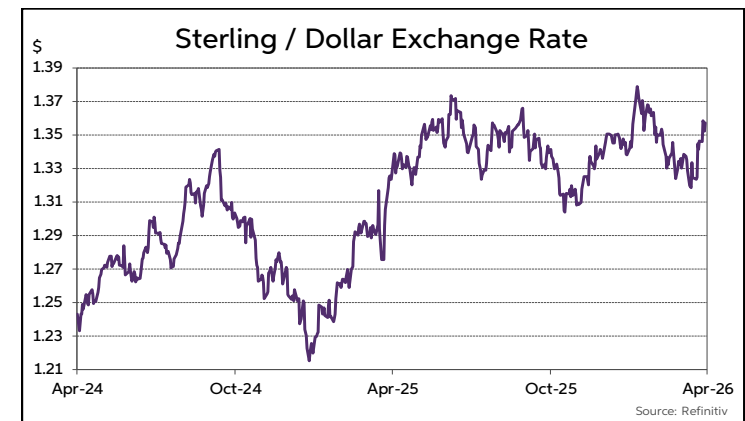
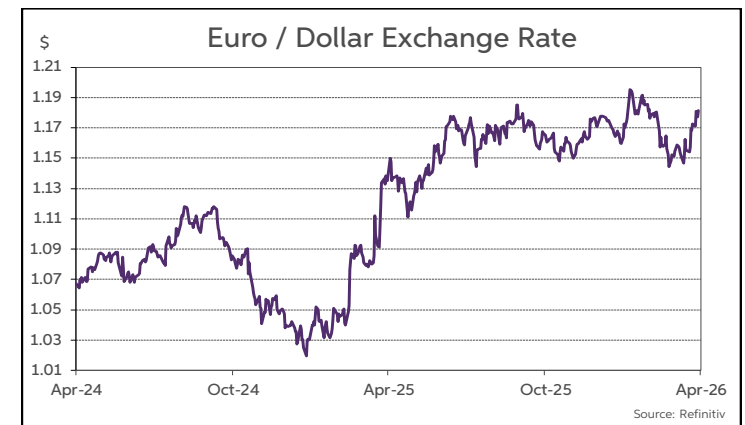
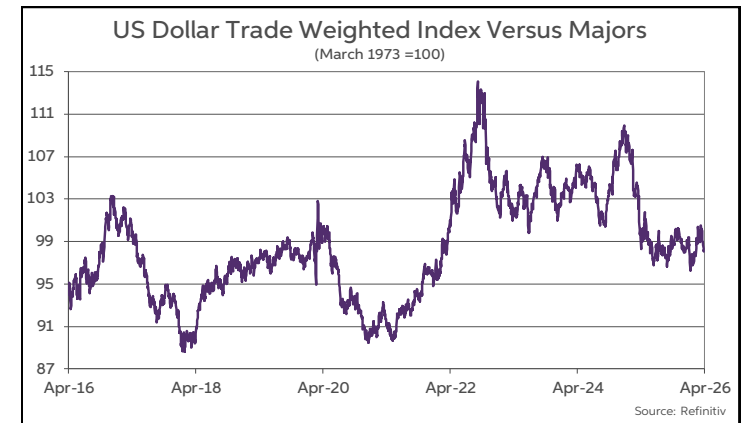
With most European countries net importers of energy, the current shock to oil prices is expected to feed through quickly to consumer prices, with inflation expected to peak around 4% in the Eurozone later this year, with risks to the upside. In that context markets have priced in between 50-75bps of hikes by the ECB since the beginning of March, trimming bets back of late.

ECB in wait-and-see mode for now

President Lagarde's comments since the conflict began suggest the ECB is happy to remain in a 'wait-and-see' position for now, with her comments emphasising both "risks to the downside" for growth, alongside "upside" risks to inflation. She also stated the ECB starts from a "good place" in terms of inflation and a deposit rate at 2%. We expect the ECB to remain on hold in 2026, while noting the risks are clearly to the upside on rates.

Euro to make further modest gains against the dollar

We expect the euro to make modest gains versus the dollar in 2026 as fundamentals reassert themselves post the conflict. We expect the pair to move from the current \$1.17-1.18 range to \$1.20 by year-end. However, risks are clearly to the downside if we see a more prolonged conflict, which would likely boost the dollar in 2026.



UK particularly exposed to energy shock amid fragile fiscal space

Sterling under pressure as energy price shock hampers UK growth

Sterling and gilts have lost ground recently as surging energy prices have dampened the UK economic outlook. Meanwhile, the available hard data for the first quarter of the year were broadly positive. The GDP grew a solid 0.5% in the three months to February, beating expectations. However, the outlook has darkened amid the current uncertainty, particularly as the Bank of England has failed to fully stamp out the previous inflation shock, with annual CPI at 3% in February, ahead of the war.

BoE set to resume easing cycle in a scenario of easing geopolitical tensions later this year

The BoE held rates in March with unanimous vote and hawkish statement. Governor Bailey has walked back these sentiments since, dampening market expectations of hikes. Our expectation is for the BoE to potentially resume its easing cycle in 2026, which is more front-loaded than the market is currently pricing in. This, combined with weak current GDP growth prospects, could act as a drag on sterling in the near term, particularly against the euro.

Sterling to remain close to current levels in the near term, risks to downside

Sterling is expected to be modestly lower through 2026 versus the euro. However, the pair is likely to remain largely range-bound as relative macro fundamentals are unlikely to drive a notable break-out from the current range. EUR/GBP is expected to move towards 88p by Q4 2026, with risks of a sharper rise if the geopolitical situation deteriorates. We see the potential for GBP/USD to hold at around \$1.36 through 2026, reflecting dollar weakness.

Japan highly exposed to energy shock, dampening yen

Yen has weakened on the back of the Middle East conflict

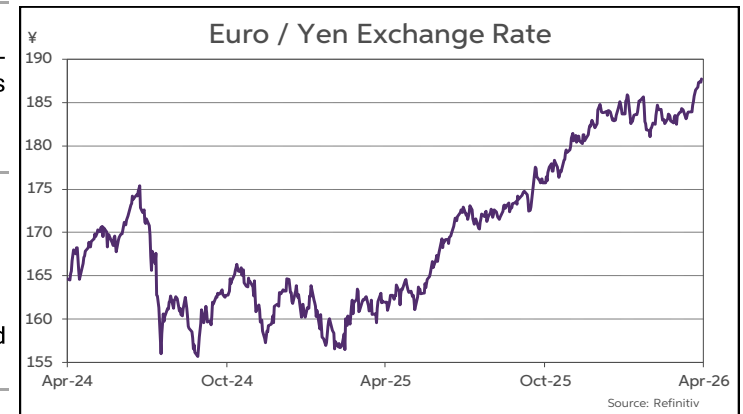
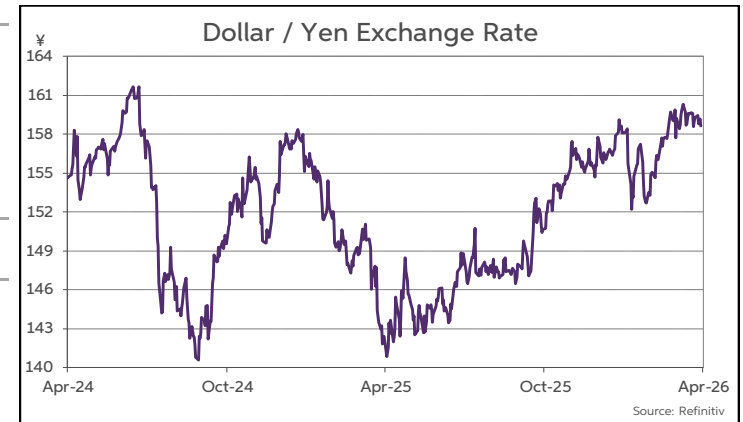
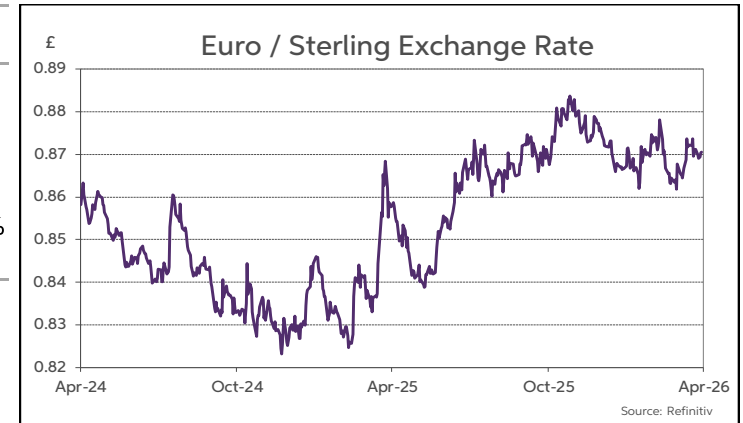
The yen has traded in a wide range recently most recently driven by a shift towards expansionary fiscal policy and the impact of the energy shock on the large net-importer. Since the beginning of March the yen is down near 2% versus the euro and dollar, with JPY/USD nearing the traditional 'pain point' of ¥160 at which authorities have intervened to support the currency.

Further central bank hikes should be supportive to the currency

However, the Bank of Japan (BoJ) is expected to raise rates further in 2026, dampening the effects of expansionary fiscal policy, and any lingering inflationary pressures. Markets are pricing in c.50 bps of hikes by the BoJ in 2026. This should provide a supportive backdrop for the currency as the post-conflict phase.

Yen expected to strengthen slightly in the near term

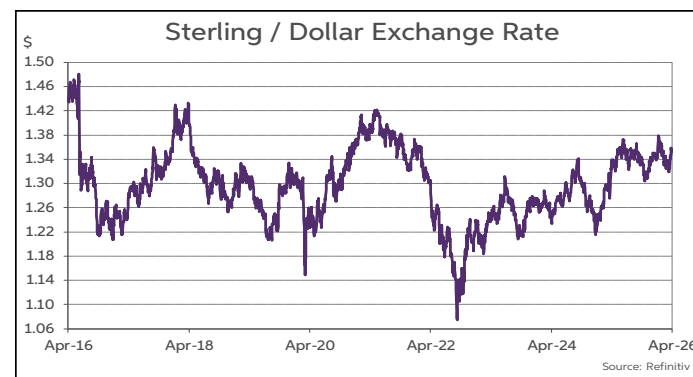
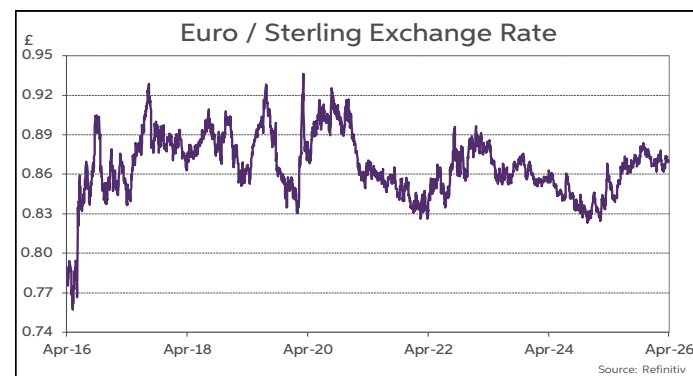
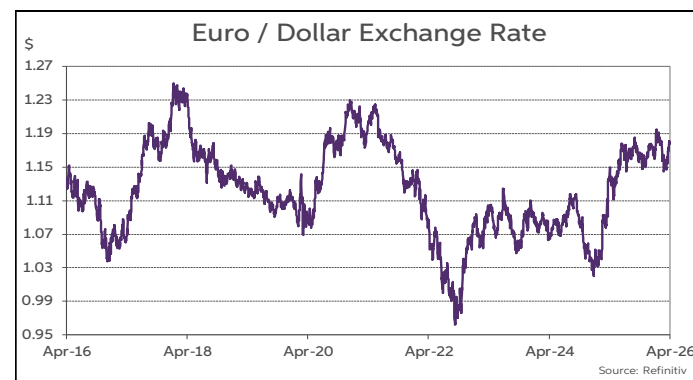
The yen is expected to appreciate modestly as political uncertainty recedes post election. We see the currency strengthening towards a range of ¥152-157 by Q4 2026 versus the dollar, from the current ¥158-160 corridor. Versus the euro, the currency is expected to remain relatively static, trading in the ¥183-189 range out to Q4-2026. BoJ rates will be a key catalyst, with current sticky inflation raising the risk of more rate hikes than currently priced in, which could support the currency further.



Summary of Exchange Rate Forecasts

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

	Current	Q2-2026	Q3-2026	Q4-2026	Q1-2027
Euro Versus					
USD	1.177	1.15-1.21	1.16-1.22	1.17-1.23	1.17-1.23
GBP	0.870	0.84-0.90	0.85-0.91	0.85-0.91	0.85-0.91
JPY	186.9	182-188	184-190	184-190	183-190
CHF	0.92	0.92	0.93	0.94	0.95
US Dollar Versus					
JPY	158.7	154-160	154-160	153-159	152-158
GBP	1.353	1.33-1.39	1.32-1.38	1.33-1.39	1.33-1.39
CAD	1.37	1.36	1.35	1.35	1.35
AUD	0.72	0.71	0.71	0.72	0.72
NZD	0.59	0.59	0.60	0.61	0.61
CNY	6.82	6.90	6.90	6.90	6.90
Sterling Versus					
JPY	215	213	212	213	211
CAD	1.85	1.84	1.83	1.84	1.84
AUD	1.89	1.91	1.90	1.89	1.89
NZD	2.30	2.30	2.25	2.24	2.24



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