

Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit



30th August 2024

- World economy continues to exhibit resilience. However, subdued growth evident again in 2024, with US outperformance starting to wane, UK accelerating, and Eurozone flagging
- Core inflation remains sticky in some markets, particularly the UK, with consumer spending underpinning high core inflation, however, headline inflation is now close to target in all markets
- Central banks have initiated rate cutting, but remain cautious on the future path of interest rates
- Main currency pairs exhibiting some volatility as central bank policy diverged. Dollar has weakened of late as economic growth has softened
- Expectation is for the dollar to weaken modestly from current high levels versus other majors

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Global Economic Outlook

Global growth picture modest but fragile

Modest, but fragile global growth

Economic data continue to signal modest global growth and easing inflation in recent months. Recent PMI surveys, while still pointing to growth, suggest the global economic picture has lost some momentum in recent months. At the same time, inflation continues to ease across all major economies, building the case for near-term rate cuts by central banks.

US growth slowing from exceptional pace of 2022-23

Having confounded pessimistic expectations last year, growing by 2.5%, US GDP expanded at a similar robust pace in H1 2024. However, there have also been signs that labour market conditions are starting to ease. Unemployment has ticked higher in recent months and payrolls growth has slowed, suggesting the lagged effects of tight monetary policy are finally being felt in the US labour market.

Data signal **up-turn in UK, but weak picture in Eurozone**

The UK economy has bounced back following a shallow recession in 2023. The most recent macro data have been broadly positive, with GDP for Q2 registering a 0.6% increase on a quarterly basis, and rising 0.9% y/y. The Eurozone economy remains on a weak growth trajectory, despite GDP growth picking-up in the first half of 2024. In Q1 and Q2 2024, GDP grew by 0.3% q/q. However, recent Eurozone data signal sagging growth momentum in the currency bloc, including PMI surveys for July and August.

Risks to the outlook focused on geo-political risks

Risks to the outlook tilted to the downside

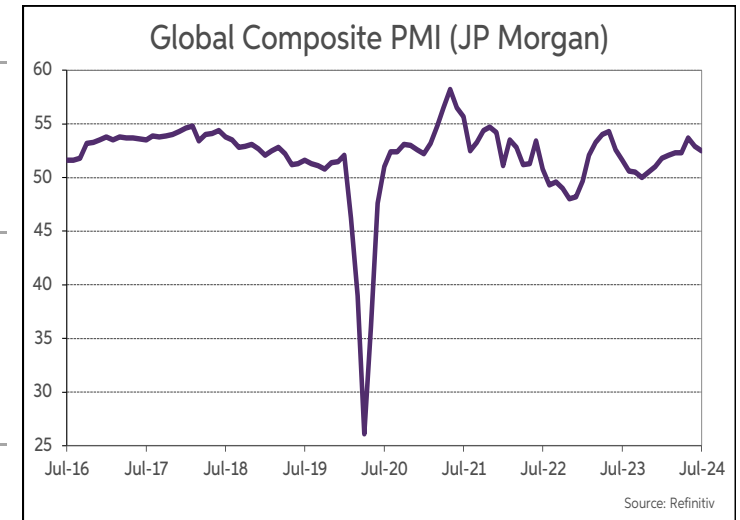
While global growth is expected at a modest c.3% in 2024 & 2025, the IMF & OECD note significant downside risks to the outlook, including current geo-political tensions and sticky inflation. The IMF, in its July 2024 update, indicated that *“Upside risks to inflation have increased, raising the prospect of higher-for-even-longer interest rates, in the context of escalating trade tensions and increased policy uncertainty”*.

Geopolitics the key downside risk to the growth and inflation outlook..

Geopolitical risks remain historically elevated, primarily due to ongoing tensions in the Middle East. These risks would likely materialise directly through a spike in commodity prices and inflation and indirectly through a decline in consumer and business sentiment, which would dampen GDP and labour market growth.

..and the lagged effects of central bank rate hikes

Another key near-term risk is a policy error by central banks in their desire to bring core inflation back down to target by keeping rates at too restrictive a level. There remains a risk that the ECB proceeds too slowly, dampening growth further in the Eurozone. This is also a risk for the US economy, with indicators pointing to slower growth amid a restrictive monetary policy stance by the Fed.



GDP (Vol % Change)				
	2022	2023	2024 (f)	2025 (f)
World	3.5	3.3	3.2	3.3
Advanced Economies	2.6	1.7	1.7	1.8
US	1.9	2.5	2.6	1.9
Eurozone	3.4	0.5	0.9	1.5
UK	4.3	0.1	0.7	1.5
Japan	1.0	1.9	0.7	1.0
Emerging Economies	4.1	4.4	4.3	4.3
China	3.0	5.2	5.0	4.5
India	7.2	8.2	7.0	6.5
World Trade Growth (%)	5.6	0.8	3.1	3.4
Inflation -CPI				
Advanced Economies (%)	7.3	4.6	2.7	2.1

Sources: IMF World Economic Outlook July 2024

Interest Rate Outlook

More central banks starting to cut rates

Rate cuts becoming more common among some of the main central banks

Over the summer, some of the main central banks have started to cut interest rates, or given an indication that rate cuts are imminent. They have become more confident of the downtrend in inflation while also being cognisant of the risks to growth. The ECB cut rates in June, followed by the BoE in August, while the Fed has given strong indications that a rate cut is on the cards for September. The one outlier, the BoJ hiked rates for a second time in August.

US Fed guides rate cut on the cards for September FOMC

As expected, the US Fed kept the funds rate in a 5.25%-5.50% range in August. However, Fed Chair Powell's press conference was dovish in tone, referencing the possibility of a rate cut in September. The subsequent meeting minutes had a strong dovish bias, noting that the "vast majority" of FOMC members think that "it would be likely appropriate to ease policy at the next meeting". This scenario was solidified by Fed Chair Powell's 'Jackson Hole' speech where he stated that the "time has come for policy to adjust" amid the cooling in the labour market and downtrend in inflation. However, he offered little insight on the size. The market is currently attaching a 70% probability to a 50bps cut in September, with around 100bps in total priced by year end.

ECB started on its easing path, with June rate cut and more to come

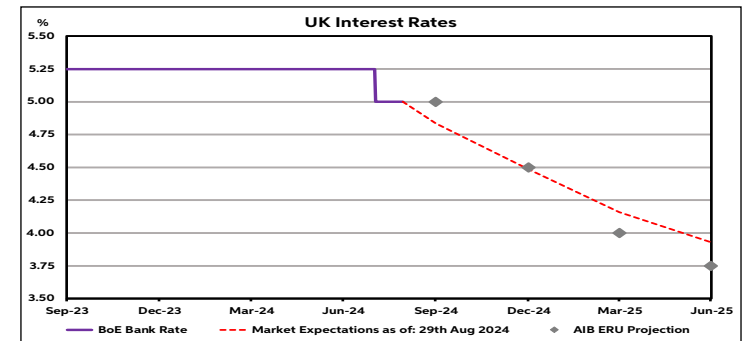
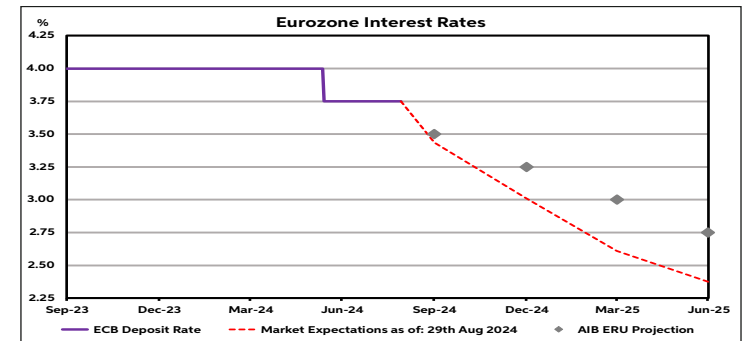
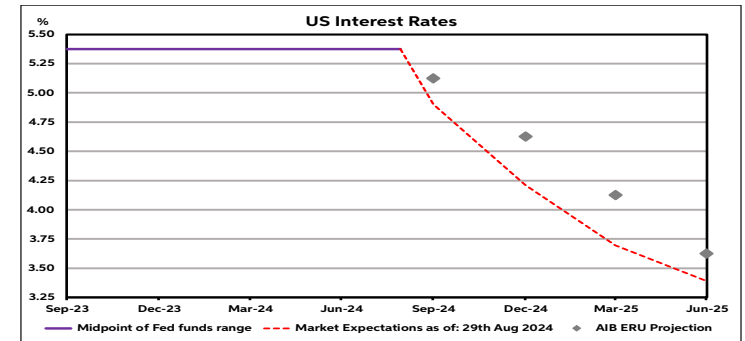
The ECB left its key deposit rate on hold at 3.75% at its most recent meeting in July. This followed a 25bps rate cut in June, its first rate change in six meetings. It continued to state that it will follow a "data-dependent and meeting-by-meeting approach" to determining the appropriate interest rate setting. It also re-emphasised that it is not "pre-committing to a particular rate path". The meeting 'account' though suggested at the possibility of a rate cut in September, with the text noting that this meeting was "widely seen as a good time to re-evaluate monetary policy". Futures contracts indicate the market is fully pricing in a 25bps cut in September. Further out, market pricing is leaning towards an additional 50bps of easing by end-year. Overall, this would see the Depo rate end the year at 3.00%. In our view, the Depo rate being lowered to at least 3.25%, by year end, is a reasonable expectation.

BoE cuts in August but non-committal on rate outlook

The BoE cuts its key 'Bank Rate' by 25bps to 5.00% at the August MPC. The decision to cut was "finely balanced", with a 5:4 split on the MPC. The statement, minutes and press conference offered very little in the way of insight on future policy changes. The BoE guided that it will take a meeting-by-meeting approach to any further rate cut decisions. More recently, Governor Bailey's speech at Jackson Hole retained this "non-committal" approach to policy guidance. Current futures pricing suggest the market is not expecting a rate cut at the BoE's next meeting on September 19th. A 25bps cut is fully priced in for November. Futures contracts suggest the market is not ruling out an additional 25bps cut in December. We expect this to materialise and the Bank Rate to end the year at 4.5%.

Interest Rate Forecasts					
	Current	End Q3	End Q4	End Q1	End Q2
		2024	2024	2025	2025
Fed Funds	5.375	5.125	4.625	4.125	3.625
ECB Deposit	3.75	3.50	3.25	3.00	2.75
BoE Repo	5.00	5.00	4.50	4.00	3.75

Current Rates Reuters, Forecasts AIB's ERU



Forex Market Outlook

Dollar **has lost ground in recent weeks** as macro data has weakened..

..prompted by a **repricing in US rate expectations**

Further modest falls in dollar in the near term

ECB to resume its rate cutting cycle from September

Fragile economic data might temper Euro gains

Euro expected to modestly strengthen from here

Dollar continues to retreat from historic high

The dollar has weakened recently on the back of markets pricing in more aggressive cuts by the Fed this year. Weakening macro data has spurred a shift in rate expectations and has seen the greenback fall, with the trade-weighted dollar index c.5% lower so far in Q3 2024. As flagged in previous Forex and Interest Rate Outlooks, we indicated that the dollar was likely to retreat further from its historic highs as macro data softened in the US towards trend growth rates.

US macro data have begun to surprise to the downside in recent weeks, putting pressure on the currency. US labour market data have been trending weaker, suggesting growing slack in the economy, and this has prompted a repricing in market rate expectations to 100bps of cuts in 2024. Having troughed at \$1.06 in H1, EUR/USD has risen to a range of \$1.10-1.12 in recent weeks. Similarly, GBP/USD has traded higher following a weak start to 2024 for sterling to a range of \$1.31-1.32.

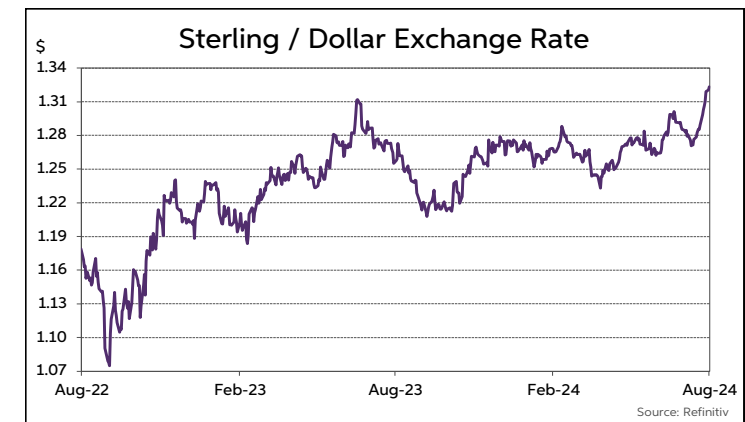
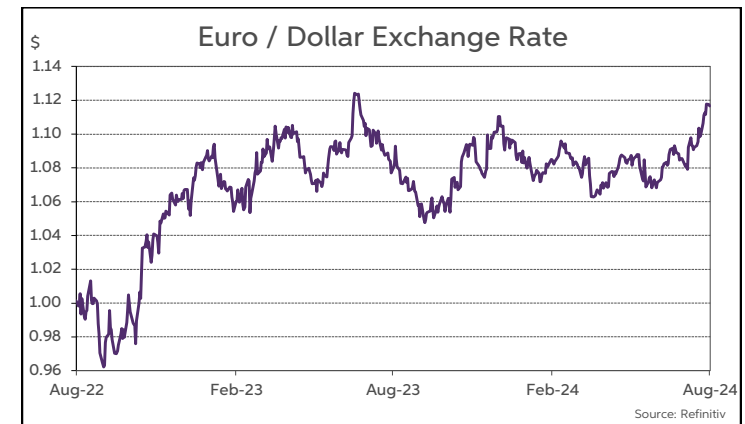
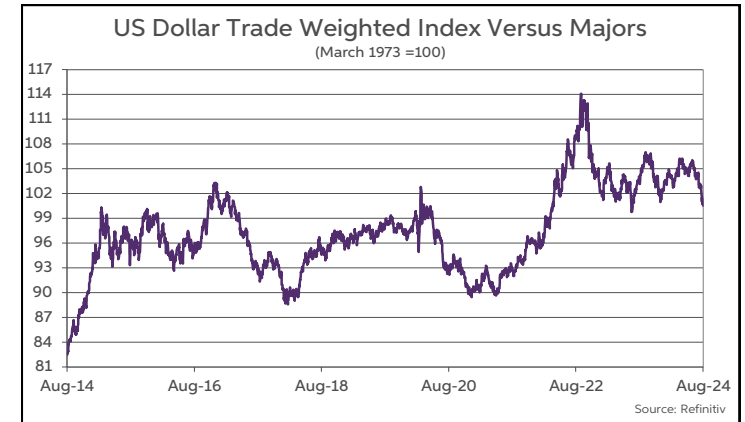
In the near term, we expect the dollar to modestly weaken further. A softer US growth outlook will support this trend, as will a Fed pivot in monetary policy. Overall, the other currencies may make modest gains against the dollar this year and during the first half of 2025, with the euro rising towards \$1.14 by Q2-2025 and sterling rising to \$1.34.

Weak growth and ECB rate cuts will temper Euro gains

Following a first cut in June by the ECB, the guidance from policymakers has been scant over the summer. Nevertheless, a weaker growth profile across the currency zone, particularly in Germany, as well as a sharp disinflationary trend, suggests the ECB will resume its rate cutting cycle in September and continue consistently thereafter over the coming quarters.

Recent gains in the euro versus the dollar largely reflects dollar weakness, rather than any upturn in Eurozone growth or rate expectations. For this reason, any further gains in the Euro are likely to be dampened by a modest Eurozone growth outlook.

Overall, we expect a modest strengthening in the euro in the near term. EUR/USD is expected to rise towards \$1.14 by mid-2025, from the current \$1.10-1.12 range. The dollar should have strong support at \$1.14 though. However, the risks here remain tilted to the downside with a further flare up in geopolitical tensions or a deterioration in Eurozone growth the keys risks which could put renewed downward pressure on the euro.



Forex Market Outlook

Euro-sterling: temporary £ strength, but overall range-bound

A first **BoE cut in August, with more to follow** before end-2024

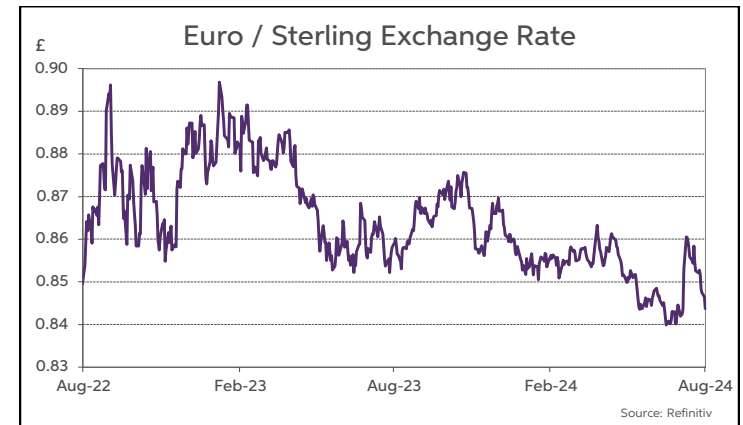
The August meeting saw a first 25bps rate cut, but the BoE remained non-committal on future policy. Given a still sticky inflation profile, the BoE is expected to proceed cautiously in cutting rates from here, but is likely to broadly follow the Fed's trajectory.

Improving macro environment supporting sterling

Sterling has gained ground in recent weeks, with UK macro data showing significant signs of improvement, this should continue to support the currency in the near term. We expect cable (GBP/USD) to reach \$1.35 by Q1 2025 from the current \$1.30-1.32 range.

EUR/GBP will **remain range bound** in the near term

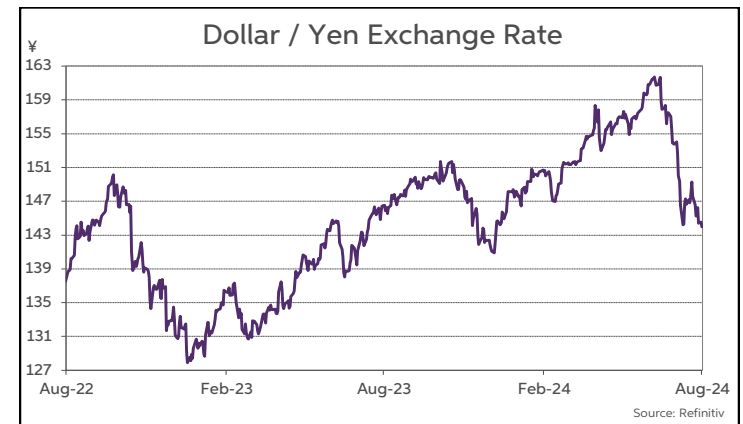
Sterling is expected to see some strength versus the euro in the near term due to the UK improving growth dynamics, but the pair is likely to remain range bound as relative macro fundamentals are unlikely to drive a significant break-out from the current range. We have EUR/GBP reaching 84p in Q3 2024, but stabilising around 85p by Q2 2025.



Dramatic swings in Yen as monetary policy normalises

Yen **moved through 38-year lows** against dollar.

The currency has seen sharp fluctuations throughout 2024 as investors digested incoming economic data and the Bank of Japan clumsily navigated its way out of its negative rate policy. A sharp depreciation of the currency this year has also spurred intervention by the authorities, but the yen still reached 38-year lows against the dollar by July at ¥162.

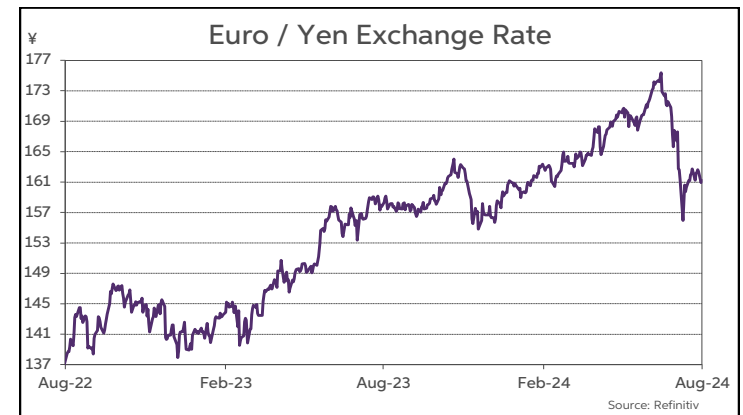


Bank of Japan hike drove dramatic appreciation in Yen

A hike by the Bank of Japan at the end of July, accompanied by a hawkish outlook, reversed almost all of the year-to-date fall in the currency, but in the process, created ructions on financial markets as yen carry trades were quickly unwound. The currency has since fallen back somewhat as BoJ officials have backed away from a further near-term hike. The currency has also met resistance at ¥144 against the dollar following the recent sharp gains.

Yen **expected to trade close to current level** in the near term

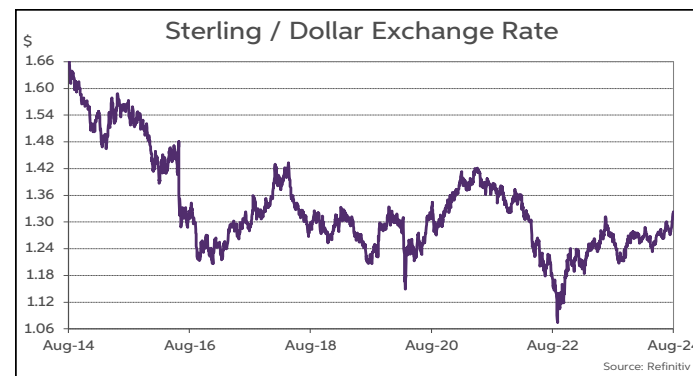
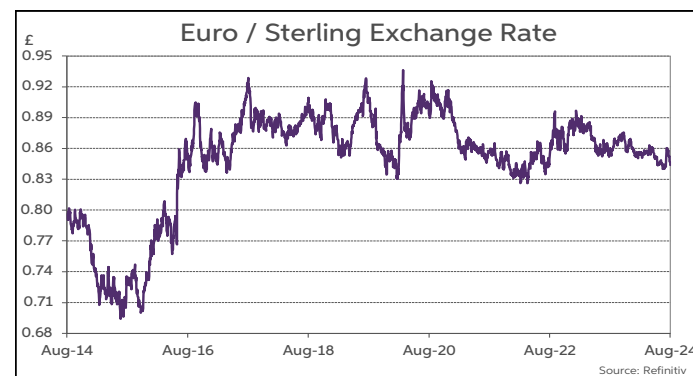
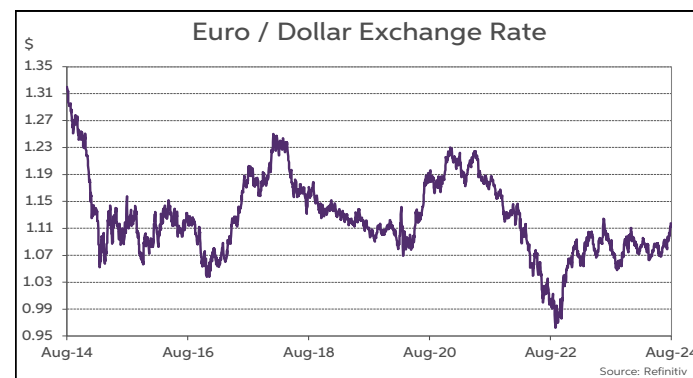
The yen may settle close to its current range in the near term. We see a modest appreciation in the yen as US rates fall, towards a range of ¥142-144 over the coming quarters. A further rate hike by the BoJ might underpin further strength in the currency, but this appears unlikely in the coming months as the inflation and growth profile in Japan remain weak. Rather, dollar weakness is likely to be the main catalyst for further yen appreciation.



Summary of Exchange Rate Forecasts

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

	Current	Q3-2024	Q4-2024	Q1-2025	Q2-2025
Euro Versus					
USD	1.108	1.08-1.14	1.09-1.15	1.10-1.16	1.11-1.17
GBP	0.840	0.81-0.87	0.81-0.87	0.81-0.87	0.82-0.88
JPY	160.77	157-163	157-163	157-163	159-165
CHF	0.94	0.96	0.98	1.00	1.00
US Dollar Versus					
JPY	145.09	141-147	140-146	139-145	139-145
GBP	1.319	1.29-1.35	1.30-1.36	1.32-1.38	1.31-1.37
CAD	1.35	1.37	1.36	1.35	1.35
AUD	0.68	0.67	0.68	0.69	0.69
NZD	0.63	0.63	0.64	0.65	0.65
CNY	7.09	7.10	7.00	7.00	7.00
Sterling Versus					
JPY	191	190	190	192	190
CAD	1.78	1.81	1.81	1.82	1.81
AUD	1.94	1.97	1.96	1.96	1.94
NZD	2.10	2.10	2.08	2.08	2.06



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