Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

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- World economy continues to exhibit uneven growth. US remains an outperformer, with signs of weakening growth in the Eurozone
- Core inflation remains sticky in most markets, particularly the UK, with risks still tilted to the upside for inflation
- Central banks have initiated rate cutting cycles, and will continue on a cautious downward trajectory in 2025
- Main currency pairs exhibiting some volatility post the US election. Dollar likely to hold most of the gains in the near term, but could lose some momentum later in 2025
- Political uncertainty in France and Germany also likely to weigh on the Euro in the coming months, risks to the downside for our euro forecasts

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Global Economic Outlook

Uneven growth picture globally

Global growth picture modest but fragile

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

Having confounded pessimistic expectations, US GDP continued to expand at a robust pace of 2.8% annualised in Q3 2024. However, there have also been signs that labour market conditions have softened. Unemployment has ticked higher in recent months and payrolls growth has slowed, suggesting the lagged effects of tight monetary policy are being felt in the US labour market.

Data signal weaker growth in UK and Eurozone

The UK economy has bounced back in 2024 following a shallow recession in 2023. However, most recent data have been slightly softer, with GDP for Q3 registering a 0.1% increase on a quarterly basis, and rising 1% y/y. The Eurozone economy remains on a weak growth trajectory, with sentiment dimmed by political uncertainty in France and Germany. In Q3 2024, GDP grew by 0.4% q/q. However, timelier Eurozone data signal sagging growth momentum, including the PMI surveys for October and November.

Risks to the outlook tilted to the downside

Risks to the outlook tilted to the downside

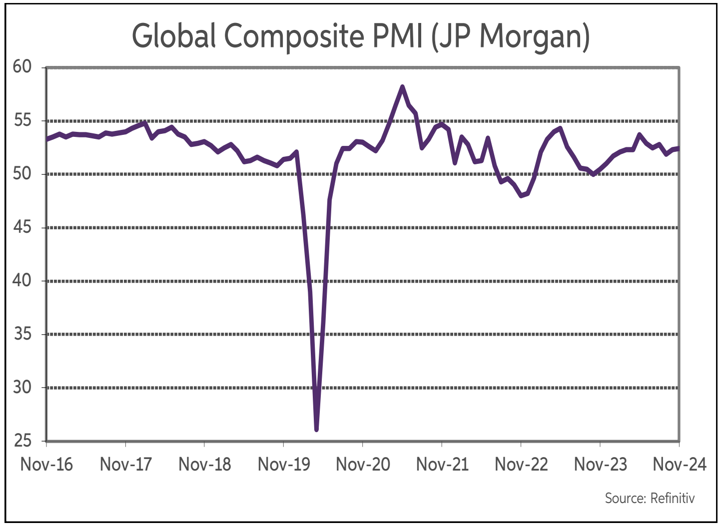
While global growth is expected at a modest c.3.2-3.3% in 2024 & 2025, the IMF & OECD note significant downside risks to the outlook, including current geopolitical tensions and sticky inflation. The IMF, in its Oct 2024 update, indicated that “services price inflation remains elevated in many regions”, requiring a cautious approach to monetary policy easing. The OECD (Dec 24) echoed this, while also calling for restraint in fiscal policy to unwind deficits.

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 and policy uncertainty in the US. These risks could likely materialise directly through a spike in inflation via trade disruptions/restrictions and indirectly through a decline in consumer and business sentiment, which would dampen GDP and labour market growth.

Eurozone growth may be dampened by **domestic political uncertainty**

In addition, the dissolution of the German and French Governments brings yet further political uncertainty. With a long lead-in time to an expected German election in February, this uncertainty may hit consumer and business confidence further, which will see another year of weak GDP growth in 2024, following a shallow recession last year. In France, the parliament has yet to pass a budget for next year, with a growing fiscal deficit weighing on investor and business sentiment.



GDP (Vol % Change)

	2022	2023	2024 (f)	2025 (f)
World	3.5	3.3	3.2	3.2
Advanced Economies	2.6	1.7	1.8	1.8
US	1.9	2.9	2.8	2.2
Eurozone	3.4	0.4	0.8	1.2
UK	4.3	0.3	1.1	1.5
Japan	1.0	1.7	0.3	1.1
Emerging Economies	4.1	4.4	4.2	4.2
China	3.0	5.2	4.8	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	2.6	2.0

Sources: IMF World Economic Outlook October 2024

Interest Rate Outlook

Central banks continue to ease , but at a gradual pace

Most of the main central banks on **a gradual easing cycle**

Over recent months, central banks have continued to cut interest rates. This has included the US Fed, the ECB and the BoE. Monetary policy officials have become more confident in achieving their respective inflation targets amid incoming data showing further progress in this regard. Central Bankers have also taken into account the risks to growth in their respective policy deliberations. The one outlier remains the BoJ, which is engaged in a tightening cycle. It hiked rates for a second time in July and is expected to hike again over the coming months.

US Fed guides a **'careful' pace** of rate cuts to get to 'neutral'

The US Fed, as expected, cut its key interest rate in November, for a second consecutive meeting. The Fed funds rate was reduced by 25bps to a 4.50-4.75% range. The Fed commenced its easing cycle with a 50bps rate cut at its previous meeting in September. Fed Chair Powell has stated that the pace of policy easing would be gradual, commenting that "the right way to find neutral is carefully". The outlook for US rates has an added layer of uncertainty given the potential for significant changes in US trade, economic and fiscal policy when President Trump takes office next year. Over recent weeks, there has been a firming in market expectations. In the near term, the market is attaching around a 90% probability to a 25bps cut in December. Meanwhile, the market is envisaging rates hitting a low of 3.75-4.00% in 2025.

ECB cuts again in December with **further rates cuts on the cards in Q1 2025**

The most recent ECB meeting (Dec 12th) saw rates cut for the fourth time this year. The Depo rate was lowered by 25bps to 3%. In terms of guidance, President Lagarde continued to state that the ECB is not pre-committing and is 'data-dependent'. However, the ECB had more of a dovish bias than it did in October, dropping the reference for the need for a "sufficiently restrictive" policy rate in its December statement. The market anticipates a rather aggressive pace of rate cuts by the ECB next year, amid increased political uncertainty in the Eurozone recently. Between 115-125bps of easing is priced in for 2025. This would see the Depo rate reach a terminal level near 1.75% during 2025. However, the ECB may not cut to this extent, with rates potentially settling nearer to 2%.

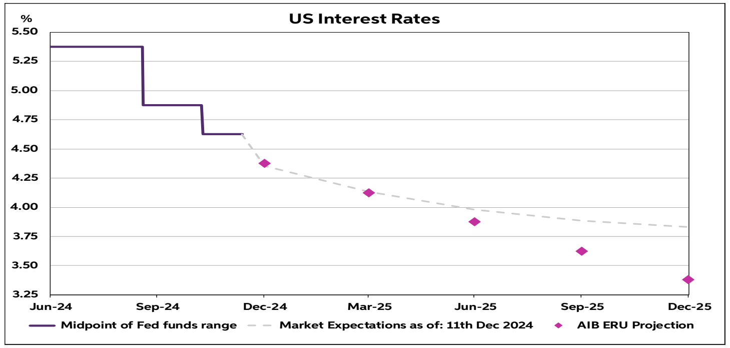
BoE Gov. Bailey has noted that "**we can't cut interest rates too quickly or by too much**"

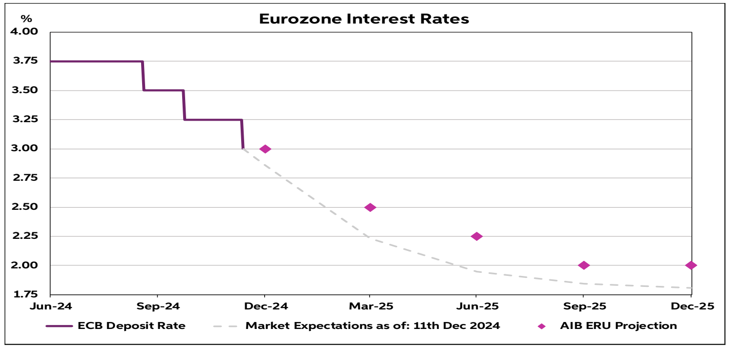
The BoE cut its key 'Bank Rate' by 25bps to 4.75% at its November meeting. It started its current easing cycle with a 25bps cut in August. The decision to cut in November was not unanimous. However, at 8:1, the vote split was more balanced than the 5:4 vote in August. The meeting statement and Governor Bailey's comments that "we can't cut" rates "too quickly or by too much" given on-going domestic price pressures suggest the BoE will continue to ease policy at a very gradual pace. Futures contracts suggest the market is not fully pricing another rate cut from the BoE until March'25. The market is envisaging rates levelling off at around 4% by end-2025. This may be underestimating the extent of easing from the BoE next year.

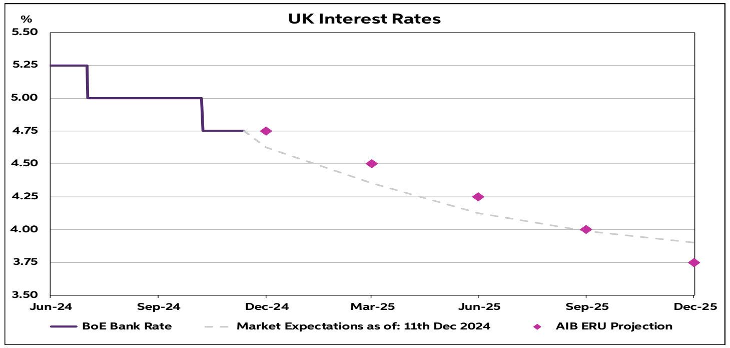
Interest Rate Forecasts

	Current	End Q4 2024	End Q1 2025	End Q2 2025	End Q3 2025
Fed Funds	4.625	4.375	4.125	3.875	3.625
ECB Deposit	3.00	3.00	2.50	2.25	2.00
BoE Repo	4.75	4.75	4.50	4.25	4.00

Current Rates Reuters, Forecasts AIB's ERU







Forex Market Outlook

"Trump trade" underpins dollar surge, but may lose momentum

Dollar **has gained ground** as investors price in shift in economic policy

The dollar strengthened considerably post the US election, with the trade weighted dollar index up over 2% in November. Against the euro, the dollar gained 2.7%, with EUR/USD breaking the key support level of $1.05 and testing the $1.04 level in recent weeks. The dollar also gained ground against sterling, rising by c.1.2% in November, with GBP/USD reaching $1.25. Cable has since given back some of these gains in December, which has seen it move back up to near the $1.27 threshold.

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

While the initial market reaction to the re-election of President Trump has been a strengthening in the dollar and a rise in Treasury yields and stock markets, it remains uncertain how these policies could play out in the longer term. Indeed, global trade fragmentation, alongside damage to domestic GDP growth from tariffs could in time even weigh on the dollar, particularly if its reserve status begins to recede.

Further modest gains for the dollar in the near term

However, in the short term, it remains more likely that Trump's policies will prove inflationary, which could limit rate cuts by the Fed and underpin the dollar for now. We expect the greenback to maintain at close to its current levels into Q1, but given much of the expected impact of Trump 2.0 has been pre-emptively priced in by markets, the currency could slowly give back some of these gains later in 2025.

Rate differential and political risk to weigh on Euro

ECB to maintain a steady rate-cutting cycle

The ECB has embarked on a steady rate-cutting cycle, with an initial 25bps cut in June, followed by successive cuts in September, October and December. With the Deposit rate now at 3%, and markets pricing in further aggressive cuts in 2025 to bring the rate below 2%, the expected divergence from UK and US rates has weighed on the Euro.

Fragile economic data might temper Euro gains

Growing political uncertainty has also likely weighed on the euro in recent weeks. In particular, the euro has weakened in the aftermath of softer sentiment and activity surveys, such as the PMIs, which show waning business and consumer confidence in the largest Eurozone economies of France and Germany.

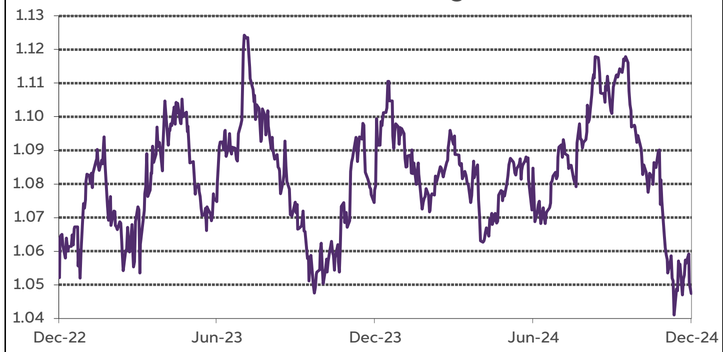
Euro expected to remain close to current level in the near term

Overall, we expect the euro to remain close to its current range in the near term. EUR/USD is expected in the range of $1.04-1.10 in Q1 2025, strengthening modestly to $1.05-1.11 by Q3 2025. However, the risks here remain tilted to the downside with a further flare up in geopolitical tensions or a deterioration in Eurozone growth the key risks which could put renewed downward pressure on the currency.

US Dollar Trade Weighted Index Versus Majors
(March 1973 =100)

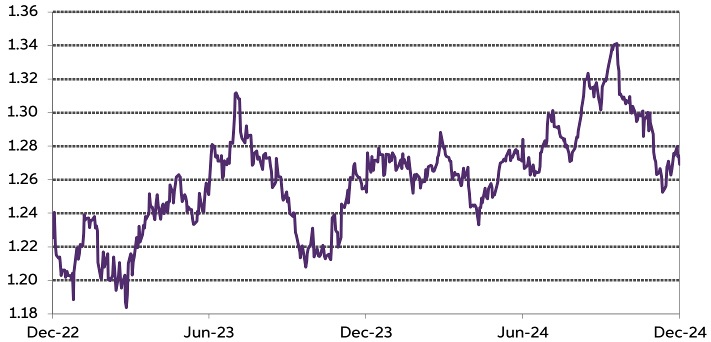
Source: Refinitiv

Euro / Dollar Exchange Rate



Source: Refinitiv

Sterling / Dollar Exchange Rate



Source: Refinitiv

Forex Market Outlook

Sterling maintains strength in near term versus Euro

Relatively stronger macro environment supporting sterling

Sterling has gained ground in recent months versus the euro, with UK macro data suggesting growth remains relatively robust, and market expectations for a shallow downward trajectory in interest rates. This should continue to support to the currency in the near term, particularly versus the Euro. Indeed, EUR/GBP has recently broken through the key 83p level, which has not been breached sustainably since before the Brexit vote in 2016.

Cautious approach to rate cuts by BoE

The BoE cut by 25bps in August and November, but its messaging has been muddled of late, pivoting from dovish to slightly hawkish in recent months. Our expectation of a cautious rate-cutting cycle by the BoE to move rates to 4% by Q2 2025, should support sterling versus the Euro and enable the currency to hold its ground against the dollar.

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

Sterling is expected to see some strength versus the euro in the near term, but the pair is likely to remain largely range bound as relative macro fundamentals are unlikely to drive a significant break-out from the current range. We have EUR/GBP holding around 83p into Q1 2025 but drifting to around 84p by Q3 2025. We expect cable (GBP/USD) to strengthen to around $1.28-1.29 in the first half of 2025 from the current $1.26-1.27 range.

Dramatic swings in Yen as monetary policy normalises

Yen **has been volatile throughout 2024**.

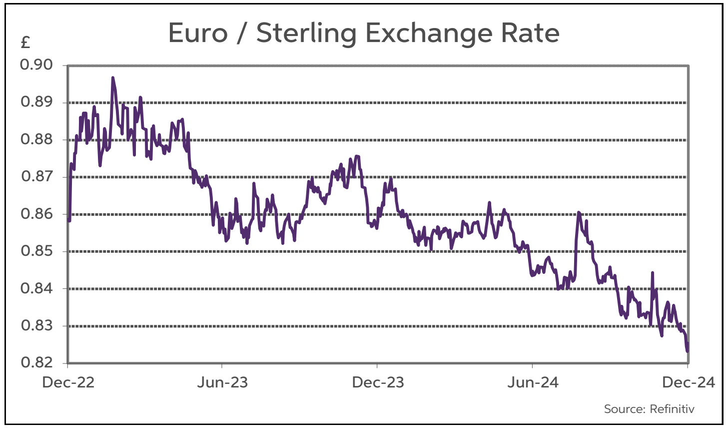
The currency has seen sharp fluctuations throughout 2024 as investors digested incoming economic data and the Bank of Japan began to normalise monetary policy. A sharp depreciation of the currency in H1 2024 has also spurred intervention by the authorities, but the yen still reached 38-year lows against the dollar by July at ¥162.

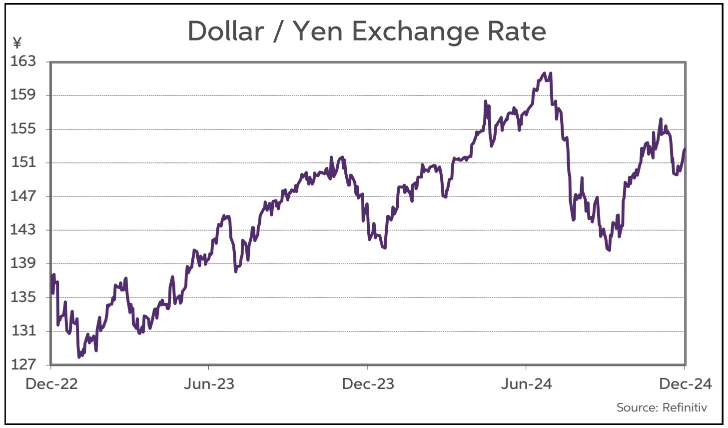
Bank of Japan expected to hike rate again shortly

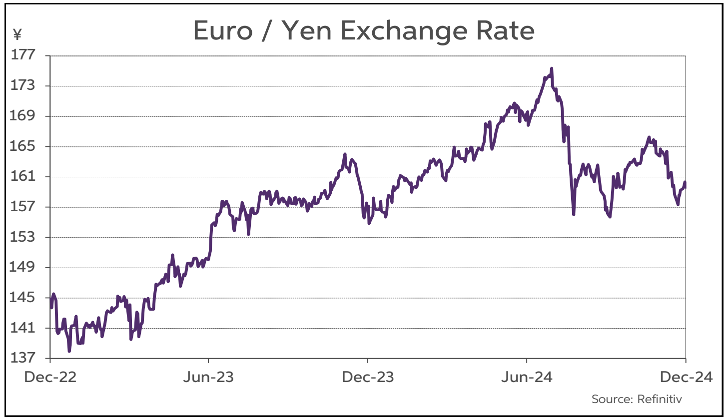
A hike by the Bank of Japan at the end of July, accompanied by a more hawkish outlook, reversed almost all of the year-to-date fall in the currency, although subsequently, the currency has lost some ground to the dollar, underpinned further by the US election result. A further BoJ rate hike is expected in the very near term, and could come as soon as the December meeting. With the BoJ expected to continue on a steady trajectory of rate hikes, this should support the yen in the near term versus the dollar.

Yen **expected to strengthen slightly 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 ¥145-151 by Q3 2025, from the current ¥150-154 range. Versus the euro, the currency is expected to trade in a range of ¥157-164, close to the current ¥160 level.



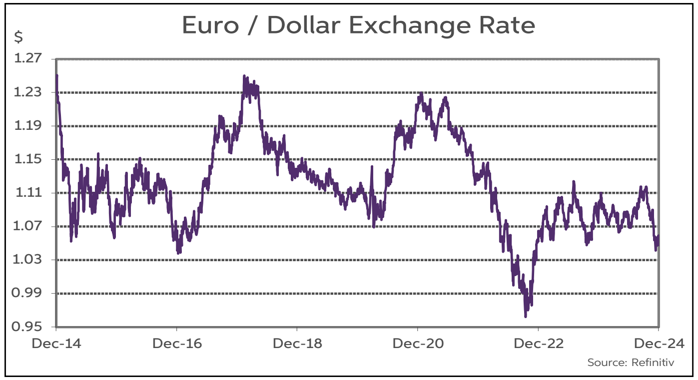


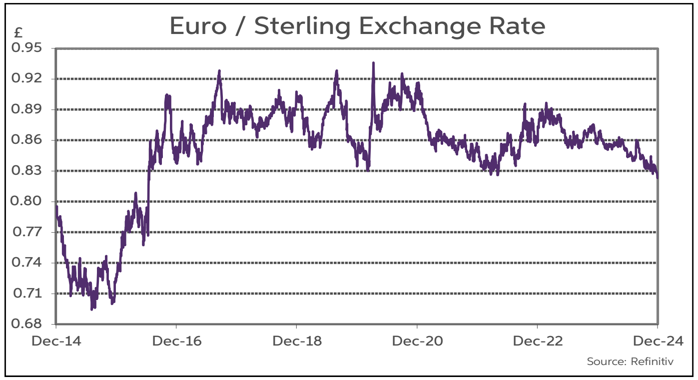


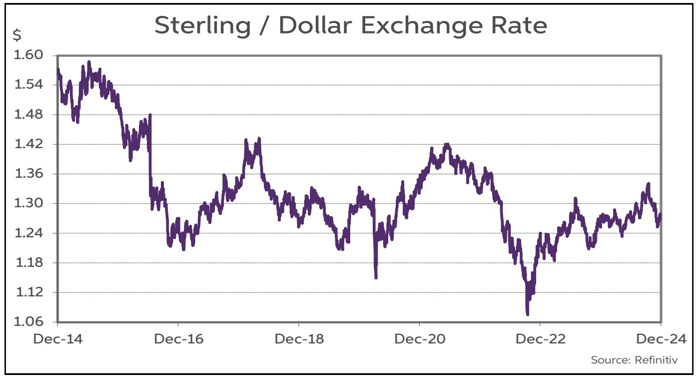
Summary of Exchange Rate Forecasts

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

	Current	Q4-2024	Q1-2025	Q2-2025	Q3-2025
Euro Versus					
USD	1.049	1.03-1.07	1.04-1.10	1.05-1.11	1.05-1.11
GBP	0.829	0.82-0.85	0.80-0.86	0.81-0.87	0.81-0.87
JPY	161.09	157-163	158-164	158-164	157-163
CHF	0.94	0.93	0.94	0.95	0.96
US Dollar Versus					
JPY	153.57	149-155	147-153	146-152	145-151
GBP	1.265	1.25-1.29	1.25-1.31	1.25-1.31	1.25-1.31
CAD	1.42	1.42	1.42	1.40	1.40
AUD	0.64	0.64	0.64	0.65	0.66
NZD	0.58	0.58	0.58	0.59	0.60
CNY	7.28	7.25	7.25	7.25	7.15
Sterling Versus					
JPY	194	192	193	191	190
CAD	1.80	1.79	1.83	1.80	1.80
AUD	1.99	1.98	2.01	1.98	1.95
NZD	2.20	2.18	2.22	2.18	2.14







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