Global Watch

May 2023

Economic and Market Update

Bank of Ireland

Summary

- Economic activity is expanding helped by lower energy prices, but higher interest rates will be a drag on growth this year
- Headline inflation is coming down, but core - or underlying - inflation remains elevated in the Euro area and has risen to a fresh high in the UK, while it has eased somewhat in the US.
- The Fed, ECB, and Bank of England have continued to tighten monetary policy in 2023, raising interest rates at each of their three meetings so far this year.
- We think interest rates in the US may have peaked, but we don't envisage the Fed easing policy for some time.
- The ECB and Bank of England have more work to do though. We expect both to hike rates by 50bps over the next two meetings - further hikes beyond this may depend on whether core inflation has started to come down.
- Having strengthened to almost \$1.11 against the dollar in early May, the euro has since fallen back below \$1.07, though we expect it to trend gradually higher over the remainder of this year.
- Sterling has also reversed course against the US currency, falling below \$1.24 from a 12-month high of \$1.2650 a month ago, but has strengthened to around 86p against the euro.
- We see the pound regaining ground against the dollar over the coming months, while continuing to trade in a relatively narrow range against the single currency.
- The European carbon market has been volatile this year. Carbon prices have come off sharply recently and are down almost 10% since early May, so it wouldn't be surprising to see them stabilise now.

Forecasts

GDP Growth*	2022	2023(f)	2024(f)
Global	3.4%	2.8%	3.0%
US	2.1%	1.6%	1.1%
Euro area	3.5%	0.8%	1.4%
UK	4.1%	0.4%	1.0%

*Annual % change, constant prices
Source: IMF (April/May 2023)

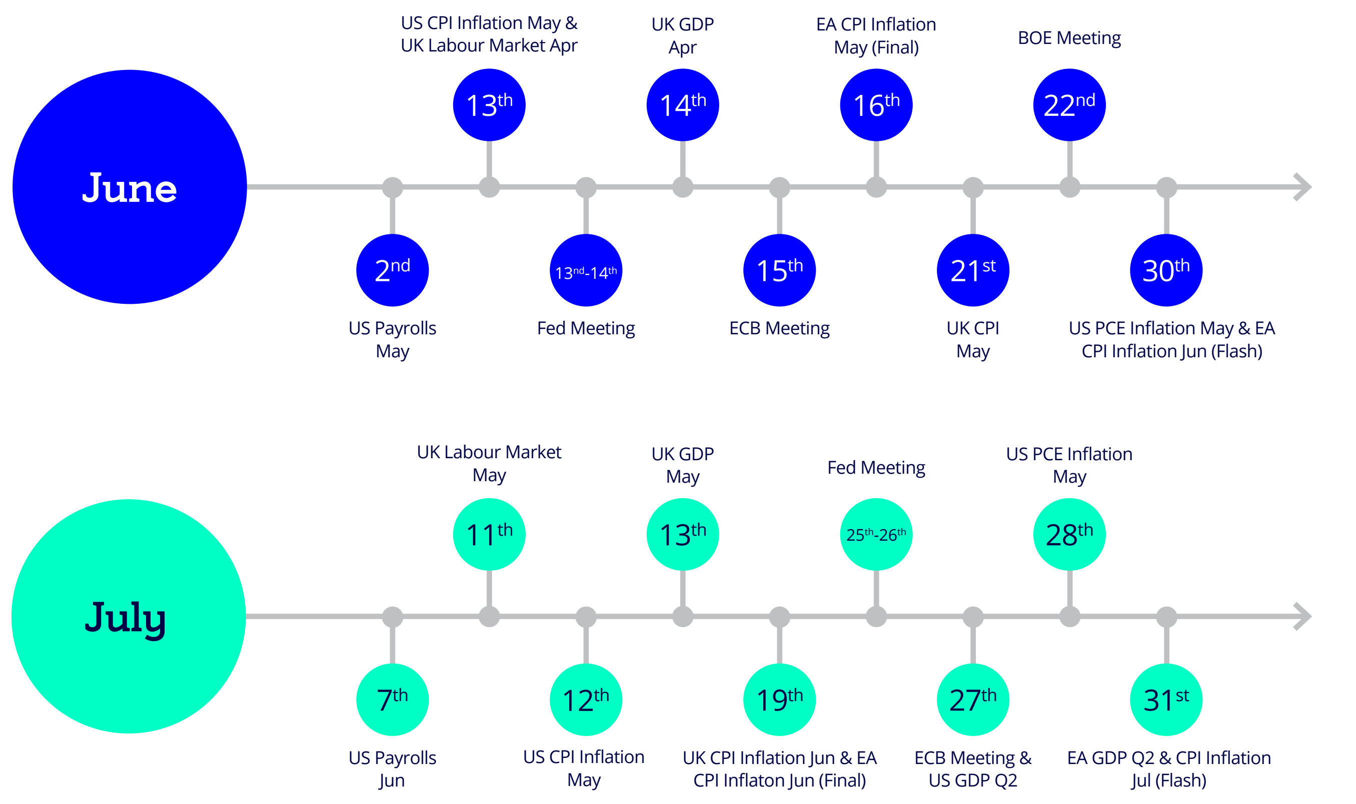
Central Bank Interest Rates (%)	Current	End-Jun 23	End-Sep 23	End-Dec 23	End-Mar 24
Fed	5.0-5.25	5.0-5.25	5.0-5.25	5.0-5.25	5.0-5.25
ECB (Deposit Rate)	3.25	3.50	3.75	3.75	3.75
BOE	4.5	4.75	5.0	5.0	5.0

Source: Bloomberg, Bank of Ireland Forecasts

FX**	Current	Q2'23	Q3'23	Q4'23	Q1'24
€/$	1.07	1.06-1.10	1.08-1.12	1.10-1.14	1.12-1.16
€/£	0.86	0.85-0.89	0.86-0.90	0.87-0.91	0.87-0.91
£/$	1.24	1.22-1.26	1.23-1.27	1.24-1.28	1.25-1.29

**Current Rate is as of 31 May 2023
Source: Bloomberg, Bank of Ireland forecasts

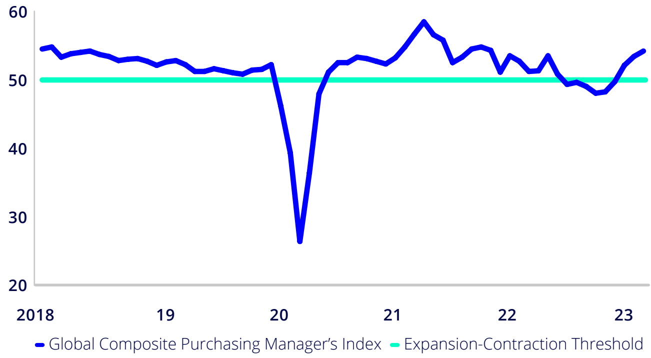
Upcoming Events



Economy

Global

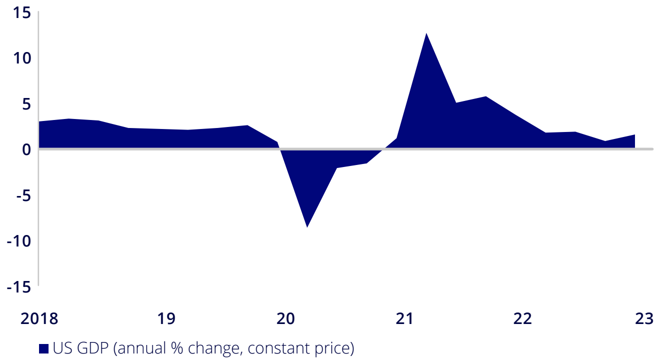
The pace of world economic activity has picked up recently judging by some high frequency data, with the Global Composite PMI returning to expansionary territory (>50) in February and increasing further in both March (53.4) and April (54.2). The lifting of COVID-19 lockdowns in China has helped - growth in its economy strengthened notably in the first quarter - as has a decline in wholesale energy prices, which is lowering inflation and giving a boost to consumer and business confidence. Nonetheless, the IMF in its latest (April) forecast sees global GDP growth slowing to 2.8% this year from 3.4% in 2022, reflecting inter alia the impact of monetary policy tightening, before improving slightly to 3% in 2024.



Source: JP Morgan, S&P Global

US

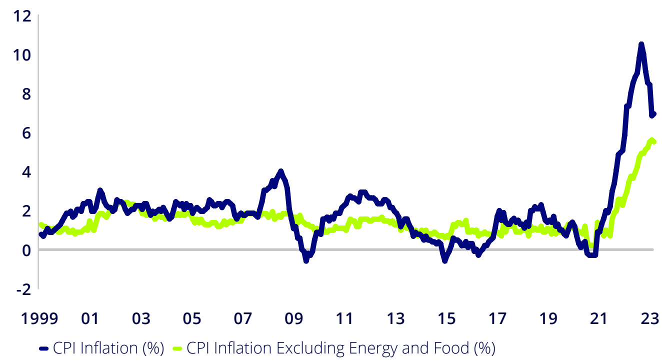
GDP growth in the US slowed to 0.3% quarter-on-quarter in Q1 2023, from 0.6% in the final quarter of 2022 and 0.8% in Q3, while tighter credit conditions (following recent developments in the bankinf sector) may dampen the pace of activity further in the period ahead. The economy is still adding jobs though and the unemployment rate (3.4%) is at a record low, but a decline in the number of job vacancies (albeit from very elevated levels) suggests some softening in labour demand is underway. The annual rate of headline PCE inflation has fallen by almost 3 percentage points from its peak in June last year to 4.4%. It is now below the current rate of core inflation (excluding food and energy) of 4.6% - though both are still running well above the Fed's target of 2%.



Source: BEA

Euro area

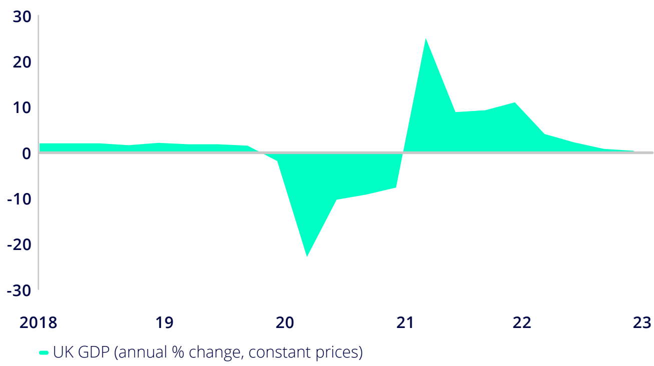
Having stagnated in the final quarter of 2022, economic activity improved very slightly in the first quarter of this year with GDP increasing by just 0.1%, while the Purchasing Managers' indices available up to May point to a pick-up in the pace of growth in Q2, helped by rising services sector activity. Lower energy prices will ease the squeeze on household incomes and boost consumer spending (which has weakened a lot in recent months), though the impact of higher interest rates means GDP growth overall is likely to remain relatively subdued (the IMF is forecasting an increase in GDP of 0.8% for 2023 as a whole). Headline inflation has fallen to 7% (April) from a peak of almost 11% last October, but core inflation rose to a record high of 5.7% in March before easing a touch to 5.6% in April.



Source: Eurostat

UK

The UK economy has flatlined over the past year or so, with GDP in the first quarter of 2023 just 0.2% higher than in Q1 2022, as high inflation, interest rate increases, fiscal policy missteps, and slower trading partner growth have all weighed on activity. Consumer confidence has recovered from its all-time low last September nonetheless, and declining domestic energy bills will bring some relief to households - and give a boost to consumer spending - over the coming months, while measures in the March budget will also provide support to the economy. The labour market remains tight, though unemployment has started to nudge up reflecting increased participation in the labour force. Headline inflation fell to 8.7% in April, from over 10% in March, and is likely to fall further over the remainder of this year, but core inflation accelerated to a circa 31-year high of 6.8%.

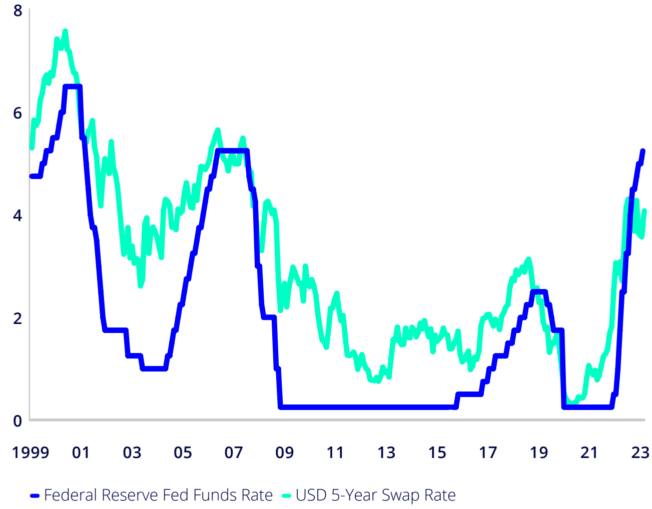


Source: ONS

Interest Rates

Fed

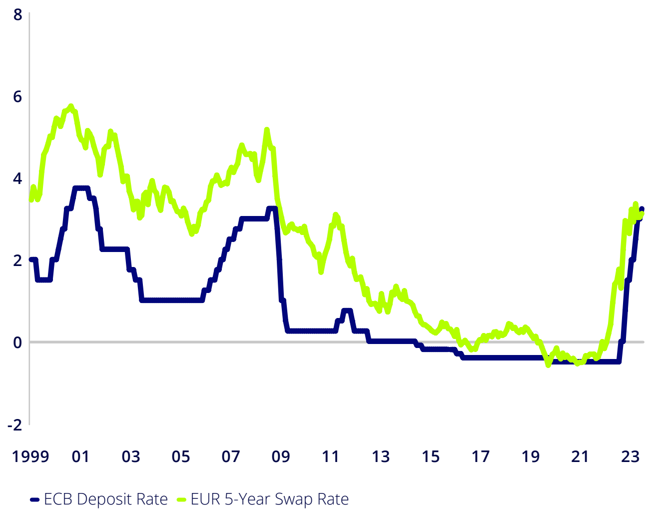
The Fed raised interest rates for a 10th consecutive time in May, by 25bps to a range of 5-5.25%, matching the peak in rates reached during the 2004-2006 tightening cycle and bringing the cumulative increase in the current one to 5 percentage points (or 500bps). However, unlike following each of the previous meetings since it commenced raising rates in March last year, when it clearly signalled further rate hikes to come, the Fed was more circumspect on this occasion, saying only that "additional policy firming may be appropriate." The Fed reiterated that "tighter credit conditions for households and businesses (on account of developments in the banking sector) are likely to weigh on economic activity, hiring, and inflation" - thus doing some of the job that further rate hikes would do - and noted the extent to which monetary policy has been tightened to date and the "lags" with which higher rates affect economic activity and inflation. Given this, we think the Fed will pass on raising rates at its June meeting, and indeed that they may now have peaked, but we do not envisage it easing policy anytime soon.



Source: Bloomberg

ECB

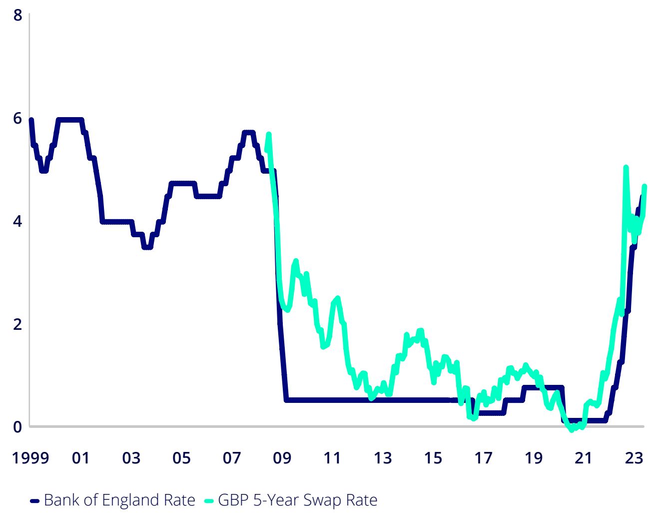
The ECB raised interest rates by 25bps in May to bring the cumulative increase since July last year to 375bps, by some distance the fastest and largest of the central bank's rate-hiking cycles since 1999 (of which admittedly there have been few). Moreover, unlike following the March meeting, when the ECB was somewhat non-committal about future rate increases given strains in the banking sector, it was more forthright this time around, with President Lagarde noting that the inflation outlook is "too high for too long", the central bank is "not pausing" its hiking cycle, and there is "more ground to cover" to get rates up to a level "sufficiently restrictive" to ensure inflation returns to its 2% target. The market sees rates rising by a further 50bps by July this year, including a 25bps hike at the June 15 meeting, before peaking. This seems reasonable though whether the ECB continues tightening beyond July may depend on how core inflation evolves over the next few months. If its has started to come done in line with current consensus forecasts - which see it averaging 5% in Q3 on its way to under 4% in Q4 - then the ECB may pause its rate hikes.



Source: Bloomberg

Bank of England

The Bank's Monetary Policy Committee (MPC) increased interest rates by 25bps to 4.50% in May - it has now raised rates by 440bps since it commenced tightening in December 2021 - though two of the nine members of the Committee dissented, instead voting to keep rates at 4.25%. The MPC noted that economic activity has been "less weak" than it had been anticipating earlier this year, with the labour market also proving "tighter" than expected. It also cautioned that there remained "considerable uncertainties around the pace at which inflation will return sustainably to the 2% target" amid significant "upside" risks to the outlook, including the possibility that wage and domestic price pressures "may take longer to unwind than they did to emerge". The MPC also reiterated the guidance offered following its March meeting i.e. "if there were to be evidence of more persistent (price) pressures, further tightening...would be required". This points to the likelihood of another 25bps rate hike at its June 22 meeting, all the more so given the jump in core inflation in April, with a similar move probable at its August meeting too.

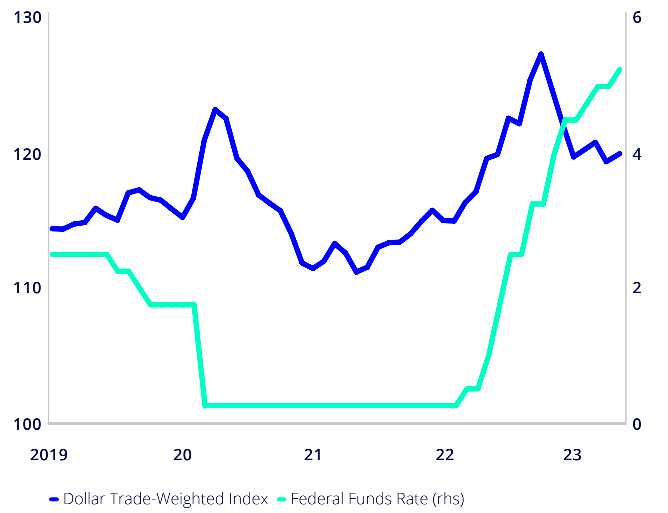


Source: Bloomberg

Currencies

Dollar

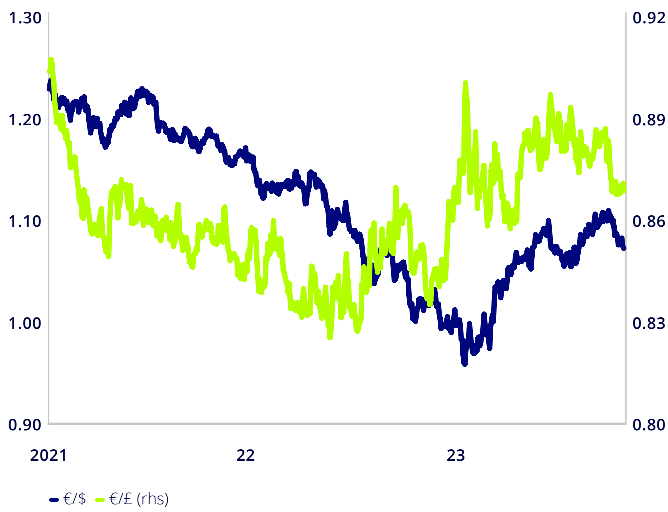
The dollar has remained relatively stable on a trade-weighted basis since we published our previous Global Watch at the beginning of April, having lost ground during March amid the turmoil in the banking sector. It did weaken following the Fed's monetary policy meeting in early May, as the market initially viewed the 25bps increase in interest rates as the last in the current hiking cycle and proceeded to price in a series of rate cuts over the second half of this year. The market has since had second thoughts about the former however - it now sees the Fed hiking by another 25bps - and has also scaled back the extent of any cut in rates in the coming months. This in turn has seen the dollar regain ground, rising by a bit more than 1% on a trade-weighted basis. As noted previously, we don't expect the Fed to ease monetary policy this year and we see the dollar continuing to 'hold its own' for while longer yet (with the resolution of the debt ceiling issue removing a source of downside risk to the currency).



Source: Bloomberg

Euro

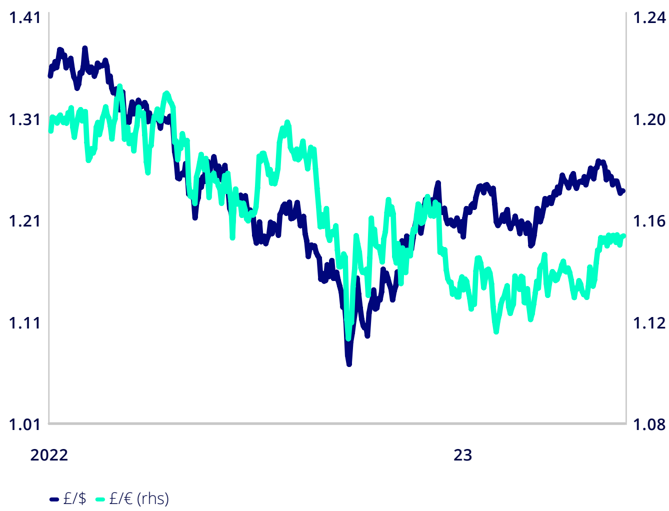
In our March Global Watch we said we thought the euro would trade in a range of $1.07 to $1.11 against the dollar during the second quarter (April-June) of this year. The quarter to date has proved to be one of two halves for this currency pair, with the euro strengthening by the best part of three cents to the top of this range by early May but then giving up all of these gains again - and then some - as it slipped back to the very bottom of this range at $1.07. Looking ahead, we continue to expect the euro to gradually appreciate against the dollar over the coming months as the ECB raises interest rates further in response to elevated underlying inflation and the Fed stays on hold (albeit while still retaining a bias to tighten policy further). The single currency is likely to accelerate its gains against the dollar if, as seems most likely, the Fed is first to embark on a rate cutting cycle, which we think will be sometime in 2024.



Source: Bloomberg

Sterling

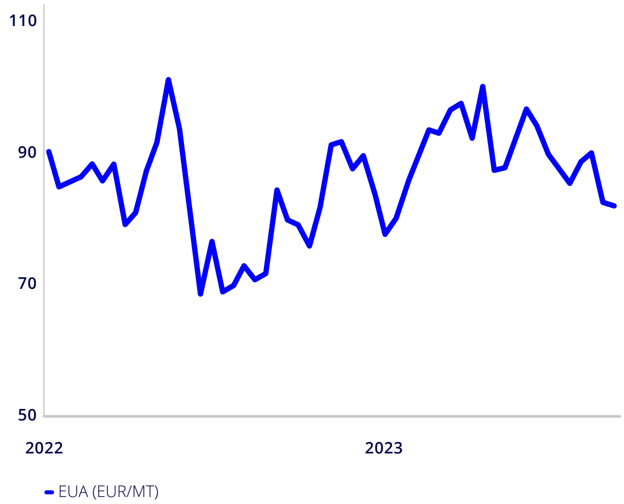
Like the euro, the pound also strengthened against the dollar through early May, hitting a circa twelve month high of almost $1.2650 in the process, before falling back to more or less where in closed out the first quarter of this year at around $1.2350. It has gained some ground against the euro over the same period, strengthening to under 87p, albeit still remaining within the range of about 85.5p to 89.5p that has prevailed for most of the time since late year. Interestingly though, the pound hasn't benefited much (at least to date) from the higher path for interest rates priced in by the market following the release of the latest (April) inflation data. Nonetheless, we are not changing the forecasts set out in our March Global Watch. We see the pound gradually trending higher against the dollar as the Bank of England continues to raise rates and the Fed stays on hold, and expect it to continue trading in a relatively narrow range against the single currency albeit with a slight weakening bias.



Source: Bloomberg

European Carbon Market

Europe's carbon price rose by about 10% in Q1 2023, with an average of around €90 a tonne. EUAs (European Union Allowances) traded to a high of €101.25 on February 21st following the curtailment of Russian gas exports, and the resulting boost in coal generation, increasing emissions and demand for carbon credits. However, since the start of May, European natural gas prices have plummeted to a two-year low as mild weather and strong LNG flows provide confidence that the region can withstand supply risks later in the year. Further adding to the bearish outlook for EUAs were reports that emissions from the EU power sector dropped 15% in January - April compared to last year with a sharp drop in coal fired generation. Having broken through the bottom of the recent range (€85), there is potential for a move towards €80. Resistance can be found at €85



Source: Bloomberg

Contact Us

economics@boi.com

+353 1 250 8900

Michael Crowley

Senior Economist

ext. 44268

Mark Leech

Head of Media Relations

+353 87 905 3679