Global Watch

August 2023

Economic and Market Update

Bank of Ireland

Summary

- The main central banks have raised interest rates further over the summer, with tighter policy to be a drag on economic growth.
- Headline inflation rates have fallen, helped by lower energy prices, but core inflation remains elevated, more obviously so in the UK and Euro area.
- The Fed raised interest rates by a quarter point in July, having taken a breather in June, which may prove to be the final increase in the current hiking cycle.
- The ECB and Bank of England (BOE) also raised rates by 25bps in July and August respectively and probably have a bit more to do, but the peak in rates is in sight.
- All three central banks have indicated rates need to remain higher for longer to ensure inflation returns to target. The Fed is likely to be the first to ease policy, albeit probably not until well into 2024.
- The euro rose to a near 18-month high of over $1.12 against the dollar in mid-July before retreating to around $1.10, though we still expect it to trend gradually higher over the next 6-12 months.
- Rising BOE rate expectations propelled sterling to $1.31 and 85p against the dollar and the euro respectively in July, before easing to $1.27 and 86p. We see it regaining ground against the US currency over the coming months, while trading in a range of around 85p-90p to the euro.

Forecasts

GDP Growth*	2022	2023(f)	2024(f)
Global	3.5%	3.0%	3.0%
US	2.1%	1.8%	1.0%
Euro area	3.5%	0.9%	1.5%
UK	4.0%	0.4%	1.0%

*Annual % change, constant prices
Source: IMF (July 2023)

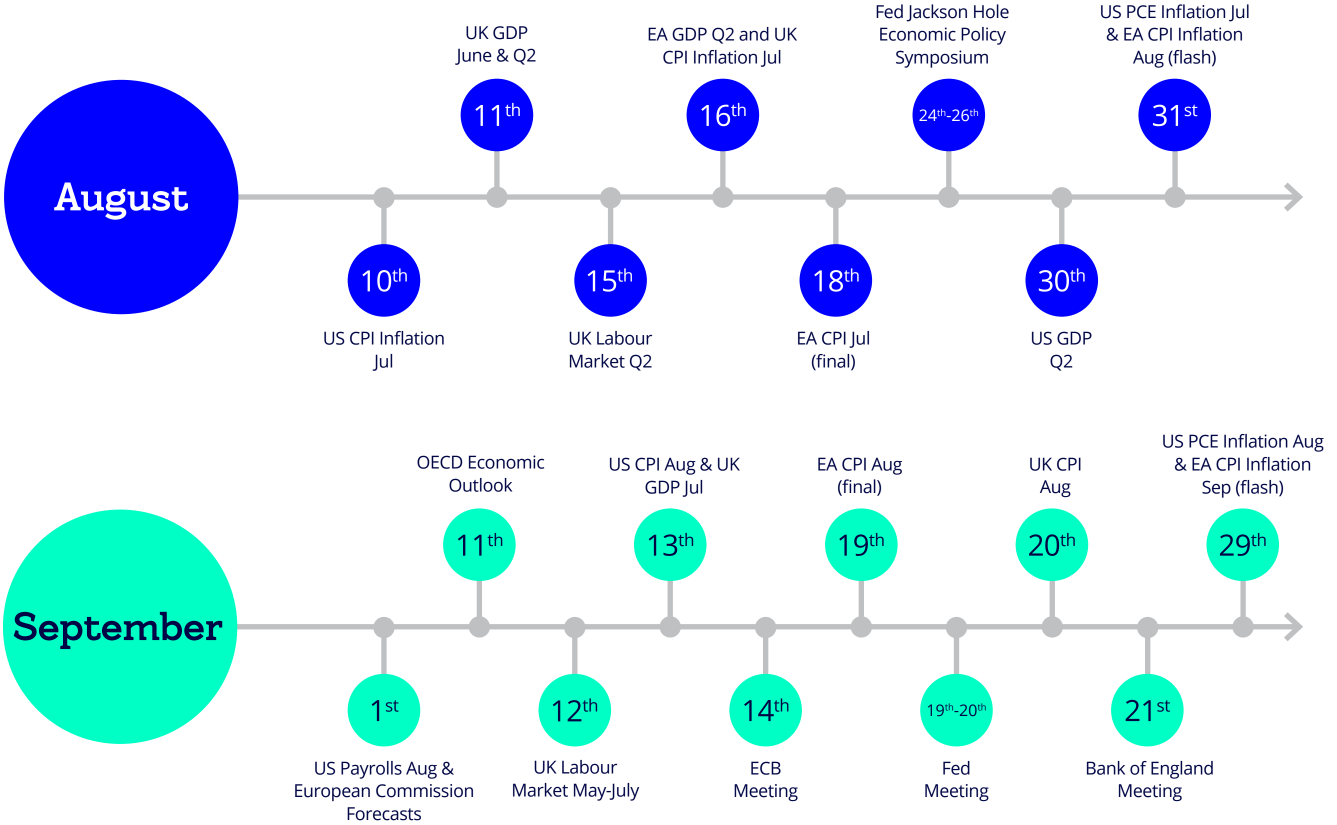
Central Bank Interest Rates (%)	Current	End-Sep 23	End-Dec 23	End-Mar 24	End-Jun 24
Fed	5.25-5.50	5.25-5.50	5.25-5.50	5.25-5.50	5.0-5.25
ECB (Deposit Rate)	3.75	4.00	4.00	4.00	4.00
BOE	5.25	5.50	5.75	5.75	5.75

Source: Bloomberg, Bank of Ireland Forecasts

FX**	Current	Q3'23	Q4'23	Q1'24	Q2'24
€/$	1.10	1.08-1.12	1.10-1.14	1.12-1.16	1.14-1.18
€/£	0.86	0.85-0.89	0.86-0.90	0.86-0.90	0.87-0.91
£/$	1.27	1.26-1.31	1.27-1.31	1.29-1.33	1.30-1.34

**Current Rate is as of 4th August 2023
Source: Bloomberg, Bank of Ireland forecasts

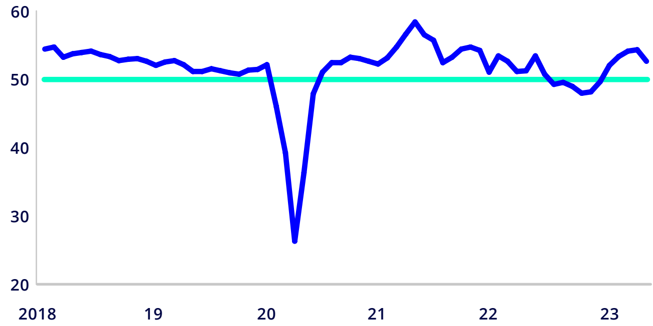
Upcoming Events



Economy

Global

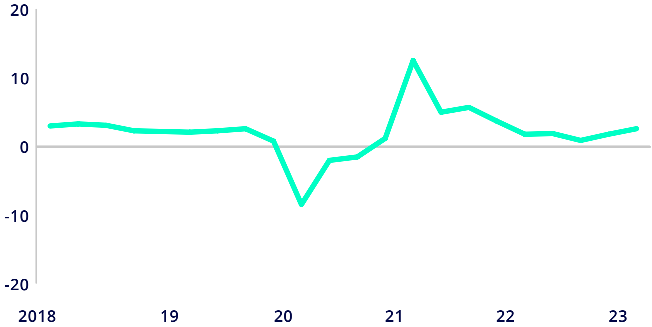
With global economic activity remaining resilient in Q1 2023, the IMF in its latest projections (July) has revised up slightly its forecast for global growth this year to 3% (from 2.8% previously) and expects the world economy to expand by 3% again in 2024. However it notes that this is still weak by historical standards, with rising central bank interest rates weighing on growth. Headline inflation is expected to fall steadily over the second half of this year and in 2024, which will ease the pressure on households' purchasing power, but core - or underlying - inflation is expected to decline more gradually. The IMF believes the risks to global growth are tilted to the downside and include, inter alia, inflation remaining higher for longer, triggering more restrictive monetary policy, and the resumption of financial and banking sector turbulence.



- Global Composite Purchasing Manager's Index - Expansion-Contraction Threshold
Source: JP Morgan, S&P Global

US

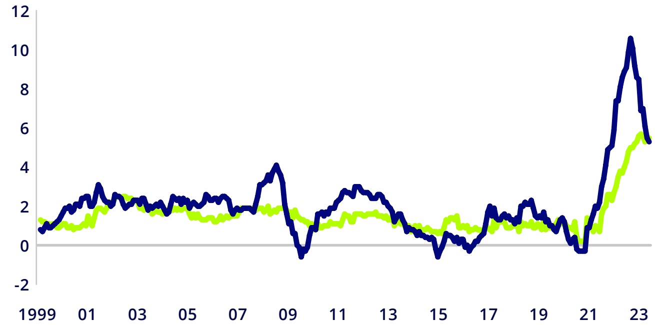
The US economy grew by 2.6% in the year to Q2 2023, a surprisingly strong performance given the Fed's tightening of monetary policy. Consumer spending has held up well over this period, though higher interest rates have clearly weighed on investment (housing investment in particular). The economy has also continued to add jobs and unemployment remains low, but employment growth is easing (private payrolls increased by 215k a month over the first half of this year, down from 317k a month in H2 2022) and job openings are declining (albeit still above normal levels), while wage growth is moderating. Headline PCE inflation has fallen steadily this year and at 3% in June was down 4 percentage points from its peak of 7% in June last year. Core PCE inflation (i.e. excluding food and energy prices) has come down more slowly, although June saw it decline to 4.1% from 4.6% in May helped by a fall in core services inflation.



- US GDP (annual % change, constant price)
Source: BEA

Euro area

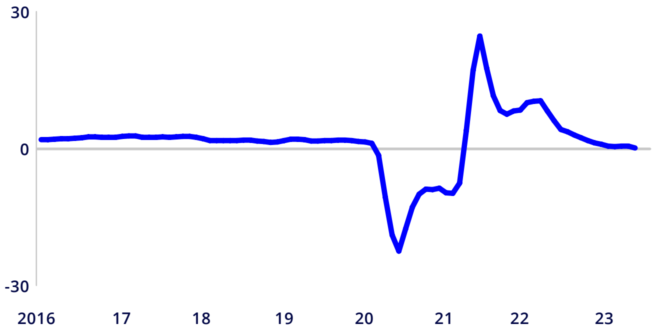
Growth in the Euro area economy has slowed with GDP rising by just 0.6% over the twelve months to June this year, well down from an increase of 4.2% over the previous twelve month period. While some step down in the pace of activity was inevitable as the COVID-related rebound ran its course for the most part, high inflation and rising interest rates have weighed on consumer spending and investment and slower global growth has taken a toll on exports. Notwithstanding the slowdown in GDP growth however, employment has continued to increase and unemployment has fallen to an all-time low of 6.4%. Lower wholesale energy prices have contributed to a notable decline in headline CPI inflation from almost 11% late last year to 5.3% in July, which will bring some relief to household budgets. It is now running below core inflation, which is proving much more sticky - it stood at 5.5% in July, only marginally below its most recent high of 5.7% in March.



- CPI Inflation (%) - CPI Inflation Excluding Energy and Food (%)
Source: Eurostat

UK

While the UK economy has proved more resilient than many expected (though in line with our forecasts), GDP has continued to just flatline recently. Growth is being held back by a range of factors, including high Inflation - which is weighing on consumer spending, rising business costs and tightening monetary policy - which is weighing on investment, and adjustment to the new post-Brexit trading arrangements - which is weighing on exports. Downside risks to growth are also rising as the Bank of England pushes monetary policy into increasingly restrictive territory in response to elevated inflation. The headline rate of inflation has fallen more slowly than in other economies, though at 7.9% it is down from its peak of just over 11% in October last year and is set to fall further over the second half of this year as domestic energy bills come down. A tight labour market is contributing to robust growth in wages, which in turn is contributing to elevated core inflation, currently running at around 7%.

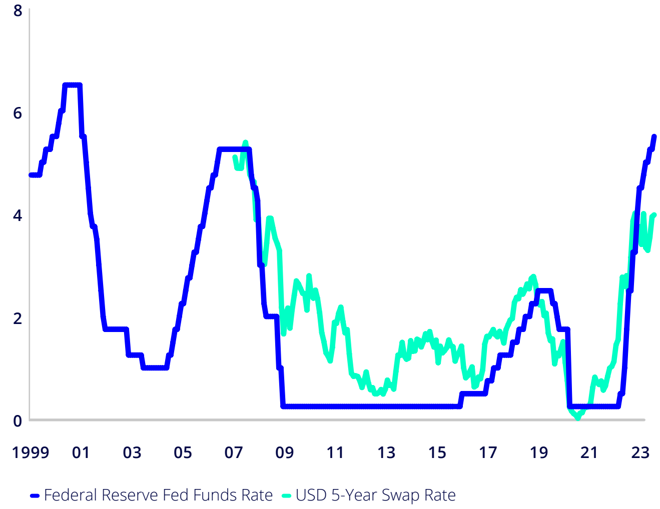


- UK GDP (3-month moving average, annual % change, constant prices)
Source: ONS

Interest Rates

Fed

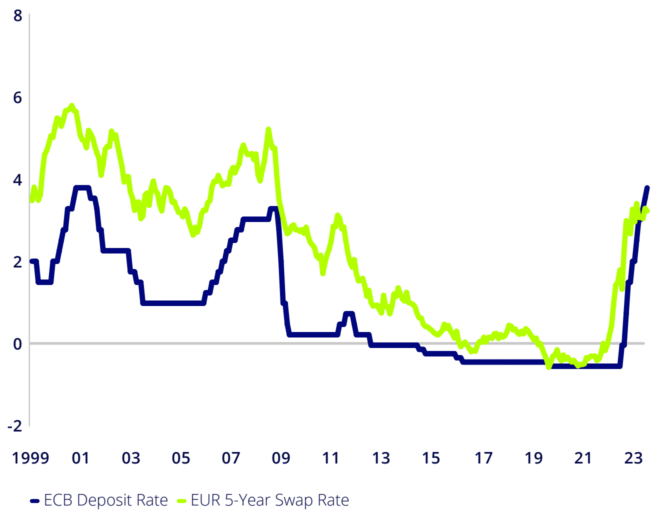
Having raised interest rates at each of its ten previous monetary policy meetings, the Fed stayed on hold in June. However, it quickly became clear, via the central bank's updated interest rate 'dot plot' and comments by the Fed Chair Jerome Powell, that this was unlikely to be the end of the tightening cycle, with the former pointing to possibly two further quarter point rate hikes by the end of this year. The Fed delivered one of these at its July meeting, taking the policy rate to a range of 5.25%-5.5% and bringing the cumulative increase since it began raising interest rates in March last year to 525bps. The July hike may prove to be the last though, if the recent progress on inflation - particularly evident in the June PCE readings - is sustained. The market is currently attaching about a 40% chance to a final quarter point hike this year and sees the Fed beginning to cut rates early next year. We doubt the Fed will be easing policy that soon though, not unless the pace of economic growth slows sharply over the second half of this year and labour market conditions soften considerably.



Source: Bloomberg

ECB

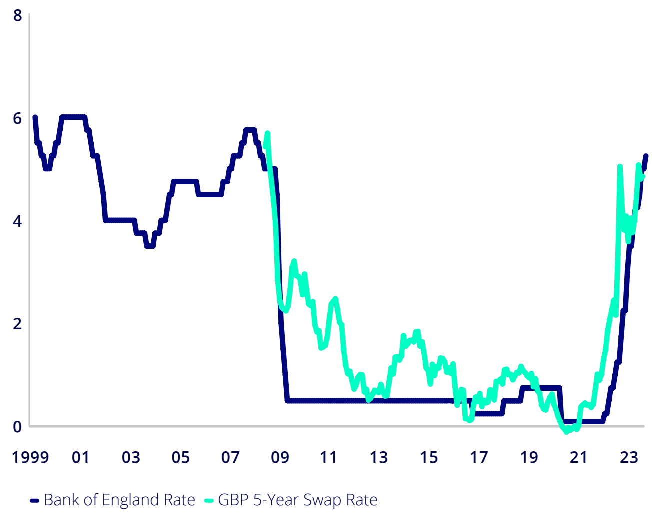
The ECB raised interest rates by another 25bps in July, taking the deposit rate and refinancing rate to 3.75% and 4.25% respectively. However, unlike after its June meeting (and indeed other meetings before that), at which it clearly indicated that it would hike rates at the immediately following meeting, the ECB was non-committal about what it would do at its next meeting in September, saying it could hike again, or it could pause, and indeed if it did pause, this would not necessarily mean the tightening cycle was at an end. The ECB's caution on this occasion probably reflects a few factors – the cumulative policy tightening to date, amounting to 425bps (which is greater than its two previous tightening cycles in the 2000s); increasing signs that higher interest rates are contributing to slowing credit growth and weaker economic growth; and a significant decline in headline inflation, which is expected to continue and which will, indirectly, contribute to some decline in core inflation albeit the latter is proving sticky to date (with core services inflation hitting a new record high in July). On balance, we think the ECB will hike by 25bps in September, and expect that to be the last in the current cycle with rates remaining on hold well into 2024.



Source: Bloomberg

Bank of England

Having raised rates by 25bps at its March and May meetings, the Bank's Monetary Policy Committee (MPC) stepped up the pace of tightening in June, hiking by 50bps to 5.0%. This was in response to higher than expected CPI readings for May - headline inflation remained at 8.7% and core inflation picked up to 7.1% - and an acceleration in underlying whole-economy wage inflation to 7.3% in February-April (and to 7.6% in the private sector), with the MPC noting that "there has been significant upside news in recent data that indicates more persistence in the inflation process." Inflation and labour market data published since the June meeting showed headline inflation falling to 7.9% in June but core inflation only marginally lower at 6.9%, while overall wage growth was unchanged (7.3%) in March-May but picked up a touch (7.7%) in the private sector. This was enough to prompt the MPC to hike rates again at its August meeting, this time by 25bps, bringing the cumulative increase since it began tightening policy back in December 2021 to 515bps. Moreover, the MPC may not be done yet, as it reiterated that a further increase in rates may be needed if inflationary pressures prove persistent.

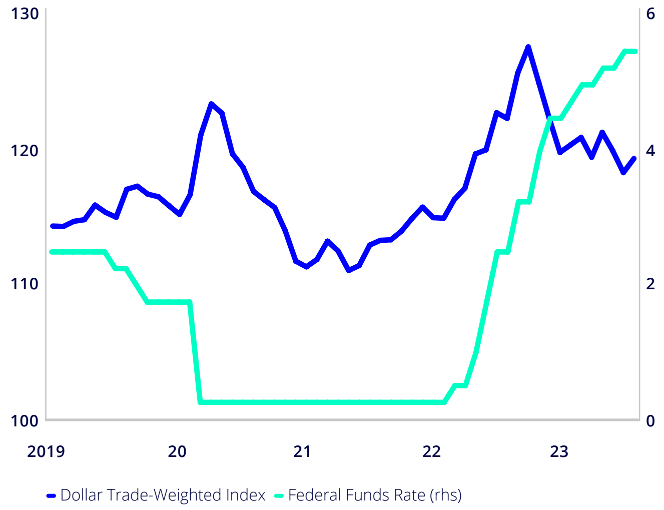


Source: Bloomberg

Currencies

Dollar

The dollar appreciated sharply on a trade-weighted basis (i.e. against a basket of currencies of its trading partners) over the first ten months of 2022 (reaching a multi-year high in the process), as the Fed tightened monetary policy aggressively, before giving up ground over the following few months when other central banks stepped up the pace of interest rate increases. It has been relatively stable since early spring, though it did lose some ground for a time in July in response to softer than expected inflation readings in the US and as markets priced in an end to the Fed's rate tightening and the start of an easing cycle from early next year. The dollar is down around 8% from last October's high, and, while we don't think the Fed will be lowering interest rates quite as soon as the market expects, nevertheless we do see the dollar gradually weakening over the remainder of this year and losing more ground through next year, as in all likelihood the Fed does begin to cut rates in 2024.



Source: Bloomberg

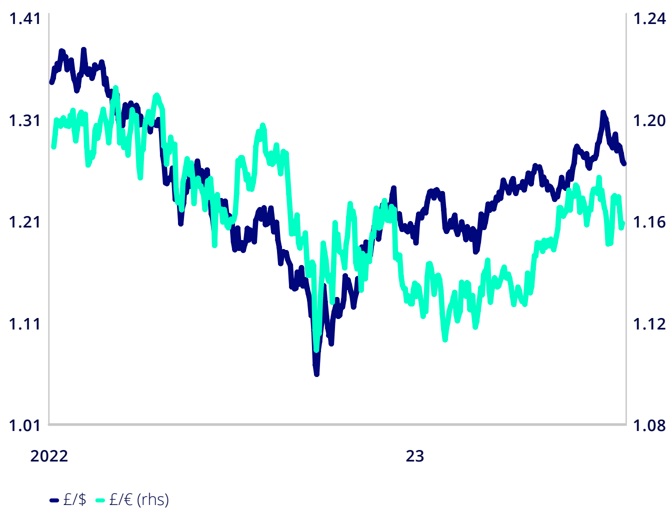
Euro

In our previous Global Watch published at the start of June, we thought the euro would trade in a range of \$1.06 to \$1.10 against the dollar over the remainder of Q2 before strengthening somewhat into a trading range of \$1.08 to \$1.12 in Q3 (July-September). In the event, the single currency rose to just over \$1.12 in mid-July before falling back to around \$1.10. The latter is also in the lower half of the euro's trading range of around \$1.05 to \$1.25 that has prevailed for the most part since the beginning of 2015, save for the notable - but still relatively short-lived - fall below parity last autumn. Looking ahead, we are not inclined to change our existing forecast very much. This sees the euro continuing to gain ground on the dollar over the remainder of this year and in 2024. While the ECB and Fed both look to be near or at the top of the interest rate-hiking cycle, the ECB has made less progress in the fight against inflation, suggesting it will keep rates on hold for longer than the Fed (and so lag the latter in any easing cycle), which in turn should support the euro.

Source: Bloomberg

Sterling

The Bank of England MPC's larger than expected 50bps interest rate hike in June prompted the market to initially price in a peak in rates of 6.5%, which in turn saw sterling strengthen to over \$1.31 against the dollar and to 85p vis-a-vis the euro in mid-July, both outside the trading ranges (\$1.23-\$1.27 and 86p-90p respectively) that we had expected to prevail in Q3. Rate expectations have since been pared back quite a bit however - the peak is now seen at circa 5.75% - and the pound has given up ground as a result, falling back to around \$1.27 and to over 86p. With UK interest rates expected to rise relative to US and Euro area rates over the coming months, this might also be expected to lend some support to sterling, though to the extent that the MPC's tightening heightens concerns about a recession in the UK, it could work in the opposite direction. For now, we still think the pound – as for the euro - is likely to trend gradually higher against the dollar over the rest of this year and into 2024, with a range of around 85p-90p prevailing for the pound against the euro.



Source: Bloomberg

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