Global Watch

October 2023

Economic and Market Update

Bank of Ireland

Summary

- Headline inflation has fallen steadily during the course of this year, though a renewed increase in oil prices has been temporarily slowing progress recently.
- Core – or underlying – inflation has fallen more gradually, but should decline further as tighter monetary policy dampens economic growth.
- Having risen sharply over the past 18-24 months, interest rates now look to be at or close to a peak, though the main central banks have indicated that they will have to remain higher for longer in order to ensure inflation returns sustainably to target.
- The higher for longer mantra has contributed to a notable rise in bond yields led by the US, with 10-year Treasury yields approaching 5%, a level not seen since 2007.
- The dollar has rebounded strongly over the past three months or so, strengthening by around 5% on a trade-weighted basis, as the market has priced out an early start to Fed rate cuts.
- We think the Fed will be the first of the main central banks to begin lowering interest rates, sometime around the middle of 2024, which should also see the dollar weaken gradually during the course of next year.

Forecasts

GDP Growth*	2022	2023(f)	2024(f)
Global	3.5%	3.0%	2.9%
US	2.1%	1.9%	1.5%
Euro area	3.3%	0.7%	1.2%
UK	4.3%	0.5%	0.6%

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

Central Bank Interest Rates (%)	Current	End-Dec 23	End-Mar 24	End-Jun 24	End-Sep 24
Fed	5.25-5.50	5.25-5.50	5.25-5.50	5.00-5.25	4.50-4.75
ECB (Deposit Rate)	4.00	4.00	4.00	4.00	3.75
BOE	5.25	5.50	5.50	5.50	5.25

Source: Bloomberg, Bank of Ireland Forecasts

FX**	Current	Q4'23	Q1'24	Q2'24	Q3'24
€/$	1.05	1.03-1.08	1.05-1.10	1.07-1.12	1.09-1.15
€/£	0.87	0.84-0.89	0.85-0.90	0.85-0.90	0.86-0.91
£/$	1.21	1.20-1.25	1.20-1.25	1.23-1.28	1.25-1.30

**Current Rate is as of 18th October 2023
Source: Bloomberg, Bank of Ireland forecasts

Upcoming Events

October

- 24th – UK Labour Market Aug
- 26th – ECB Meeting & US GDP Q3
- 27th – US PCE Inflation Sep
- 30th – US Employment Cost Index Q3
- 31st – EA GDP Q3 & CPI Oct (flash)

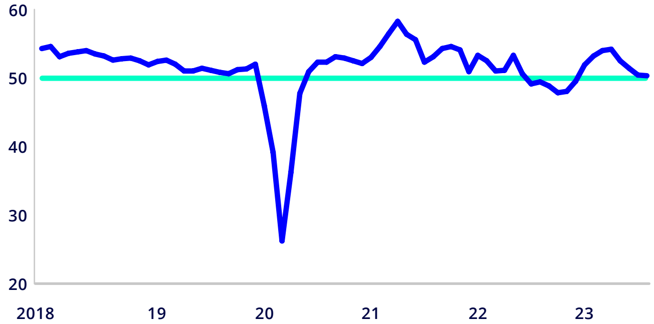
November

- 1st – Fed Meeting
- 2nd – Bank of England MPC Meeting
- 3rd – US Payrolls Oct
- 10th – UK GDP Sep and Q3
- 14th – UK Labour Market Q3
- 15th – UK CPI Oct & European Commission Forecasts
- 17th – EA CPI Oct (final)
- 20th – OECD Economic Outlook
- 30th – EA CPI Nov (flash) & US PCE Inflation Oct

Economy

Global

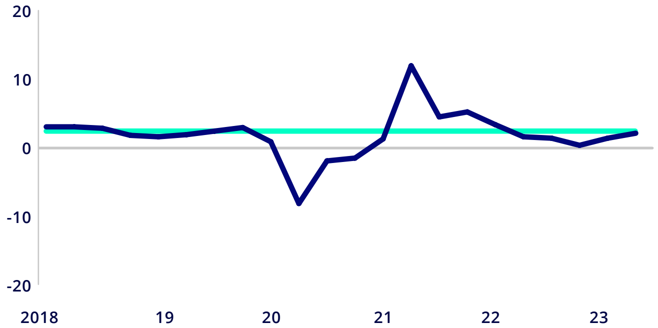
While world economic activity was relatively resilient over the first half of this year, high frequency data suggest the pace of growth is moderating in response to tighter monetary policy. The global composite PMI fell for a fourth consecutive month in September albeit remaining in expansionary territory (at 50.6), with services activity clearly slowing and manufacturing remaining weak. The IMF In its latest forecasts expects global GDP growth to average 3% this year, down from 3.5% in 2023, before dipping further to 2.9% in 2024. It also believes the risks to growth are tilted to the downside - they include underlying inflation remaining higher for longer and China's economy slowing by more than expected - while escalating geopolitical tensions have added a new layer of uncertainty lately.



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

US

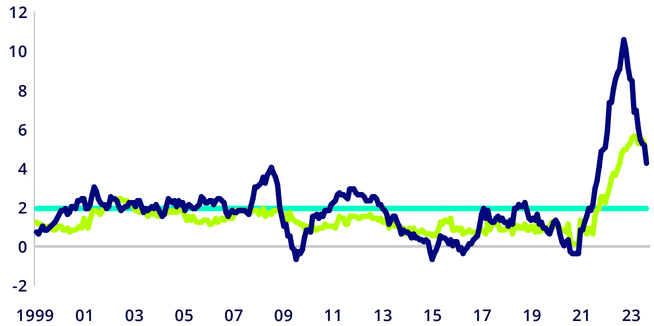
The US economy has proved more resilient in the face of rising interest rates than was widely expected. GDP rose by 0.5% in Q2 to take the year-on-year increase to 2.4%, while consumer spending looks to have driven another solid increase in Q3. However the latest survey data point to some softening in the pace of growth ahead, while the recent tightening of financial conditions (including a notable run up in bond yields and a strengthening of the dollar) is likely to weigh on economic activity. Labour market conditions are continuing to ease, with job openings trending down, employment gains moderating albeit still solid, and wage growth slowing. On the inflation front, the annual rate of headline rate PCE inflation has ticked up recently due to rising energy prices, though at 3.5% (August) it remains well down from its peak of 7.1% in 2022, while core inflation has fallen to 3.9%, a full percentage point lower than at the end of last year.



US GDP (annual % change, constant price) · Average GDP Growth 2010-2019
Source: BEA

Euro area

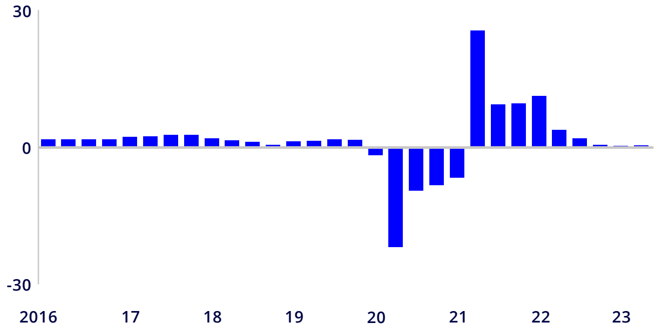
The Euro zone economy more or less stagnated over the first half of this year, with GDP increasing by just 0.1% in the second quarter (revised down from an initial estimate of +0.3%) having been flat in Q1. The latest PMI data suggest the economy may have contracted in the third quarter - the composite PMI remained below 50 for a fourth consecutive month in September amid a noticeable weakening in services activity - as higher interest rates increasingly take a toll. The unemployment rate has continued to fall nonetheless, reaching a new all-time low of 6.4% in August, though employment growth has started to slow as economic activity wanes. Headline and core CPI inflation fell noticeably in September helped by positive base effects - prices rose sharply in the month of September last year - albeit both remained well above the ECB's 2% target at 4.3% and 4.5% respectively (down from 5.2% and 5.3% in August).



CPI Inflation (%) · CPI Inflation Excluding Energy and Food (%) · ECB Inflation Target
Source: Eurostat

UK

GDP in the UK rose by 0.2% quarter-on-quarter in Q2 2023, following a 0.3% increase in Q1, with consumer spending slowing a touch and exports posting a second consecutive quarterly decline. Economic data for the period since have been soft. GDP rose by 0.2% in August, only partially reversing a decline of 0.6% in July, and the composite PMI remained below the key 50 level in September suggesting economic activity may have declined slightly in the third quarter. The labour market has continued to loosen with the unemployment rate rising to 4.3% in the three months to July (up from a low of 3.5% in summer 2022), though wage growth has remained robust to date. Consumer price inflation has eased recently but is still elevated - the headline rate remained at 6.7% in September while the core rate dipped to 6.1% from 6.2% in August - and is clearly running well above the Bank of England's target of 2%.

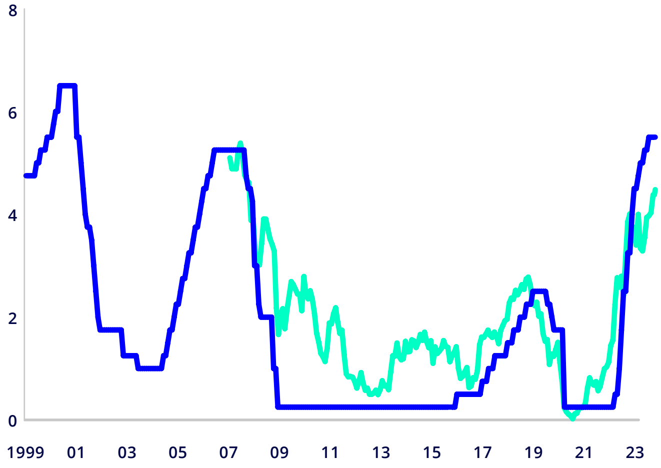


UK GDP (annual % change, constant prices)
Source: ONS

Interest Rates

Fed

The Fed left interest rates on hold at its September meeting, having hiked by 25bps to 5.25%-5.50% in July. In its updated macroeconomic projections, the Fed raised its forecast for GDP in 2023 and 2024 - though the annual rate of growth is expected to slow to 1.5% by the end of next year from 2.1% at the end of this year - and lowered its forecast for unemployment – albeit the jobless rate is seen nudging up to 4.1% by end-2024 from 3.8% at end-2023. Both headline and core PCE inflation are expected to fall further over the course of next year, to 2.5% and 2.6% respectively (from 3.3% and 3.7% at the end of 2023), before declining to 2.2% and 2.3% in 2025. In terms of interest rates, the Fed indicated one further 25bps hike may be appropriate by the end of this year and pared back expected cuts in both 2024 and 2025 (by 50bps for each year to 5.1% and 4.6% respectively). The market sees about a 50% chance of a final quarter-point hike this year and has reduced considerably expectations for Fed easing next year – it currently see rates seen ending 2024 at about 4.75%, some 100bps higher than it was pricing in three months ago in mid-July.

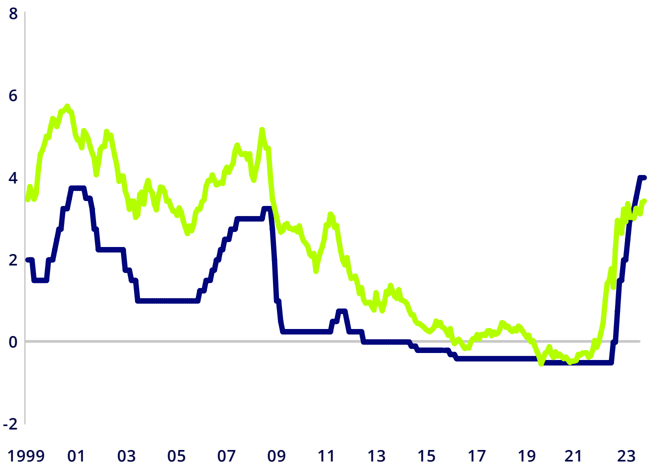


Federal Reserve Fed Funds Rate USD 5-Year Swap Rate

Source: Bloomberg

ECB

The ECB raised interest rates by another 25bps in September, its tenth consecutive hike, taking the deposit rate and refinancing rate to 4% and 4.5% respectively. The decision to do so was 'fine balanced' according to subsequent ECB commentary, which noted that a further increase in rates would help reinforce the 'progress' made towards returning inflation to target. Moreover, with higher interest rates 'increasingly dampening demand' in the Euro area economy, the ECB indicated it was pausing its tightening cycle, saying that rates are now at 'levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our (2%) target". It did, though, leave the door open to a further increase if needed, saying that 'our future decisions will ensure that (rates) will be set at sufficiently restrictive levels for as long as necessary.' The market thinks the ECB is now done raising rates, and expects it to embark on an easing cycle from the middle of next year with rates seen falling by some 75bps by the end of 2024.

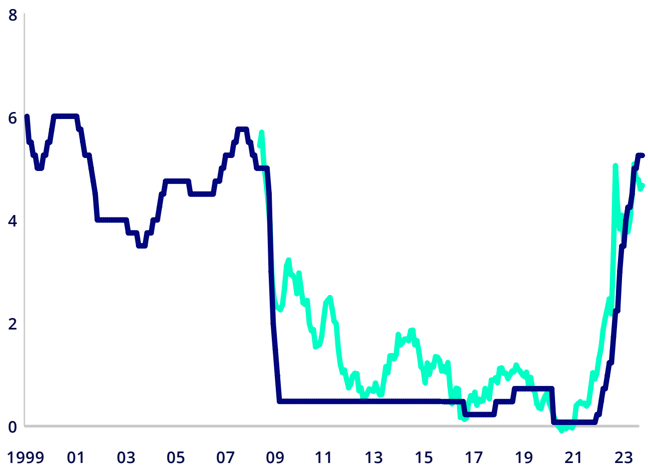


ECB Deposit Rate EUR 5-Year Swap Rate

Source: Bloomberg

Bank of England

Having raised interest rates at each of its thirteen meetings since the end of 2021, the Bank of England Monetary Policy Committee (MPC) stayed on hold at 5.25% in September, though the decision to do so was a very close call with four of the nine members of the MPC voting to hike rates by 25bps. While the 'no change' outcome took the market somewhat by surprise, the Bank of England Governor, Andrew Bailey, had noted at the time of the August MPC meeting that 'different paths (for interest rates) can secure a return of inflation to target", one of which was keeping rates at 5.25% for an extended period of time (another was raising rates further to around 6% in the nearer-term before lowering them later). The MPC's post-September meeting statement noted that, given the significant increase in rates since the start of the tightening cycle (+515bps), monetary policy is 'restrictive' (and) will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably', while also warning that 'further tightening would be required if there were evidence of more persistent inflationary pressures'. The market is pricing in about a 60% chance of a final 25bps rate hike by the end of this year/ early 2004, with the MPC then seen on hold until early autumn next year when it is expected to begin gradually lowering rates.



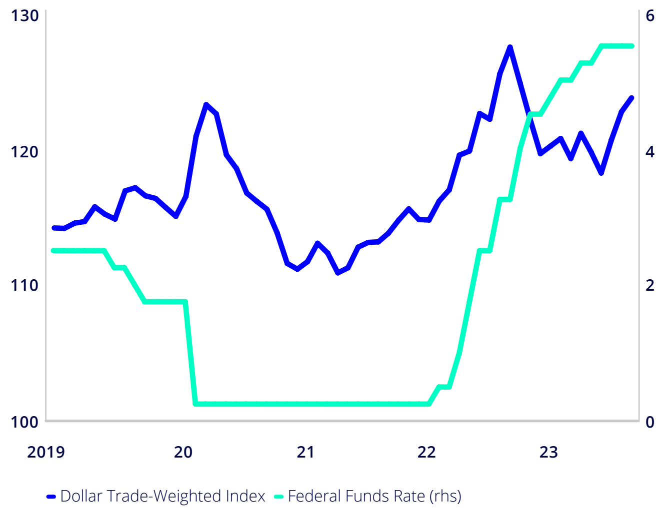
Bank of England Rate GBP 5-Year Swap Rate

Source: Bloomberg

Currencies

Dollar

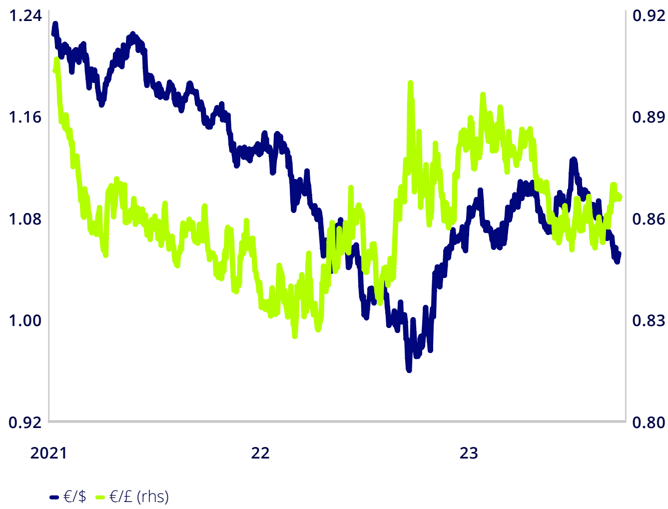
After falling to a 2023 low on a trade-weighted basis (i.e. against a basket of currencies of the United States' main trading partners) in the middle of July, the dollar has risen by around 5% over the past three months. This has been driven largely by a marked shift in market expectations regarding the outlook for US interest rates during this period, which in turn reflects the ongoing resilience of the economy, despite a significant tightening of monetary policy, and the Fed's guidance that rates need to remain higher for longer to ensure inflation returns to target. This reassessment of the outlook for interest rates has contributed to a notable rise in US bond yields since July - both in absolute terms and relative to bond yields elsewhere – which in in turn has contributed to a strengthening of the dollar. With the Fed leaving the door open to a further rate increase before the end of 2023, the currency is likely to remain well underpinned in the final quarter of this year. Looking to 2024, we think the Fed will be first of the major central banks to start lowering interest rates, probably from late in the second quarter, which in turn should see the dollar gradually weaken over the course of next year.



Source: Bloomberg

Euro

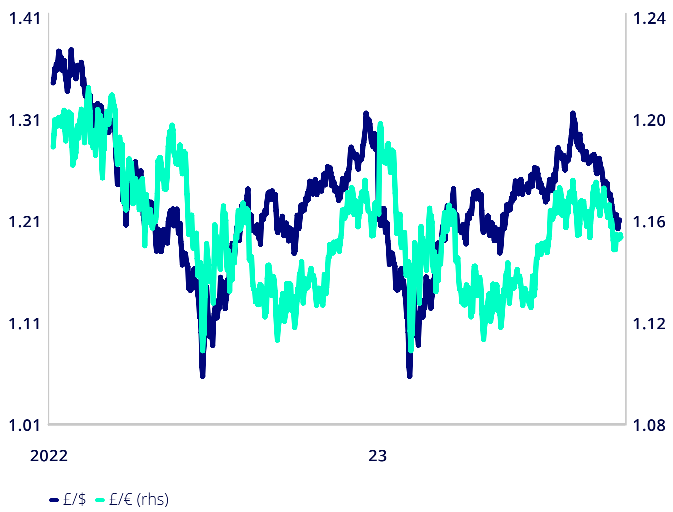
In our previous Global Watch published in early August, we thought the euro would continue to trade in a range of 1.08 to 1.12 against the dollar for the remainder of Q3. In the event, the single currency weakened steadily during the month of September, falling to under $1.05 towards the end of the month - from around $1.0850 at end-August and a 2023 to date high of $1.12 in mid-July - and has traded between $1.04 and $1.06 in October to date. While market expectations for ECB interest rates have not changed much recently, as noted above there has been a marked shift in expectations regarding the outlook for US rates. This has resulted in a significant rise in US government bond yields relative to European yields, which seems to explain a good portion of the euro's fall from its July highs. Given the positive sentiment towards the dollar recently, as well as heightened geopolitical tensions related to events in Israel, there's a chance the euro loses more ground in the short-term even absent any further significant movement in yield differentials. The latter, though, are likely to be an important driver of EUR/$ in 2024. If, as we expect, the Fed is first out of the blocks to cut rates, this will be reflected in an increase in European yields relative to US yields, which should see a renewed strengthening of the euro next year.



Source: Bloomberg

Sterling

Sterling has fallen sharply from its 2023 to date high of over 1.31 against the dollar in mid-July, shedding 10 cents to $1.21. The pound is also off its year to date high of 85p to the euro, also set in mid-July, currently trading at around 87p, with this pair confined to a narrow range of 85-89p so far in 2023 (which in turn is within the broader range of 83p to 94p that has prevailed since 2017 post the UK's exit from the EU). A combination of the market paring back expectations for Bank of England interest rate hikes, which for a time during the summer envisaged a peak of 6.5% early next year, while at the same time scaling back expectations for Fed rate cuts, has weighed on sterling. The pound could weaken further in the short-term given positive sentiment towards the dollar, but we think it will regain some ground against the US currency during the course of 2024 as the Fed is likely be ahead of the Bank of England in cutting interest rates. Given our expectation for EUR/$, this in turn would be consistent with sterling continuing to trade within a range of about 85p to 90p to the euro next year.



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