

Fed to commence rate cuts

Inflation is in retreat in the main economies, with headline rates close to target, and central banks have begun to lower interest rates following the sharp tightening of monetary policy in 2022-2023. The ECB and Bank of England are among a number of central banks to have cut policy rates, while the Fed is certain to do so this month amid concerns about a slowdown in the US economy and a cooling in the labour market. Government bond yields and swap rates have fallen recently and are now well below policy rates as the market sees the latter being cut steadily over the next 12-15 months. The dollar has lost ground as Fed rate cut expectations have been building, with the euro and sterling setting new highs for the year against the US currency in late August.

Step down in US growth, Euro area and UK expanding again

The pace of growth in the US economy has stepped down in 2024, albeit remaining solid to date, having been surprisingly resilient in 2023, while the Euro area and UK economies are expanding again having essentially stagnated for much of last year. Headline inflation has fallen close to target in the three economies - to 2.5% in the US and 2.2% in both the Euro area and UK - with goods inflation in particular declining sharply as the shocks that pushed up prices significantly in recent years have abated. Services inflation still remains relatively high but is coming down, and should decline further as wage growth eases in response to looser labour market conditions.

Central banks now lowering interest rates

Central banks are now lowering interest rates from the high levels that prevailed following the aggressive tightening of monetary policy in 2022-2023, with the ECB and Bank of England cutting by 25bps in June and August respectively. The ECB looks certain to lower rates by another 25bps this month with a further quarter-point reduction likely at its final meeting of the year in December. We expect the BoE to cut once more this year - by 25bps in November - and see the Fed lowering rates by a quarter-point at each of its final three meetings of 2024 in September, November and December. Rates are expected to fall further in 2025, with all three central banks seen cutting by 75bps over the first half of the year. For its part, the market is pricing in cuts of the order of 150-200bps from the three central banks by the end of 2025, but sees policy rates settling well above the exceptionally low levels that prevailed during the post-global financial crisis, pre-pandemic period when inflation ran persistently below target.

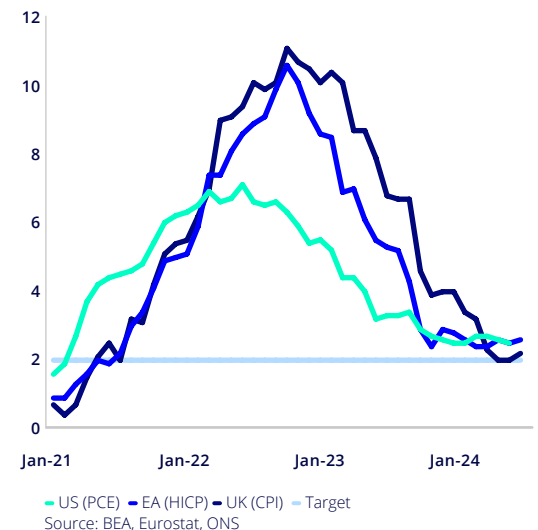
Bond yields and swap rates have fallen

In terms of market interest rates, both government bond yields and swap rates have declined steadily in recent weeks, by around 50-100bps, and are now well below policy rates. Shorter-maturity rates - which are the most sensitive to changes in market expectations for central bank policy rates - have fallen the most and curves have dis-inverted as a result. Further dis-inversion and eventual normalisation is likely as market rates fall further, though the scope for them to decline significantly from current levels may be limited given the scale of policy rate cuts already priced in.

Dollar loses ground

In FX markets, the dollar has been on the defensive in recent weeks as Fed rate cut expectations have firmed and US yields have fallen relative to elsewhere. This saw the euro and sterling strengthen to new highs for the year of \$1.12 and north of \$1.32 respectively in late August (up some 6% and 7% from their respective 2024 lows in April). We expect both to gain some more ground against the US currency over the coming months and to trade in ranges of \$1.11-\$1.17 and \$1.31-\$1.36 respectively over the first half of 2025, leaving EURGBP trading in a range of around 83p to 87p.

Annual Consumer Price Inflation (%)



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Inflation in retreat



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Rate-cutting cycle ahead



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Dollar on the defensive



Forecasts

GDP

GDP Growth*	2023	2024(f)	2025(f)
Global	3.3%	3.2%	3.3%
US	2.5%	2.6%	1.9%
Euro area	0.5%	0.9%	1.5%
UK	0.1%	0.7%	1.5%

*Annual % change, constant prices
Source: IMF (July 2024)

Interest Rates

Central Bank Rates (%)	Current	End-Q3'24	End-Q4'24	End-Q1'25	End-Q2'25
Fed	5.25-5.50	5.00-5.25	4.50-4.75	4.25-4.50	3.75-4.00
ECB	3.75	3.50	3.25	3.00	2.50
BoE	5.00	5.00	4.75	4.25	4.00

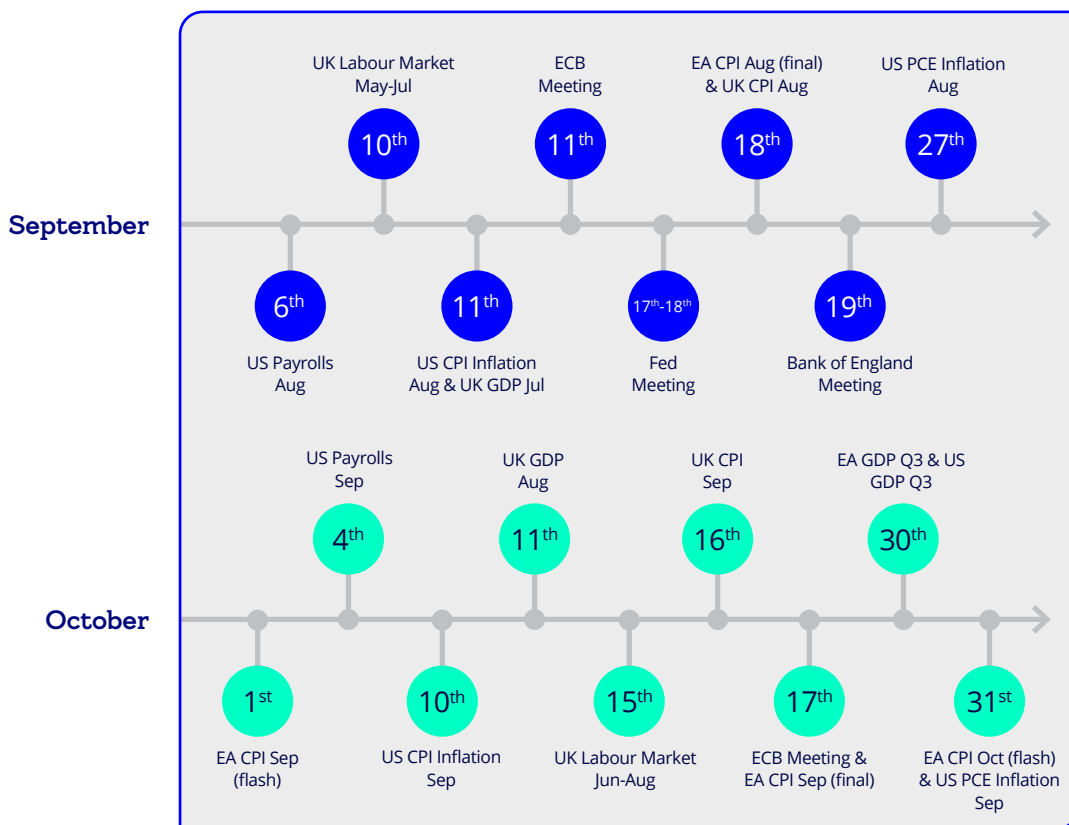
Source: Bloomberg, Bank of Ireland Forecasts

Exchange Rates

Exchange Rates	Current	Q3'24	Q4'24	Q1'25	Q2'25
€/\$	1.1050	1.07-1.13	1.09-1.14	1.11-1.16	1.12-1.17
€/£	0.8415	0.83-0.87	0.83-0.87	0.83-0.87	0.84-0.88
£/\$	1.3125	1.26-1.33	1.29-1.34	1.31-1.36	1.31-1.36

**Current Rate is as of 30th August 2024
Source: Bloomberg, Bank of Ireland forecasts

Upcoming Events

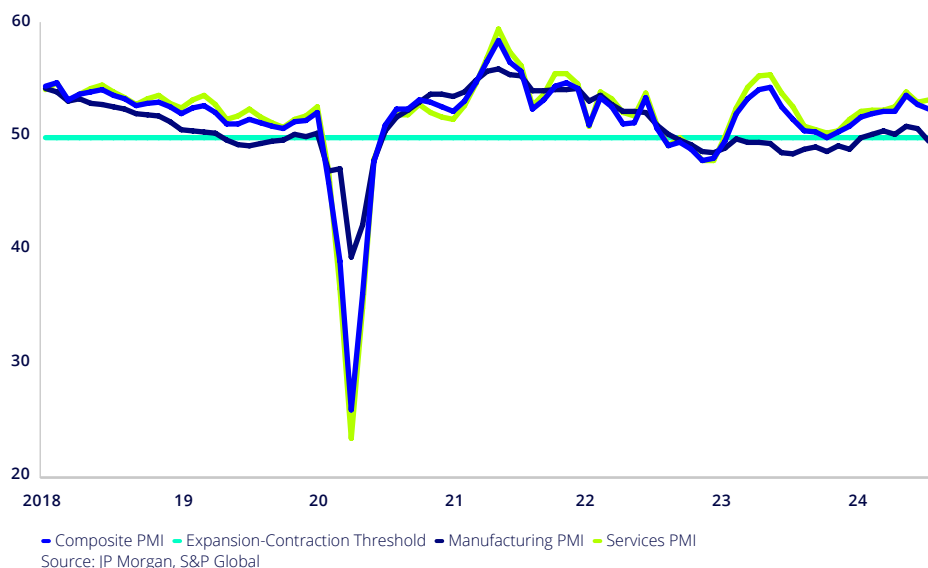


Economy

Modest global growth

Global growth strengthened over the first half of 2024, albeit still remaining relatively modest, with continued expansion in China and a pick-up in activity in Europe offsetting a moderate slowdown in the US. The services sector is the main driver of growth, as declining inflation supports real incomes and consumer spending, while manufacturing continues to underperform with the global Purchasing Managers Index (PMI) of activity in this sector falling below the key 50 level again in July. The IMF is projecting world GDP growth of 3.2% and 3.3% in 2024 and 2025 respectively, supported by less restrictive monetary policy as central banks lower interest rates in response to declining inflation. The IMF sees the latter falling to about 2% in advanced economies next year, in line with the target of the main central banks, down from a peak of over 7% in 2022.

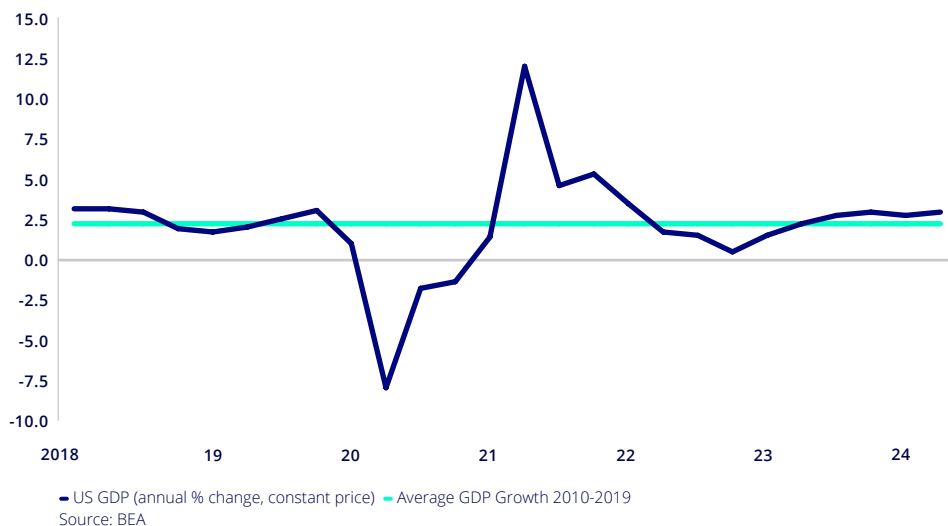
Global PMIs



US economy slowing

The US economy proved resilient last year notwithstanding a sharp tightening of monetary policy between March 2022 and July 2023. GDP growth accelerated to 2.5%, from 1.9% in 2023, as a rundown of pandemic-related excess savings and expansionary fiscal policy contributed to robust increases in consumer spending and investment. Growth has eased in 2024 though - GDP rose by 0.5% quarter-on-quarter (q-o-q) over the first two quarters, down from more than 1% a quarter over the final two quarters of 2023 - largely reflecting a step down in consumer spending. While the IMF expects growth to average 2.6% in 2024, the year-on-year (y-o-y) increase in GDP is seen slowing to 2.0% in Q4, dipping to 1.8% in 2025, amid a cooling labour market and less supportive fiscal policy.

US Annual GDP Growth (%)



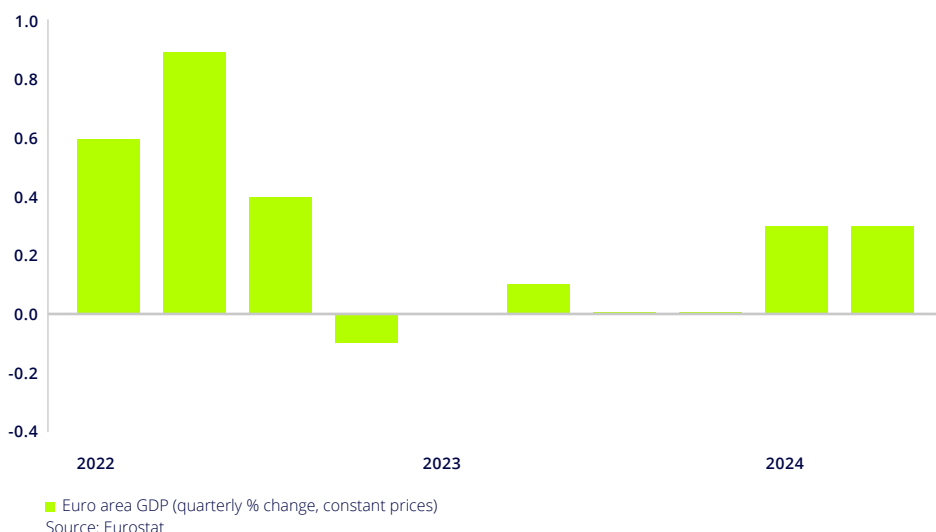
Economy

Consistent with the moderation in economic growth, employment gains have also slowed albeit remaining solid. Non-farm employment increased by an average of 200k a month in January-July, down from 250k a month in 2023. Jobs growth came in at 170k in the three months to July, weighed down by a weaker than expected outturn in July (+114k). This, together with another increase in the unemployment rate, contributed to fears of an imminent recession and triggered turmoil in financial markets in early August, though the latter proved short-lived suggesting recession concerns are overdone. Labour demand is cooling however, evident in a steady decline in job openings in the economy. Wage growth is also slowing, which will contribute to a deceleration in services inflation, currently the main contributor to above-target overall inflation of 2.5%.

Euro area returns to growth

The cost of living squeeze, increasing borrowing costs, and a fading of 'reopening' demand post-pandemic weighed on the Euro area economy in 2023. High frequency indicators, particularly the PMIs, had pointed to a recovery in activity from late last year, which has come through in the hard data with GDP increasing by 0.3% q-o-q in each of the first two quarters of 2024. Declining inflation and strong nominal wage growth are supporting consumer spending, while firming global growth is helping exports. The latest PMI data though point to a moderation in GDP growth in the third quarter, with services activity slowing, posing some downside risk to the IMF's forecast for growth of 0.9% in 2024 (after 0.5% in 2023).

Euro area Quarterly GDP Growth (%)



Headline CPI inflation has fallen sharply and stood at 2.6% in July, down from a peak of almost 11% in late 2022. Goods inflation has declined to 1%, but services inflation remains relatively high at 4%. High services inflation in turn is largely the result of robust wage growth as pay settlements have attempted to catch up with the past increase in inflation. Wage growth is likely to slow over the second half of 2024 and in 2025 however reflecting lower headline inflation and softening labour demand, which in turn should feed through to a decline in services inflation.

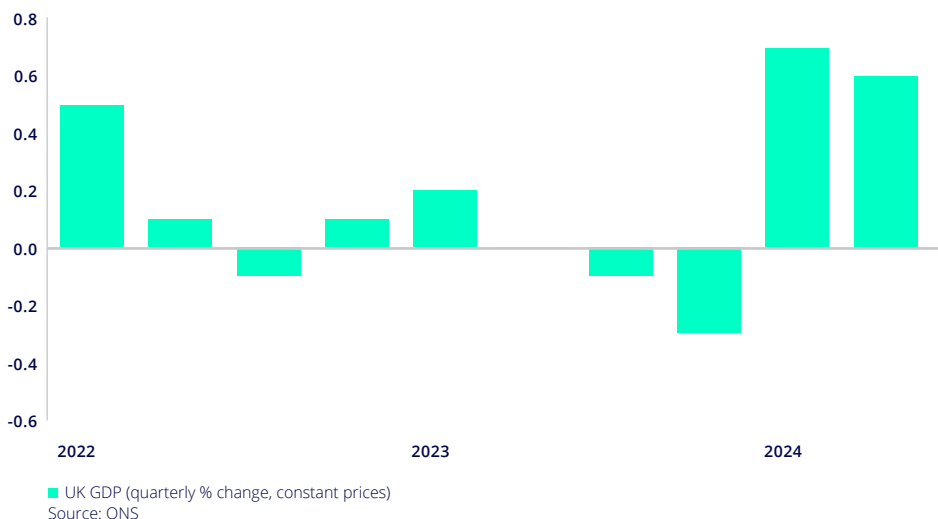
UK emerges from a mild recession

The UK economy has rebounded strongly from a mild recession over the second half of 2023. GDP increased by 0.7% q-o-q in the first quarter of this year and by 0.6% in Q2, driven by a recovery in consumer spending and investment. The economy ended the second quarter on a soft note though - GDP was flat in June - while PMI data for July-August are consistent with continued but more moderate growth in the third quarter. Nonetheless rising real household incomes will continue to support consumer spending, while investment should pick up further amid a more stable political backdrop. The new Labour government faces significant challenges in terms of the public finances however, so fiscal policy is likely to be a drag on growth, although monetary policy will become less restrictive as the Bank of England continues to lower interest rates.

Economy

The labour market has softened recently, probably a lagged response to the weak economy over the second half of last year. Employment growth has slowed and unemployment has risen, while wage growth is moderating although it remains elevated at around 5% in the private sector. Elevated wage growth is contributing to still high (but declining) services inflation, currently just above 5%, which is the main reason core inflation (3.3%) is still a good bit above headline inflation. The latter returned to the 2% target in May-June before edging up to 2.2% in July. It is likely rise further in the near-term but fall back towards target in 2025 as core inflation declines on the back of moderating services inflation.

UK Quarterly GDP Growth

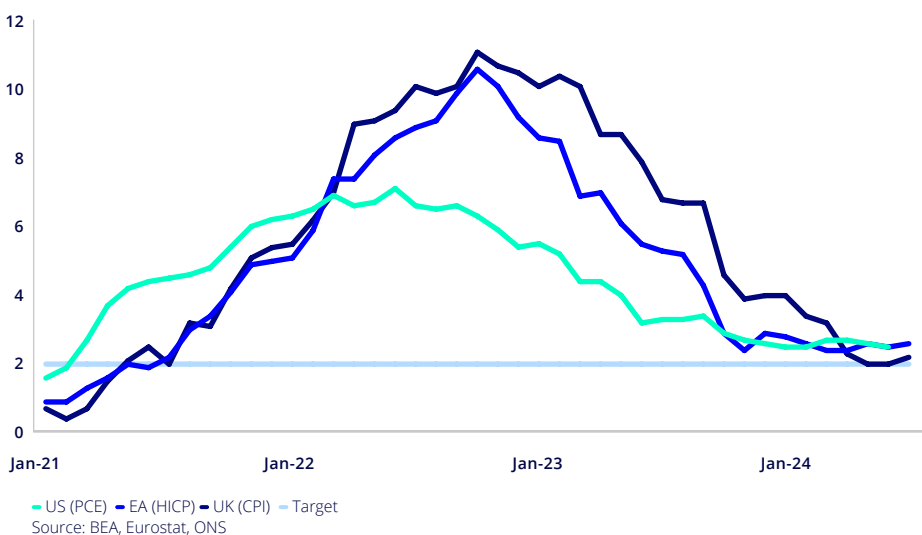


Central Banks

Rate cuts begin

Having kept interest rates on hold since Q3 last year, the main central banks have now begun to lower them as inflation has fallen close to the 2% target. Given the high levels to which rates were raised to address the surge in inflation, there is plenty of scope to reduce them considerably over the next 12-18 months. However they are unlikely to return to the very low levels that prevailed in the decade to 2019, when inflation ran persistently below target. The Bank of Japan is a notable exception to the other central banks. It has raised interest recently (albeit to just 0.25%) as the Japanese economy appears to be finally emerging sustainably from a long period of deflation

Annual Consumer Price Inflation (%)



Central Banks

Fed to finally lower rates

While the Fed has yet to begin lowering interest rates - after it was widely expected that it would be the first to do so - it now looks certain to cut them in September. Following its July meeting the Fed said that it is “attentive” to the risks to both inflation and employment, a significant change from June when it stated it remained “highly attentive” to the risk of persistently high inflation. Moreover, in his Jackson Hole speech in late August, Fed Chair Powell said that “downside risks to employment have increased (and) the time has come to adjust policy.” Having been pricing in a very high probability of a 50bps cut following the soft July jobs data and the ensuing sell-off in stocks, the market now sees a 25bps reduction in September as more likely. In any case, with growth moderating, the labour market softening, and inflation declining, this is likely to be the start of a sustained fall in rates. As in our previous Global Watch, we expect the Fed to cut by 25bps this month and by 25bps at each of its following two meetings in November and December (slightly less than the circa 100bps of cuts by year-end currently priced in by market).

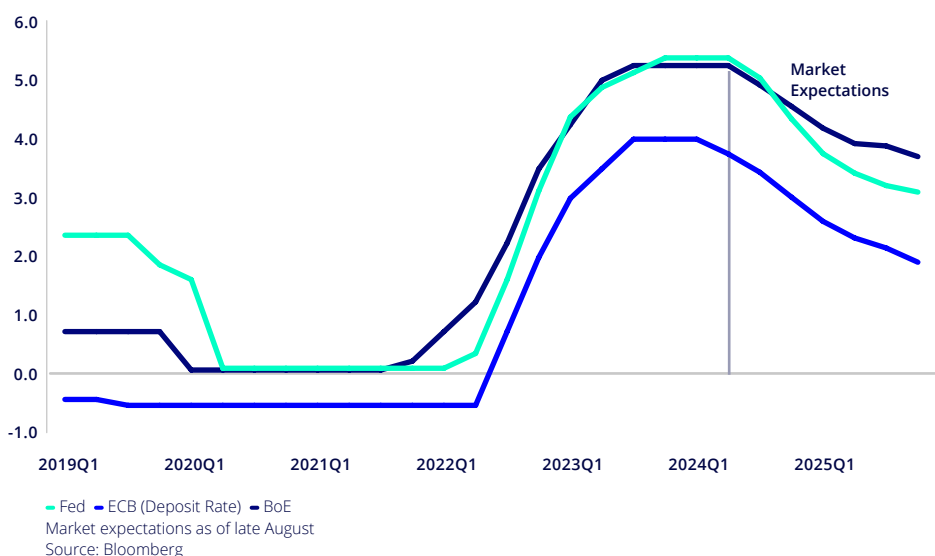
ECB to cut by another 25bps

Having cut the deposit rate - now the official policy rate - by 25bps to 3.75% in June, the ECB remained on hold in July and didn't give much away about what it might do at its next meeting in September, reiterating that it will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level of interest rates. However, while underlying inflation has been sticky recently, the ECB's September projections are likely to again show overall inflation returning to the 2% target over the second half of 2025. This will be the cue for the ECB to lower rates by another 25bps this month, with a further quarter-point reduction likely at its final meeting of the year in December (the market sees some chance of three quarter-point cuts over this period).

BoE to move again in November

With headline inflation having fallen close to target, the Bank of England Monetary Policy Committee (MPC) cut its key interest rate by 25bps to 5% at its August meeting. The decision to do so was a very close call though, with four of the nine MPC members voting to keep rates on hold. Even amongst the five who voted to cut rates, ‘some’ said the decision was ‘finely balanced’ given that ‘inflationary persistence had not yet conclusively dissipated’. This suggests these members won't be rushing to lower rates at the September meeting. However with both private sector wage growth and services inflation likely to moderate further we expect the MPC to cut rates once more this year, by 25bps in November (which is a bit less than the 40bps expected by the market).

Central Bank Policy Rates (%), End-Quarter

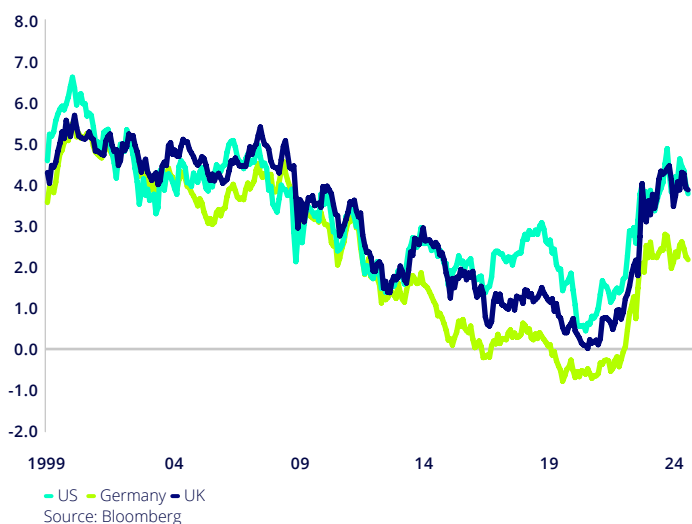


Markets

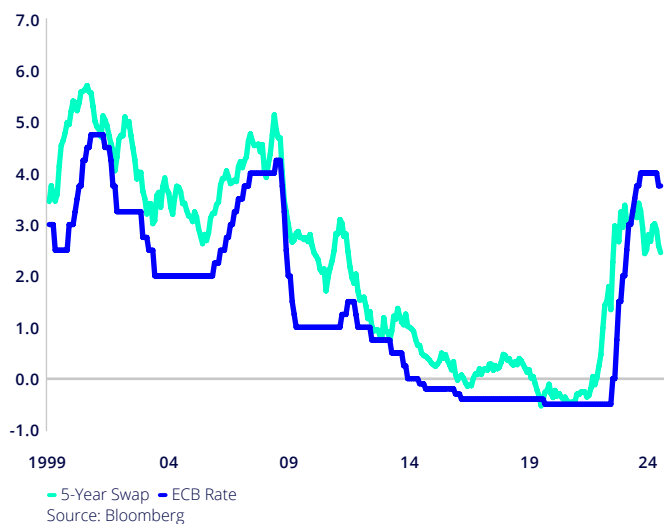
Fall in bond yields/swap rates

Based on current pricing, the market expects the main central banks to lower rates considerably over the next 15 months or so - by some 200bps, 175bps and 150bps in the case of the Fed, ECB, and Bank of England respectively. This has been reflected in a sharp fall in market interest rates, with government bond yields and swap rates declining by around 50-100bps over the past couple of months. Shorter-maturity rates - which are the most sensitive to changes in central bank policy rate expectations - have fallen the most and yield/swap curves have dis-inverted as a result. Further dis-inversion and eventual normalisation (i.e. curves become upward sloping) is likely as market rates fall, though the scope for the latter to decline significantly further may be limited given they are already trading well below central bank policy rates (and assuming policy rates don't return to the very low levels that prevailed for most of the 2010s).

Government 10-Year Bond Yields (%)



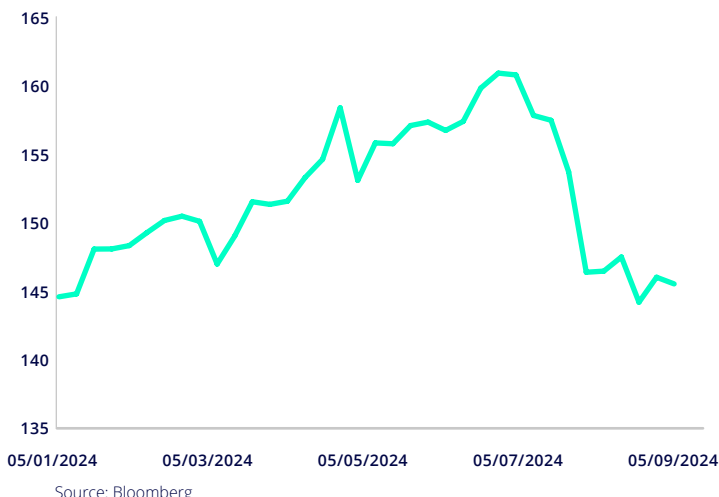
Euro 5-Year Swap Rate and ECB Policy Rate



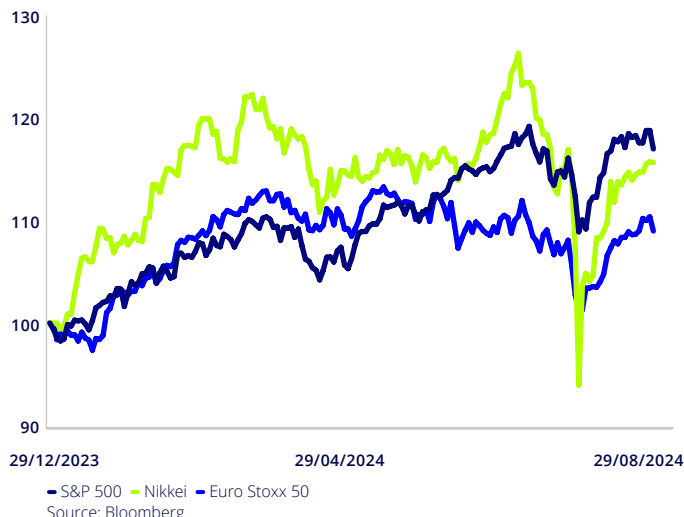
Dollar off its high

In FX markets, the dollar was on the front foot over the first half of 2024 - as higher than expected US inflation in the opening quarter of the year saw a marked paring back of Fed rate cut expectations - strengthening by around 5% on a trade-weighted basis, with the extreme weakness of the yen adding to its gains over the period. However as Fed rate cut expectations have built again more recently and US bond yields have fallen quite sharply relative to elsewhere, the dollar has retreated from its year to date high in early July, with a rebound in the yen as the Bank of Japan raised interest rates adding to its decline. Indeed a surge in the Japanese currency in early August (on foot of an unwinding of the yen carry trade) exacerbated the slide in equity markets triggered by the weak US jobs data released at that time. The S&P 500 fell by around 6%, led by a decline in tech stocks, but it has rebounded strongly since albeit remaining below its all-time high in mid-July this year (with equity markets generally remaining very sensitive to data relating to the health of the US economy).

USDJPY Exchange Rate



Equity Indices (End 2023 = 100)

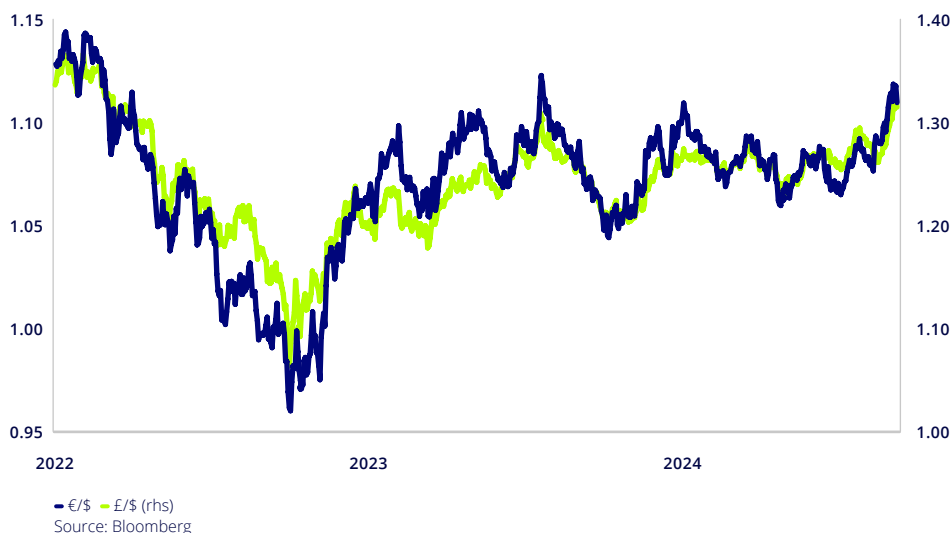


Markets

EURUSD and GBPUSD to strengthen

In our previous Global Watch, we thought that both the euro and sterling would establish new higher trading ranges against the dollar once it became clearer that the Fed would begin lowering interest rates. This seems to be transpiring with EURUSD and GBPUSD strengthening to new highs for the year of \$1.12 and north of \$1.32 respectively in late August. While there may be some volatility in and around November’s presidential election in the US, we expect both to strengthen further over the coming months although the gains from current levels may be modest enough (considering what is already priced in terms of Fed rate cuts). This is predicated on the US economy slowing but not turning over in the period ahead. Any significant deceleration in US growth would have a negative impact on risk assets - as we saw with the sharp but short-lived sell-off in equity markets in early August as recession fears took hold - and would probably be accompanied by a strengthening of the dollar.

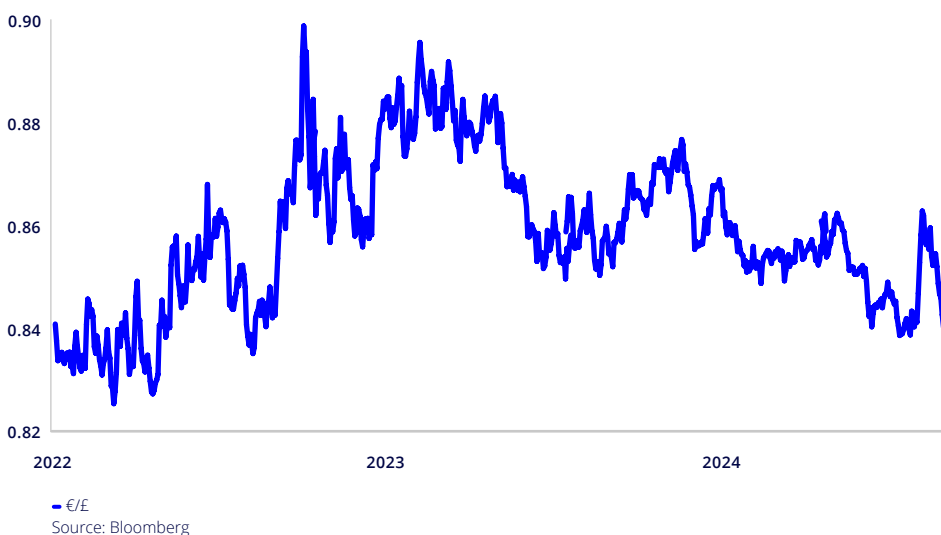
Euro and Sterling versus Dollar



EURGBP to remain range-bound

The surprise calling of elections in France in June and Labour’s landslide victory in the UK general election saw EURGBP decline steadily to a circa 2-year low of just under £0.84 in mid-July. It is currently trading just above £0.84, with market expectations that the BoE will lag the Fed (particularly) and the ECB in terms of the pace of rate cuts supporting the pound. Given our outlook for ECB and BoE rates, and our expectation for the euro and sterling against the dollar, we think EURGBP is likely to be confined to a trading range of around £0.83 to £0.87 in the period ahead.

Euro-Sterling Exchange Rate



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