# Forex and Interest Rate Outlook

## AIB Treasury Economic Research Unit

7th September 2026

- Economic picture has been robust in the face of geopolitical shocks, but ongoing energy shock brings risks to the outlook
- US economy continues to outperform, with Eurozone and UK dented by higher energy prices and policy uncertainty
- Markets anticipate further rate hikes from central banks. However, the outcome could differ if inflation undershoots expectations
- Higher rate expectations supporting the dollar, but Fed policy outlook tilted dovish with new Chair
- Modest upside for the euro, while sterling could remain on the defensive amid fiscal policy uncertainty

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# Global Economic Outlook

### Economic outlook highly uncertain amid Middle East conflict

**Energy prices have escalated once again**

The announcement of a ceasefire and tentative peace agreement between the US and Iran in July saw a sharp fall in oil prices, but a recent re-escalation in rhetoric and attacks has seen oil ratchet higher to a $90-100 per barrel range. Traffic through the Strait of Hormuz remains at a fraction of pre-war levels, impacting the supply of oil and other commodities from the region.

**Oil prices trading between $90-100, natural gas prices reach 4-year high**

The current oil price surge was similar to 2022, reaching a recent peak of $120/barrel in March/April. However, European natural gas prices remained at a fraction of the peaks reached in 2022. At the beginning of the war, gas prices have ranged between €40-60/kwh, compared to a peak of €350/kwh in 2022. However, in recent weeks, gas prices have reached 4-year highs above €70, as European demand rises ahead of the heating season.

**Central banks remain weary of second round effects**

While underlying inflation appears muted, central banks are weary of a repeat of the 2022 inflationary surge. Indeed the ECB delivered a 25bps hike in June, and warned of further hikes to come, even in a milder scenario for oil prices. However, there are few signs that second round price effects have emerged yet, or that inflation expectations have become unanchored.

### Steeper yield curve reflect inflation and fiscal risks

**Long-date government bond yields reaching multi-decade highs**

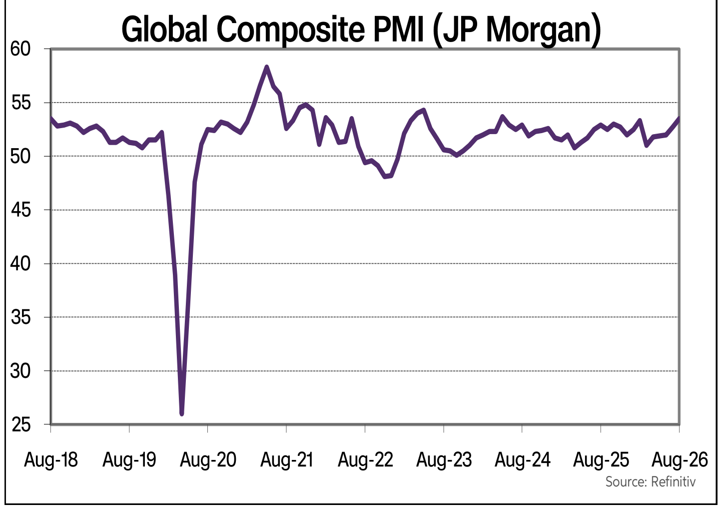
Amid the uncertainty created by the Middle East conflict, bonds markets have repriced sharply over the summer. While some of this reflects growing inflationary risks, lingering fiscal vulnerabilities have now resurfaced, particularly for G7 countries. In the US, the 30-year Treasury has traded above 5.3%, prompting interventions by the Treasury to 'cap yields'. This announcement has proved ineffective so far (operational Sept 9th), reflecting broader concerns on the size of the US fiscal deficit and potentially rising Fed interest rates.

**European governments faces sharply higher borrowing costs**

With many European governments running substantial fiscal deficits and high debt levels, most do not have the fiscal space to repeat the energy supports of 2022. Interest rates are structurally higher today, and growth is broadly weaker. In particular, government bond yields surged for European countries with a combination of high public debt, and a heavy reliance on energy imports (France, UK, Italy). UK 30-year yields have proved to be highly cyclical, reaching their highest level since 2008, as the new government prepares a budget for end-October.

**Japan facing marked pressure on currency and bond market**

The pressure on borrowing costs is also related to the intervention in the currency markets to prop up the yen in recent weeks. This action stemmed from fears the Japanese authorities would be forced to liquidate their large US Treasury holdings to underpin their currency. This scenario could have seen a major dislocation in the US Treasuries market, prompting the US intervention. Japanese yields have risen sharply in recent months as investor price in higher inflation and looser fiscal policy.




*GDP (Vol % Change)*

| | 2024 | 2025 | 2026 (f) | 2027 (f) |
|---|---|---|---|---|
| World | 3.5 | 3.5 | 3.0 | 3.4 |
| Advanced Economies | 1.9 | 1.9 | 1.7 | 1.8 |
| US | 2.8 | 2.1 | 2.3 | 2.2 |
| Eurozone | 1.0 | 1.4 | 0.9 | 1.2 |
| UK | 1.0 | 1.4 | 1.0 | 1.3 |
| Japan | -0.2 | 1.1 | 0.6 | 0.7 |
| Emerging Economies | | | | |
| China | 5.0 | 5.0 | 4.6 | 4.1 |
| India | 7.1 | 7.7 | 6.4 | 6.7 |
| World Trade Growth (%) | 3.7 | 5.0 | 3.5 | 4.3 |
| Inflation -CPI | | | | |
| Advanced Economies (%) | 2.6 | 2.5 | 3.0 | 2.4 |

*Sources: IMF Economic Outlook Update, July 2026*

# Interest Rate Outlook

**Firming in rate expectations amid risk of prolonged Middle East conflict**

**Lack of resolution to US-Iran war a key challenge for central banks inflation objectives**

The war in Middle East has produced an energy price shock for the global economy which, in turn has resulted in elevated inflation risks for monetary policymakers to contemplate. Higher energy prices have already seen a sharp rise higher in headline inflation. So far though, second-round impacts appear to be fairly muted. Nonetheless, central bankers remain concerned of upside risks to underlying inflation. Indeed, the ECB hiked rates in June amid concerns over broadening price pressures. Elsewhere, both the Fed and BoE have had to pause their easing cycles and have not ruled out raising rates. Against this backdrop, there has been a notable firming in market rate expectations compared to the start of the year.

**Fed on hold for now, but Warsh sounding more hawkish**

In July, as expected, the Fed left the policy rate unchanged in a 3.50-3.75% range. The statement was once again very concise and absent of any forward guidance, in keeping with the 'succinct' communication strategy of the new Fed Chair, Kevin Warsh. His press conference also offered no policy guidance, other than emphasising that the Fed "will not waiver" in its commitment to price stability. However, Chair Warsh's recent Jackson Hole speech did elaborate further, stating that the Fed's "predominant focus" at the moment should be on prices. He also noted that current inflation metrics are concerning. Overall his remarks were less hawkish in tone. Rate expectations firmed in reaction to his comments. The market is now attaching around a 55% probability to a September rate rise (was 40%) and envisages rates rising towards 3.9% by year end. While the prospect of a hike has increased, we believe that a softening in the US labour market will see the Fed to keep rates unchanged into year end.

**ECB on course for another hike in September**

The ECB hiked rates by 25bps to 2.25% in June. This was its first rate change since June'25 and its first hike since September 2023. The most recent Governing Council meeting in July saw rates left unchanged. President Lagarde commented that some Governing Council members did discuss if the central bank should consider a hike. The statement showed that the ECB remained concerned about the upside risks to inflation. President Lagarde noted that there would be some key data published that will inform its decision on whether to hike or not in September. Overall a hike this month seems likely and is fully priced-in. The market is envisaging rates rising to 2.75% by year end. However, we believe, that following this month's expected hike to 2.50%, the ECB will refrain from further hikes unless there is significant new upward pressure on prices.

**BoE content to hold steady for now**

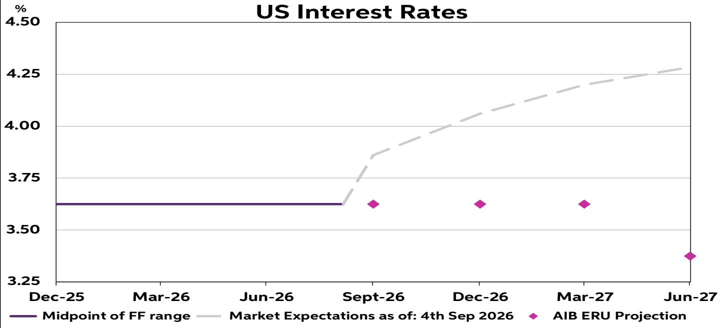
The BoE kept its Bank Rate unchanged for a fifth successive meeting in July, at 3.75%, as expected. There was a further hawkish shift in the voting. The decision split at 6:3, with three members in favour of a 25bps rate hike. The statement had a less hawkish tone to it though, noting that there is "little evidence" regarding second-round inflation, whilst at the same time "there have continued to be clear signs of underlying disinflation in recent data". Governor's Bailey's press conference remarks were also less hawkish in tone. He was keen to clarify any misconception that the BoE was "edging towards a hike". However, futures contracts indicate that the market anticipates a rate hike from the BoE in Q4, with rates seen as ending the year at 4.00%. Our view is for no change from the BoE in 2026, with the potential for rate cuts to come back on the cards during H1'27.

**Interest Rate Forecasts**

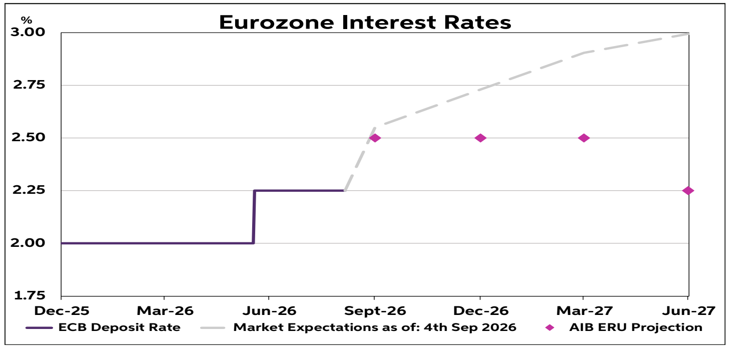
| | Current | End Q3 2026 | End Q4 2026 | End Q1 2027 | End Q2 2027 |
|---|---|---|---|---|---|
| **Fed Funds** | 3.625 | 3.625 | 3.625 | 3.625 | 3.375 |
| **ECB Deposit** | 2.25 | 2.50 | 2.50 | 2.50 | 2.25 |
| **BoE Repo** | 3.75 | 3.75 | 3.75 | 3.75 | 3.50 |

Current Rates Reuters, Forecasts AIB's ERU

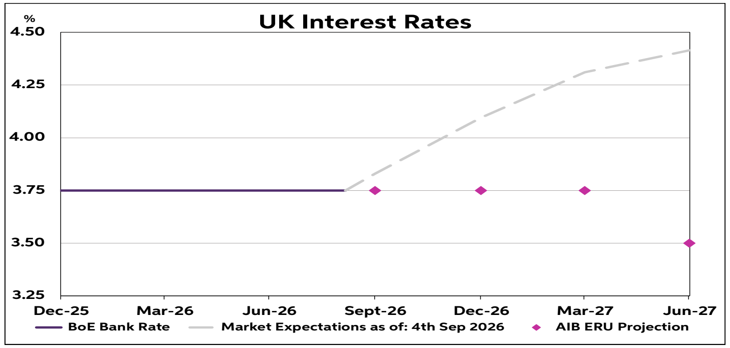
**US Interest Rates**




**Eurozone Interest Rates**




**UK Interest Rates**

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# Forex Market Outlook

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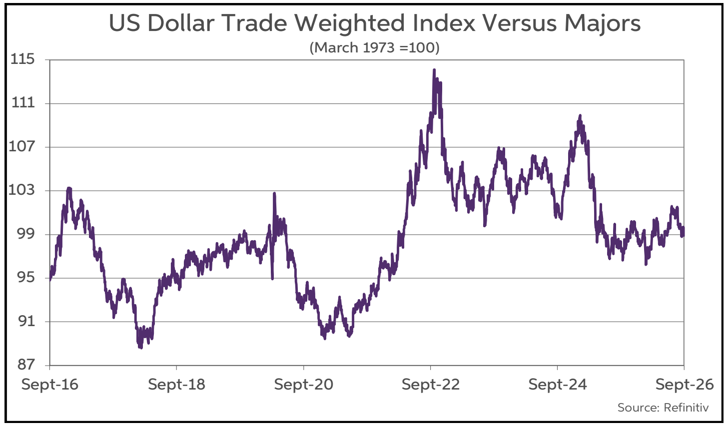
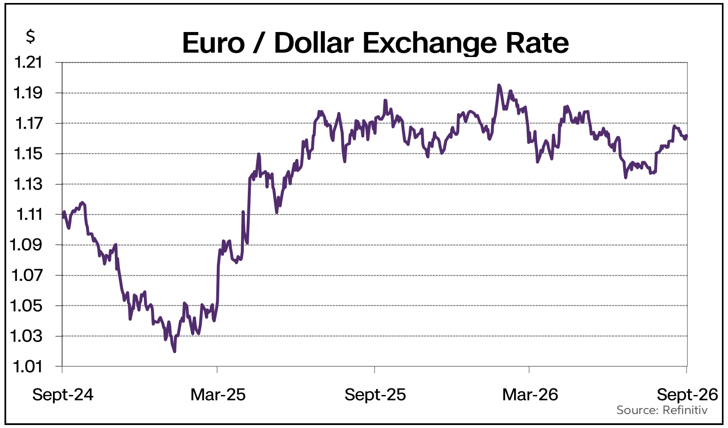
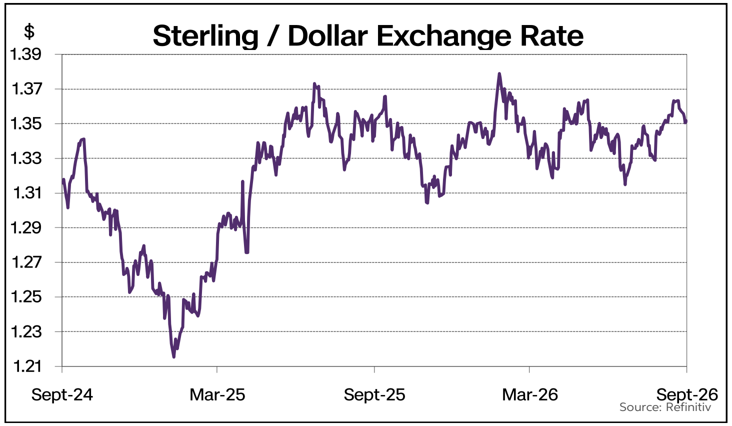
| | **Dollar has lost some ground in recent months** |
|---|---|
| **Dollar has benefitted from current conflict and higher market interest rates** | The dollar has lost some ground over the course of the third quarter of 2026, with the trade-weighted DXY index down 1.8%. Against the euro, the dollar lost similar ground. While the dollar benefitted somewhat from the terms of trade boost of higher oil prices in earlier months, it appears the 'safe-haven' flows to the greenback have been weaker than in previous cycles, reflected in Treasury yields reaching 20-year highs in recent weeks. |
| **An enduring conflict could be a boost to dollar, but this risk has diminished** | While the Strait of Hormuz trade flows remain well below pre-war levels, oil prices have not spiked to the same extent as in March/April. A combination of higher supply (from the US, in particular), alongside lower global demand has kept a lid on oil prices. A more adverse scenario of a sustained war and energy price shock would likely be a boost for the dollar in the short term, but this risk appears to have diminished for now. |
| **Dollar weakness expected if the Fed holds rates** | The policy trajectory of the Fed will be a key driver of the dollar, with Chair Kevin Warsh setting out his stall in detail at the Jackson Hole conference. Warsh talked up the strength of the US economy and long-run productivity benefits of AI, while retaining tough language on inflation. The big picture is Warsh is a relatively dovish Chair, who will look to corral support across the FOMC to hold rates steady in the near term. This could spur a more sustained rise in EUR/USD in the coming months, reflected in a top end of our forecast range being $1.20 for year-end. |
| | **Europe more exposed to energy shocks, ECB will be key for euro** |
| **Europe highly exposed to energy shock, reflected in sharp market rate repricing** | With most European countries net importers of energy, the recent shock to oil prices has fed through quickly to consumer prices, with inflation peaking at around 3.0-3.5% across the Eurozone. In that context markets have priced in circa 50bps of hikes by the ECB by year-end, and 75bps in total by mid-2027. However, with underlying inflationary pressures muted and the economy weak, a hike in September may be the last of this cycle for the ECB. |
| **ECB jumps the gun on rates, further hikes on the cards** | Eurozone headline inflation has risen sharply. It printed at 3.3% in August, its highest level since September 2023 and up from just 1.7% at the start of the year. Perhaps unsurprisingly then, the ECB hiked rates by 25bps in June, bringing the deposit rate up to 2.25%. However, there are few signs, as yet of second round inflation, with the core HICP measures trending between 2.1-2.5% in recent months. |
| **Euro to make further modest gains against the dollar** | We expect the euro to make modest gains versus the dollar over the remainder of 2026 as Fed and ECB policy diverges somewhat. We expect the pair to move from the current $1.13-1.19 range to $1.17 by year-end, and could test $1.20 in 2027. However, risks are clearly to the downside if we see a more prolonged conflict, which would likely boost the dollar further. |



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# Forex Market Outlook

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### Sterling more cyclical amid geopolitical risks

**Uk gilts and sterling more cyclical amid geopolitical risks**

Sterling and gilts have proved volatile in the current geopolitical environment. Meanwhile, the available hard data point to a weaker UK economy, with domestic political uncertainty likely to weigh on growth further in the coming months ahead of the October budget. Long-dated UK gilt yields have touched 20-year highs in recent weeks, with further risks on the horizon. While the new Prime Minister has committed to operating within the bounds of the existing fiscal rules set down by Chancellor Reeves two years ago, a series of spending pledges have been announced, which may require tax rises in the budget.

**BoE set to holds rates steady in 2026, dampening sterling**

The BoE held rates in July once again. On the inflation front, while member's views diverged, the majority still view the risks of second-round inflation as relatively muted compared to the last price shock in 2022. Our expectation is for the BoE to hold rates in 2026, which is more dovish than the market is currently pricing in. This, combined with weak GDP growth prospects, could act as a drag on sterling in the near term, particularly against the euro.

**Sterling to remain close to current levels in the near term, risks to downside**

Sterling is expected to be modestly lower through the remainder of 2026 versus the euro. However, the pair is likely to remain largely range-bound as relative macro fundamentals are unlikely to drive a notable break-out from the current range. EUR/GBP could move towards 87p by Q4 2026, with risks of a sharper rise if the political situation deteriorates. We see the potential for GBP/USD to hold at around $1.34-1.36 through to Q2 2027.

### Yen weaker, but FX interventions and rate hikes to provide support

**Yen has weakened on the back of the Middle East conflict**

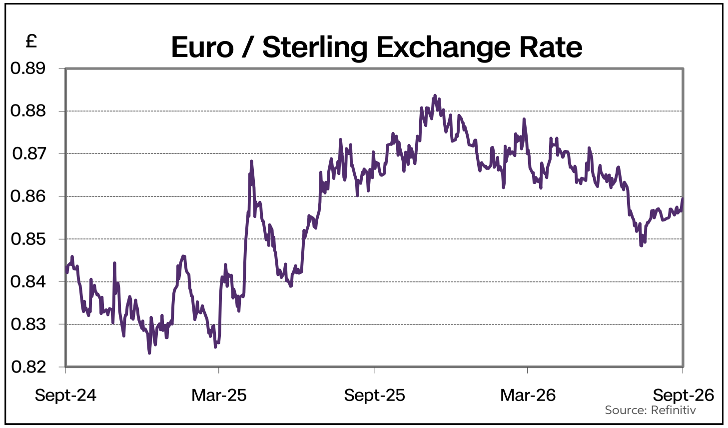
The yen had traded sharply lower, driven by a shift towards expansionary fiscal policy and the impact of the energy shock on the economy, as Japan is a large net-importer. With JPY/USD recently trading above the 'pain point' of ¥160, authorities have intervened to support the currency, alongside a first US intervention since the late-1990's. This pushed the pair to c.¥156. The upshot is an expectation that Japan will tighten both fiscal and monetary policy to sustain the recent rise in the yen.

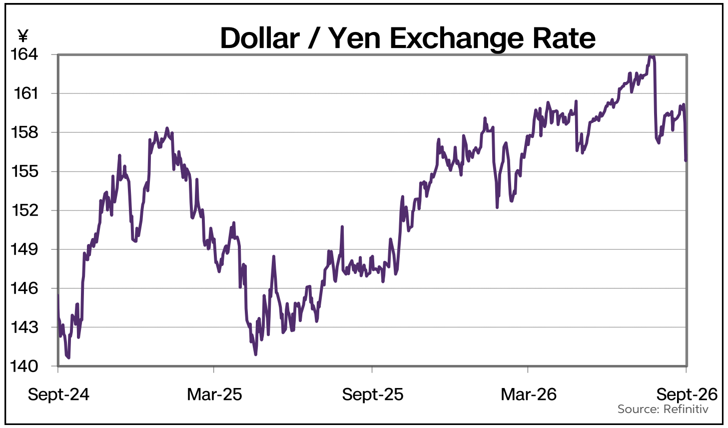
**Further central bank hikes should be supportive to the currency**

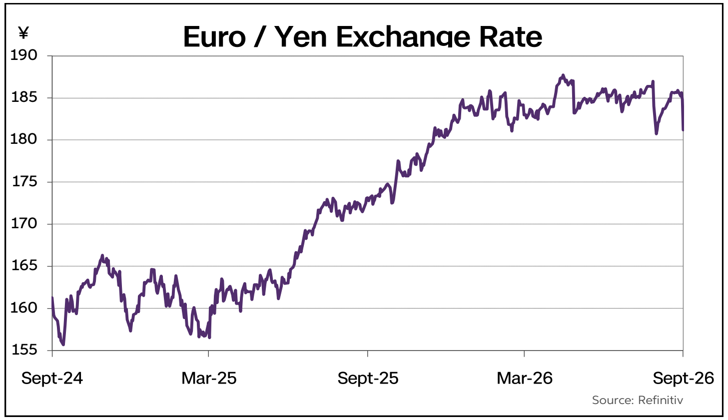
Markets are pricing in a further 25bps hike by the Bank of Japan (BoJ) which should provide a supportive backdrop for the yen. Around 40bps in total is priced in before the end of 2026, with circa 100bps priced in overall by end-2027. The BoJ may move faster than is priced in, frontloading its interventions given the recent pressure on the yen.

**Yen expected to strengthen slightly in the near term**

The yen is expected to appreciate modestly for the rest of the year. We see the yen staying within ¥153-159 by Q4 versus the dollar, from the recent ¥156-162 corridor. Versus the euro, the currency is expected to remain relatively static, trading in the ¥179-185 range for the remainder of the year and into 2027. BoJ rates will be a key catalyst, with current sticky inflation raising the risk of faster rate hikes than currently priced in.



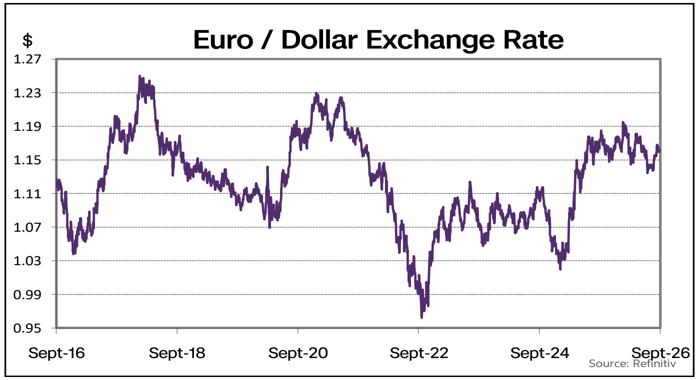



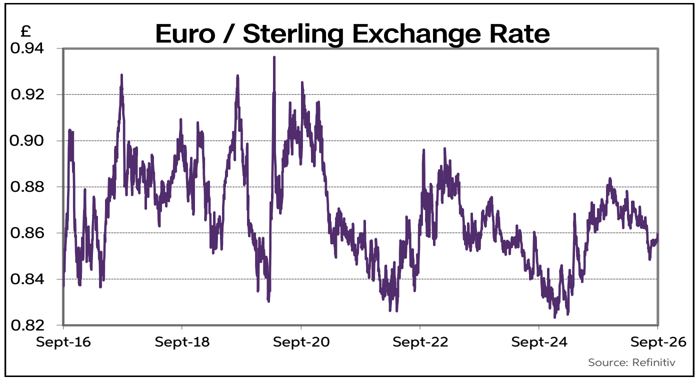



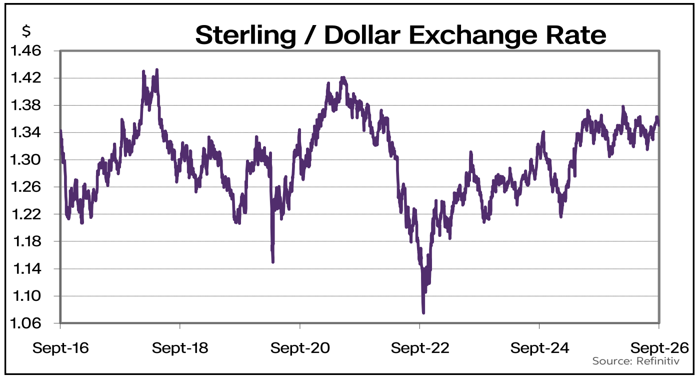
# Summary of Exchange Rate Forecasts

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

| | Current | Q3-2026 | Q4-2026 | Q1-2027 | Q2-2027 |
|---|---|---|---|---|---|
| **Euro Versus** | | | | | |
| **USD** | 1.163 | 1.13-1.19 | 1.14-1.20 | 1.15-1.21 | 1.16-1.22 |
| **GBP** | 0.859 | 0.83-0.89 | 0.84-0.90 | 0.84-0.90 | 0.85-0.91 |
| **JPY** | 179.8 | 179-185 | 179-185 | 180-186 | 180-186 |
| **CHF** | 0.94 | 0.93 | 0.94 | 0.95 | 0.95 |
| **US Dollar Versus** | | | | | |
| **JPY** | 154.6 | 154-160 | 153-159 | 152-158 | 151-157 |
| **GBP** | 1.354 | 1.32-1.38 | 1.31-1.37 | 1.33-1.39 | 1.32-1.38 |
| **CAD** | 1.38 | 1.41 | 1.40 | 1.39 | 1.38 |
| **AUD** | 0.72 | 0.71 | 0.72 | 0.73 | 0.74 |
| **NZD** | 0.59 | 0.58 | 0.59 | 0.60 | 0.61 |
| **CNY** | 6.71 | 6.70 | 6.80 | 6.90 | 6.90 |
| **Sterling Versus** | | | | | |
| **JPY** | 209 | 212 | 209 | 211 | 208 |
| **CAD** | 1.87 | 1.90 | 1.88 | 1.89 | 1.87 |
| **AUD** | 1.88 | 1.90 | 1.86 | 1.86 | 1.82 |
| **NZD** | 2.30 | 2.33 | 2.27 | 2.27 | 2.21 |



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