Forex and Interest Rate Outlook

AIB Treasury Economic Research Unit

2nd July 2026

- Economic picture has been robust in the face of geopolitical shocks, de-escalation of Middle East War has driven relief rally for markets
- US economy continues to outperform, with Eurozone and UK dented by higher energy prices and political uncertainty
- Central banks diverged in June. Market has repriced for higher rates, but only ECB has delivered a hike of the three majors so far
- Higher rate expectations supporting the dollar, but Fed policy outlook more uncertain with new Chair in situ
- Modest upside for the euro, while sterling could remain on the defensive amid political uncertainty

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Global Economic Outlook

Economic outlook highly uncertain amid Middle East conflict

The energy shock has dissipated for now, with inflation peaking in May

The announcement of a ceasefire and tentative peace agreement between the US and Iran has seen a sharp fall in oil prices, currently trading around $72 per barrel, futures markets pricing in further declines in the coming months. With a rapid pass through to consumer prices, inflation across the main markets peaked in April and May around 3.0-4.0%, with sharp falls in headline inflation in June.

Oil prices have touched $120 per barrel during the Iran war

The current oil price surge was similar to 2022, reaching a recent peak of $120/barrel. However, European natural gas prices remained at a fraction of the peaks reached in 2022. Since the beginning of the war, gas prices have ranged between €40-60/kwh, compared to a peak of €350/kwh in 2022. This is one of the factors why inflationary pressures have been muted, alongside weaker second-round price pressures.

Central banks weary of second round effects

Nevertheless, central banks have been 'talking tough' on rates, 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 scenarios for oil prices. However, there are few signs that second round price effects have emerged yet, or that inflation expectations have become unanchored.

Markets have largely brushed off geopolitical risks

In 2022-23, European Government spent 3% of GDP on energy supports

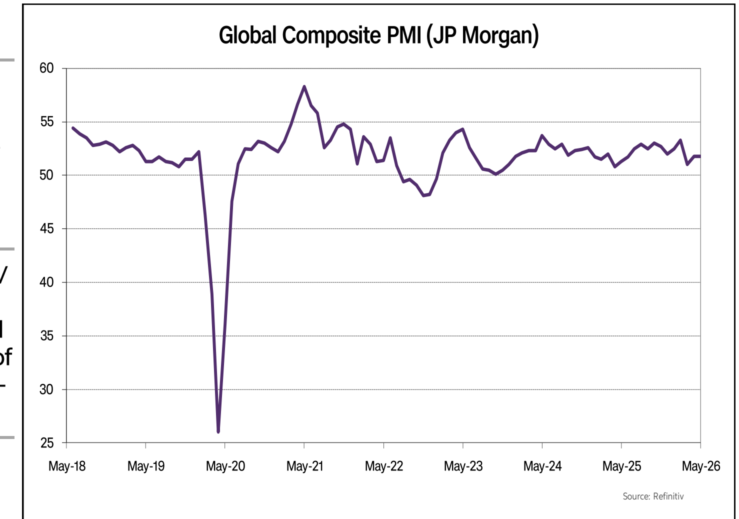
Despite the uncertainty created by the Middle East conflict, markets have been relatively becalmed. Equites have continued to rally globally, boosted in particular by expected returns from emerging AI technology. On currency markets, the dollar has benefitted both during the initial "risk off" period in March and higher oil prices and latterly as markets have priced in potentially more hawkish monetary policy from the Fed.

Higher rates and weak growth mean European governments will be unable to offset an inflation shock

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 countries with a combination of high public debt, and a heavy reliance on energy imports (France, UK, Italy). As the war as de-escalated though, these bond markets have seen a relief rally.

Second-round inflationary effects are expected to be less than 2022 as the labour market is looser and wage growth weaker

We expect some modest second-round effects on non-energy inflation and wages, although our assumption is that these pressures will be more modest than occurred following the energy shock in 2022. This is primarily due to softer trends in the labour market, with less job vacancies and wage bargaining power at present in the economy. The economy is also in a relatively more balanced position than in 2022, when demand was surging post the re-opening of all sectors after the pandemic.



GDP (Vol % Change)

	2024	2025 (e)	2026 (f)	2027 (f)
World	3.3	3.4	3.1	3.2
Advanced Economies	1.8	1.9	1.8	1.7
US	2.8	2.1	2.3	2.1
Eurozone	0.9	1.4	1.1	1.2
UK	1.1	1.4	0.8	1.3
Japan	-0.2	1.2	0.7	0.6
Emerging Economies				
China	5.0	5.0	4.4	4.0
India	6.5	7.6	6.5	6.5
World Trade Growth (%)	3.6	5.1	2.8	3.8
Inflation -CPI				
Advanced Economies (%)	2.6	2.5	2.8	2.2

Sources: IMF Economic Outlook Update, April 2026

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Interest Rate Outlook

Progress in Middle East peace talks eases hiking pressures

De-escalation in Middle East conflict and subsequent oil prices fall a helpful development for central banks

The escalation of the Middle East conflict has had a significant impact on central bank policy deliberations. The inflationary risks stemming from the war has seen the ECB hike rates. Meanwhile, both the Fed and BoE have paused their easing cycles, whilst at the same time not ruling out raising rates. Against this backdrop, there has been a notable firming in market rate expectations. However, the recent progress in the US-Iran talks and the resulting sharp fall in oil prices and the re-opening in the Strait of Hormuz has eased some of the 'tightening' pressure on central banks. If the conflict de-escalation becomes more sustained, attention will turn to when rates may start to fall again.

Fed under new leadership, on hold for now

The Fed, under new Chair Warsh kept rates steady, as expected, in a 3.50-3.75% range in June. The Fed has been on hold YTD (last rate cut in Dec'25 for total easing of 175bps). Chair Warsh's impact was evident in the statement being shorter and lacking in forward guidance. His press conference remarks also emphasised the removal of guidance. Chair Warsh also refrained from submitting rate forecasts (i.e. 'dots'), rendering the median projections inconclusive. He announced the setting up of five taskforces on Fed communications, balance sheet policies, data sources, productivity and the inflation framework. The market took a hawkish interpretation of the June FOMC, with c. 30bps of hikes now priced-in by year end. However, we believe this is overdone. Given Chair Warsh's dovish bias and our view that the taskforces could aid this bias, we expect the next policy action from the Fed will be a cut, not a hike, arriving possibly in early'27.

ECB seems intent on hiking again, despite easing inflationary pressures

As expected, the ECB increased interest rates by 25bps in June, with the Depo rate rising to 2.25%. It represented the first rate change since June'25 (and first hike since Sept'23). President Lagarde stated that the policy tightening should not be viewed as an "insurance hike" and she also emphasised the upside risks to inflation from "broadening price pressures". This suggests that the ECB maintains a hawkish bias and the June hike was not a "one and done", albeit the meeting occurred before the US/Iran 'peace' deal. The market concurs, with another 25bps hike priced-in by Dec'26. The market is anticipating that rates settle at 2.5%. Recent inflation data indicate that price pressures are easing, but the ECB seems intent on hiking again, despite their own assessment that longer term inflation expectations remain supportive of their 2% target. Given this mindset, a 2.50% Depo rate by year end seems a plausible, if not warranted, outcome.

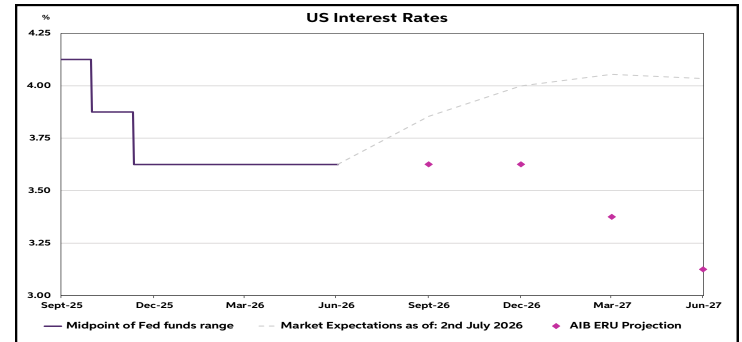
BoE appears to favour holding steady

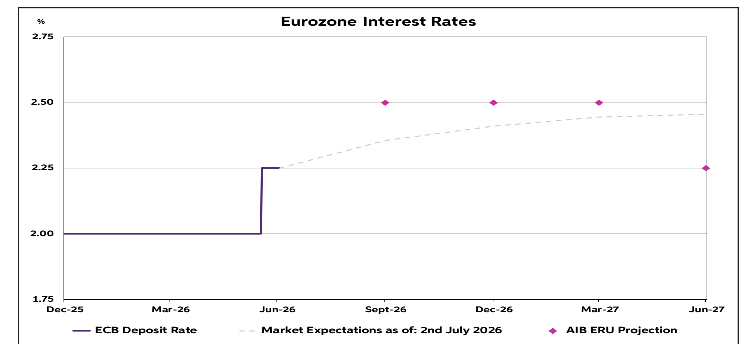
The BoE maintained the Bank rate at 3.75% in June, as expected. This was the fourth successive meeting where it was left unchanged. There was a 7:2 voting split, with two MPC members in favour of a 25bps rate hike. The most recent rate change from the BoE occurred back in Dec'25, when they cut by 25bps. This brought the total magnitude of easing to 150bps. The BoE retains a bias to hike. However, assessing the meeting minutes suggests that the centre ground within the MPC is content with keeping rates on hold over the coming months. The market though expects the BoE to hike by 25bps by early 2027. We believe that the longer the BoE is on hold, the more likely it is that the next move will be a resumption of its easing cycle, possibly by Q1'27, as inflation pressures continue to ease, while growth remains muted.

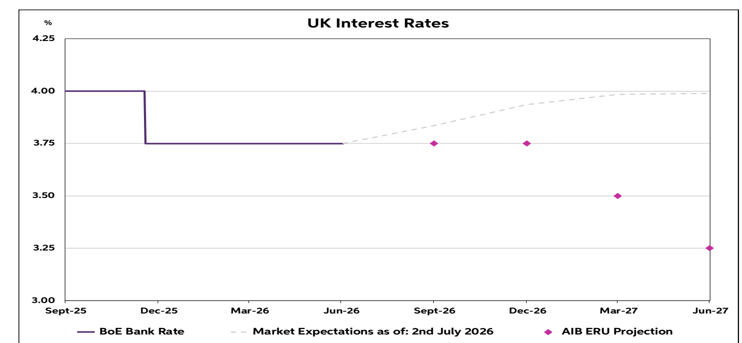
Interest Rate Forecasts

	Current	End Q3 2026	End Q4 2026	End Q1 2027	End Q2 2027
Fed Funds	3.625	3.625	3.625	3.375	3.125
ECB Deposit	2.25	2.50	2.50	2.50	2.25
BoE Repo	3.75	3.75	3.75	3.50	3.25

Current Rates Reuters, Forecasts AIB's ERU







Forex Market Outlook

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Dollar has benefited from higher energy prices and rates

Dollar has benefitted from current conflict and higher market interest rates

The dollar has seen further gains since the Middle East conflict, with the trade-weighted DXY index gaining 4% over the course of Q2. Against the euro, the dollar gained similar ground, but has given back most of these gains, as markets have begun to price out multiple hikes by the Fed. While benefitting from the terms of trade boost of higher oil prices in recent months, it appears the 'safe-haven' flows to the greenback have been weaker than in previous cycles, reflected in higher Treasury yields.

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, it looks like both sides are moving towards a permanent settlement. 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 significantly.

..but dollar weakness expected as Fed holds rates

The policy trajectory of the Fed will be a key driver of the dollar, with a new dovish Chair Kevin Warsh now in situ. We expect rate cuts by early 2027. The strength of the US economy will be in focus, with clear signs of a slow down in the labour market, and growth becoming increasingly reliant on AI. Finally, the political noise from the White House could provide an unhelpful backdrop for the currency in the run up to the US mid-term elections. This could spur a more sustained rise in EUR/USD in the coming months, reflected in a top end of our forecast range being $1.19 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

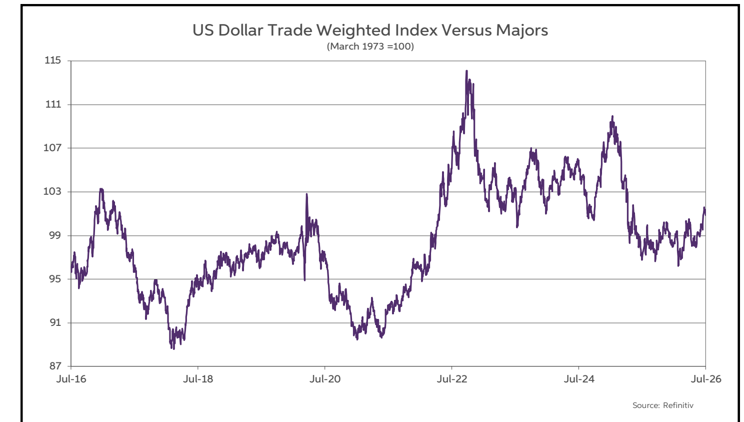
With most European countries net importers of energy, the recent shock to oil prices fed through quickly to consumer prices, with inflation peaking at around 3.0-3.5% across the Eurozone in April/May. In that context markets had priced in between 50-75bps of hikes by the ECB in March, but began to scale back these bets to below 50bps from April as energy prices moderated.

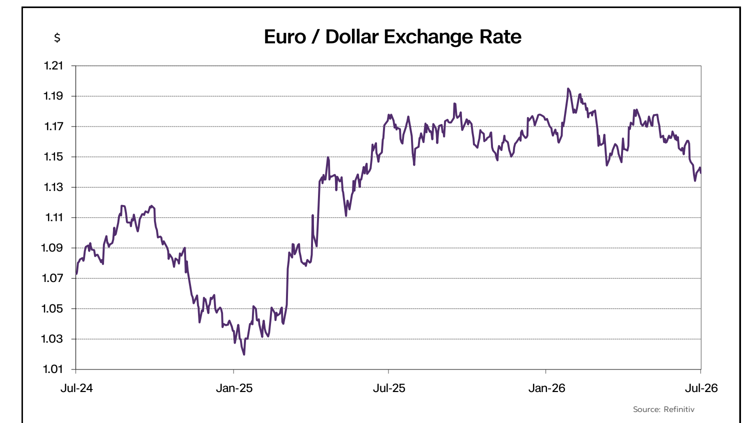
ECB jumps the gun on rates, further hikes on the cards

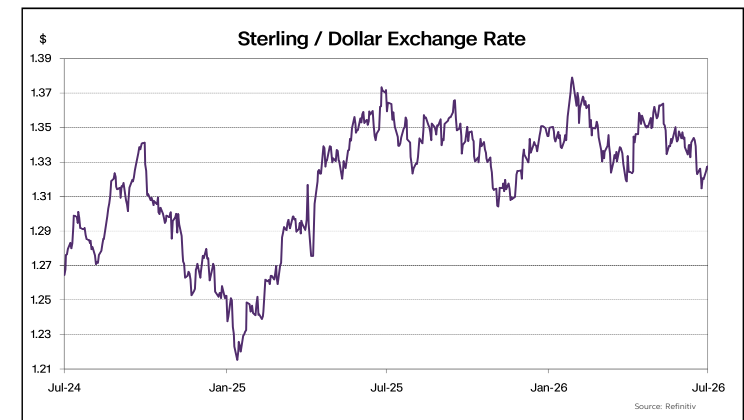
Eurozone headline inflation has risen sharply. It printed at 3.2% in May, its highest level since September 2023 and up from just 1.7% at the start of the year. Perhaps unsurprisingly then, the ECB hiked rates by 25bps in June, bringing the deposit rate up to 2.25%. The outcome was in line with market expectations, with further hawkish comments from ECB Governing Council members since then raising the risk of further hikes.

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. We expect the pair to move from the current $1.14-1.15 range to $1.18 by year-end. However, risks are clearly to the downside if we see a more prolonged conflict, which would likely boost the dollar in 2026.







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Forex Market Outlook

UK particularly exposed to energy shock amid fragile fiscal space

Sterling has found support as energy price shock passes

Sterling and gilts have regained ground recently as energy prices have normalised. Meanwhile, the available hard data point to a weak picture, with domestic political uncertainty likely to weigh on growth further in the coming months. Nonetheless, bond markets remain becalmed for now, as investors await details on the political programme of the expected new PM Andy Burnham.

Burnham's record as Mayor of Greater Manchester suggests his premiership may not see too significant of a lurch to the left versus the current administration. He has also committed to operating within the bounds of the existing fiscal rules set down by Chancellor Rachel Reeves less than two years ago.

BoE set to holds rates steady in 2026, dampening sterling

The BoE held rates in June 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 88p 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 $1.33-1.34 through 2026.

Yen weakens, but FX interventions provide support

Yen has weakened on the back of the Middle East conflict

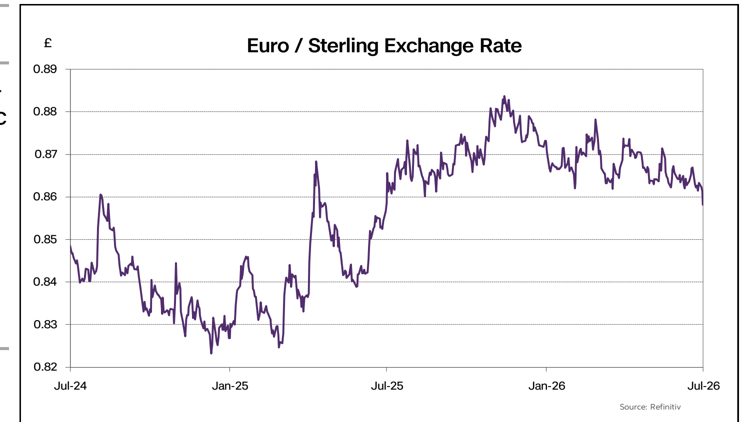
The yen has traded lower recently, driven by a shift towards expansionary fiscal policy and the impact of the energy shock on the economy, as Japan is a large net-importer. Since the start of April the yen is down 0.5% versus the euro and 1.5% against the dollar, with JPY/USD recently trading above the 'pain point' of ¥160 at which authorities have intervened to support the currency in the past.

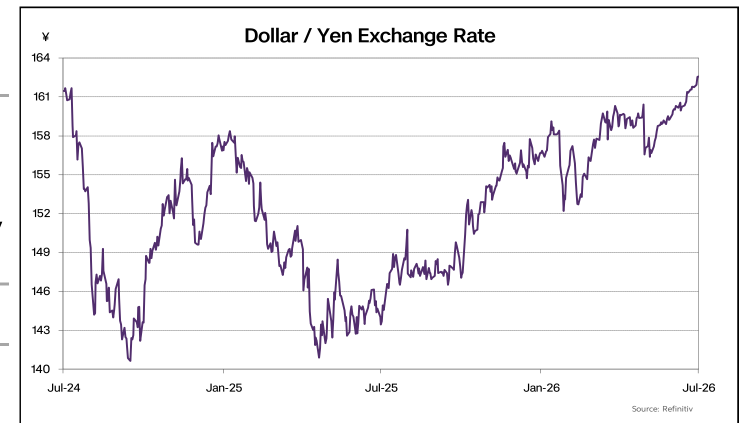
Further central bank hikes should be supportive to the currency

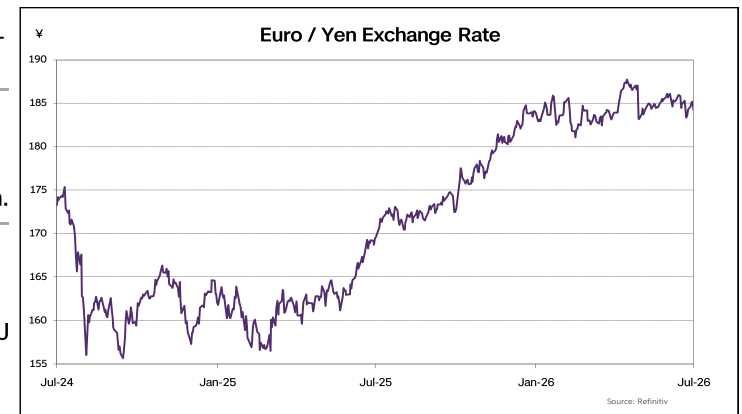
However, the Bank of Japan (BoJ) is expected to raise rates further in 2026 following a 25bps hike in June, dampening the effects of expansionary fiscal policy, and lingering inflationary pressures. Markets are pricing in a further 25bps hike by the BoJ which should provide a supportive backdrop for the yen.

Yen expected to strengthen slightly in the near term

The yen is expected to appreciate modestly in the second half of the year. We see the yen strengthening towards ¥156-162 by Q4 versus the dollar, from the current ¥160-162 corridor. Versus the euro, the currency is expected to remain relatively static, trading in the ¥181-187 range for the remainder of the year. BoJ rates will be a key catalyst, with current sticky inflation raising the risk of more rate hikes than currently priced in, which could support the currency.



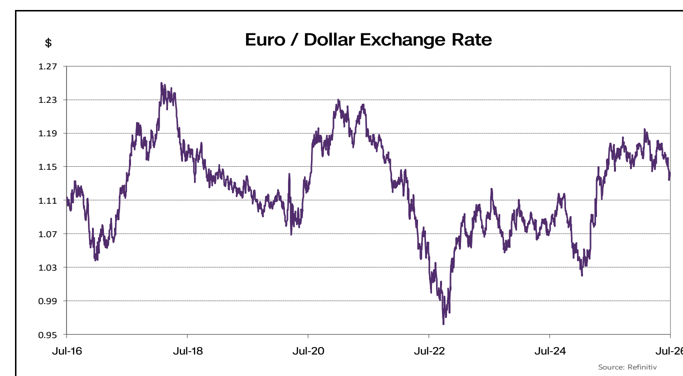


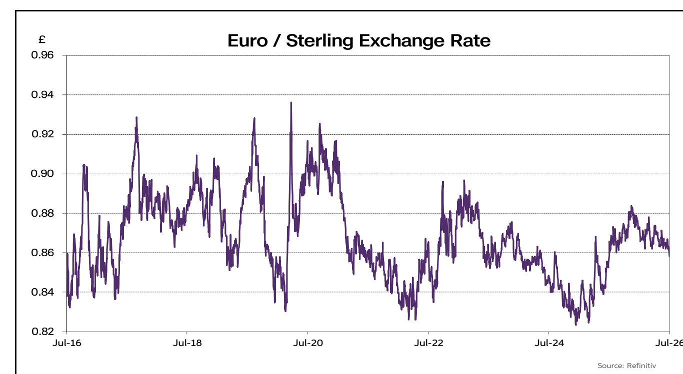


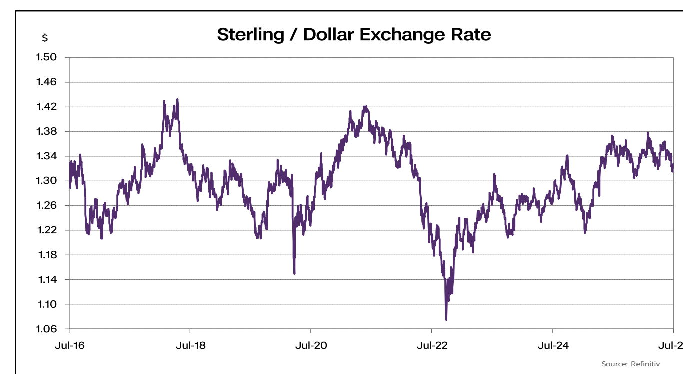
Summary of Exchange Rate Forecasts

("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	1.144	1.12-1.18	1.13-1.19	1.14-1.20	1.15-1.21
GBP	0.857	0.84-0.90	0.85-0.91	0.85-0.91	0.85-0.91
JPY	184.5	181-187	181-187	182-188	182-188
CHF	0.92	0.93	0.94	0.95	0.95
US Dollar Versus					
JPY	161.3	157-163	156-162	155-161	154-160
GBP	1.335	1.31-1.37	1.30-1.36	1.30-1.36	1.33-1.39
CAD	1.42	1.41	1.40	1.39	1.38
AUD	0.69	0.70	0.71	0.72	0.72
NZD	0.57	0.58	0.59	0.60	0.61
CNY	6.78	6.80	6.90	6.90	6.90
Sterling Versus					
JPY	215	214	211	210	214
CAD	1.90	1.89	1.87	1.85	1.85
AUD	1.93	1.91	1.87	1.85	1.89
NZD	2.34	2.31	2.25	2.22	2.24







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