COMMERCIAL BANKING

International Financial Outlook

January 2019

BANK OF SCOTLAND

Contents

All historical data sourced from Bloomberg
All forecasts sourced from Bank of Scotland (BoS)
Data sourced 22nd January 2019

This document should be regarded as a marketing communication, it is not intended to be investment research and has not been prepared in accordance with legal requirements to promote the independence of investment research and should not necessarily be considered objective or unbiased.

Overview

Financial market review – past month

Global risk appetite rebounded in the New Year, led by signs of progress in US-China trade talks and indications from US Federal Reserve Chairman Powell of greater 'patience' regarding further policy tightening. Closer to home, the House of Commons rejected the government's proposed EU Withdrawal Agreement by a record 230 votes, although the government subsequently defeated a vote of no confidence called by the main opposition. Cross-party talks have begun, although there appears to be limited progress, at the time of writing. With Brexit looming on 29 March, it remains to be seen whether parliament can coalesce around a way forward.

In spite of the political uncertainty, the pound outperformed the US dollar and the euro over the past month. The reason seems to be that markets are attaching an increasing probability that a 'no deal' Brexit will be averted, after indications parliament is against that outcome. It also reflects a more dovish Fed, as noted above, and increasing concerns at the ECB of a more protracted economic slowdown in the Eurozone.

In other markets, the oil price rebounded broadly in tandem with global equity indices. Brent crude oil increased above $60 a barrel, having reached a nadir of $50 in December. That has supported the Canadian dollar and Norwegian krone. The US 10 year Treasury yield moved back up towards 2.80%, although it remains below the 2018 high of around 3.25%. The UK 10 year gilt yield has risen above 1.30%, having come off its recent lows.

Latest UK indicators reaffirm that economic growth is likely to have slowed in Q4, following the 0.6% rise in Q3. Monthly GDP figures show rolling three-month growth moderating to 0.3% in November. Official retail sales, including fuel, fell by 0.9%m/m in December and were slightly negative for the quarter as a whole. Business surveys, meanwhile, reported some firms are stepping up their preparations for a potential 'no deal' Brexit. Headline CPI inflation fell to 2.1%y/y on the back of lower energy prices, with a further decline to below the 2% target expected in January. Underlying core inflation, however, edged up to 1.9%y/y, while labour market data showed pay growth rising for a fifth consecutive month to 3.4%y/y in the three months to November.

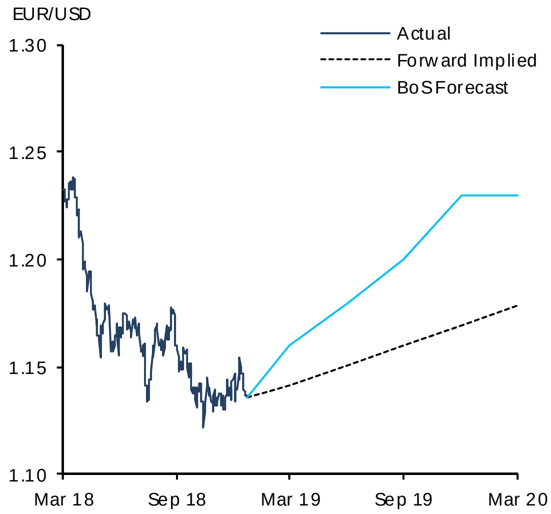
In the US, the government shutdown has become the longest in history and concerns about the potential negative impact on the economy have risen. There appears to be little sign of a breakthrough between President Trump and the Democrats in Congress to agree on funding for a Mexican border wall. Available data, however, indicate the economy continues to perform strongly for now. Manufacturing output increased by 1.1%m/m in December, confounding weaker sentiment in business surveys. Nonfarm payrolls surged by 312k in December, while the rise in the unemployment rate to 3.9% led by a higher participation rate points to some labour market slack. Headline December CPI inflation fell to 1.9%y/y from 2.2%y/y, while core inflation was steady at 2.2%y/y. Overall, domestic inflation pressures continue to build, but remain well contained.

Latest Eurozone data point to downside risks to Q4 GDP, which could extend into early 2019. November industrial production fell sharply by 1.7%m/m, while the December composite PMI declined to a four-year low of 51.1. Among the largest economies, Germany's Q4 growth rebound is expected to be modest following the temporary contraction in Q3, while 'yellow vest' protests in France are likely to weaken Q4 GDP growth and Italy is at risk of posting another slight contraction. Ahead of the ECB's January policy meeting, President Draghi said that the slowdown could last longer than expected, but added that the economy is not heading for a recession. Headline Eurozone CPI inflation dropped to 1.6%y/y in December as a result of weaker energy prices, while core CPI remained subdued at 1.0%y/y despite signs of rising wage growth.

Summary of key forecasts

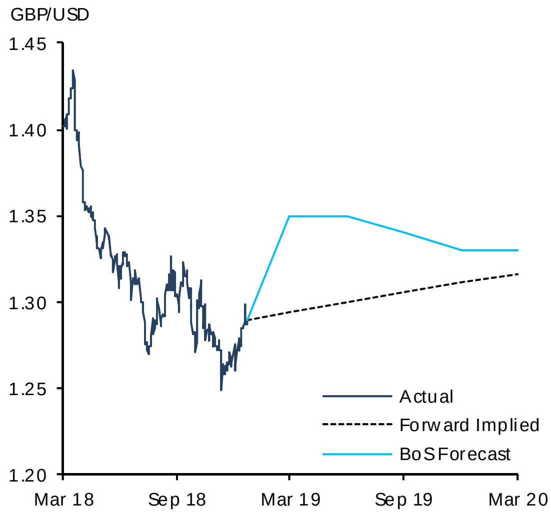
- Our central assumption remains that the UK and the EU will avoid a 'no deal' outcome, and that a political agreement will eventually be reached for an orderly departure. The House of Commons will vote on PM May's 'plan B' on 29 January. Any amendments to the motion will be closely watched, with a second 'meaningful' vote scheduled to follow in February. Market volatility, however, could intensify given the prevailing political uncertainties. We maintain our central forecast for UK Bank rate to rise to 1.00% in Q3 2019. However, financial markets are not fully discounting the next rate rise until mid-2020, potentially due to continued 'no-deal' risk.
- The US Federal Reserve raised rates in December to 2.5%, as expected. FOMC comments suggest a risk that the next increase may not come until somewhat later in the year. We continue to see two further increases this year to 3%, though uncertainty regarding the timing has risen.
- In the euro area, the ECB confirmed an end to its net asset purchases and has maintained its guidance that interest rates are expected to remain at present levels "at least through the summer of 2019". We continue to expect the first rate rise in Q4 2019, while financial markets anticipate this to occur in mid-2020. Risks around its timing have increased more recently.
- We retain our UK and German 10-year gilt yield targets for end-2019 at 1.6% and 0.6% respectively, while US 10 year Treasury yield forecasts remain at 3.2% for end-2019.
- We see GBP/USD and GBP/EUR at 1.33 and 1.08 by end-2019, implying a rise in EUR/USD to 1.23. However, there is a risk of higher volatility as we approach the March 2019 deadline for Brexit.

Fundamental Views – G10 FX



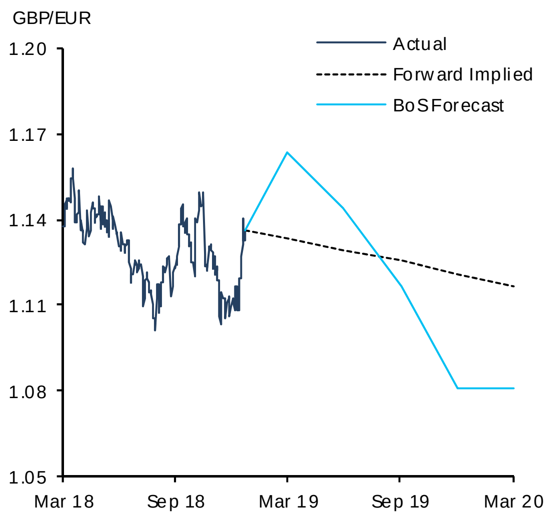
EUR/USD

Since October 2018, EUR/USD has been confined within a narrow 1.12 to 1.16 range. In the US, trade tensions with China and domestic political uncertainty have weighed on confidence and pressured equity markets. As a result, the Fed indicated it would be 'patient' in tightening monetary policy any further. By aggressively pricing out the chance of additional hikes in the Fed funds rate, financial markets may have overreacted to recent comments. Given the strength of domestic activity and tightness in the labour market, we still expect 50bps of tightening from the FOMC in 2019. In contrast, a raft of weaker activity indicators and subdued 'core' inflation have pressured the Eurozone economy, so much so that market expectations of the first deposit rate rise from the ECB have been pushed back to mid-2020. We, on the other hand, are more optimistic. Should euro area growth pick up in H2 2019, there is every chance that the ECB will start its tightening cycle by the end of the year. Improvements in global growth prospects and risk appetite would help that outlook. With the market still positioned 'net short' of euros, fundamental and technical factors suggest EUR/USD will rally over our forecast horizon.



GBP/USD

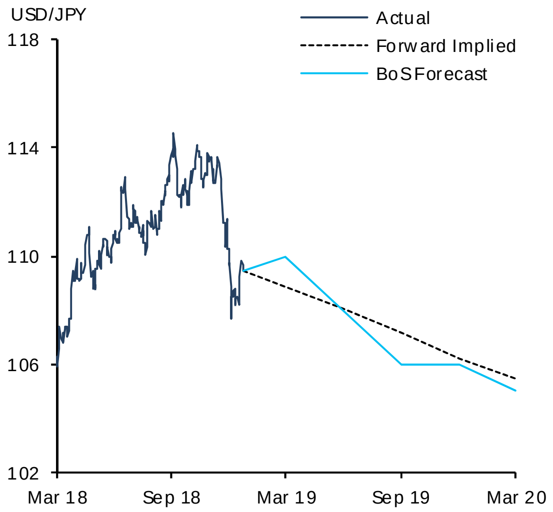
Changes in the political risk premium associated with the UK have been the key driver of the pound in recent weeks. After falling to 1.2440, its lowest level against the US dollar since April 2017, sterling briefly rallied above 1.30 as parliament displayed its determination to avoid a 'no deal' Brexit. In fact, the implied risk of such a scenario at the end of March has fallen from close to 35% earlier this month to around 10%. Even so, uncertainty is rife. The House of Commons is due to vote on PM May's 'plan B' on 29 January and it remains to be seen whether her withdrawal agreement will pass at the second attempt. Price dynamics reflect this uncertainty, with the option market currently suggesting that GBP/USD could fall towards 1.24 or rally above 1.34 by 1 April. Away from politics, labour market data show that the UK economy is on a reasonable footing. However, forward-looking sentiment surveys have deteriorated in recent months. In the US, real economic variables remain robust. However, trade tensions with China and volatility in equity markets have weighed on confidence and led to a paring back of policy rate expectations. Brexit developments are crucial for GBP/USD. Given the high degree of uncertainty around the outcome, the currency pair is likely to remain volatile.



GBP/EUR

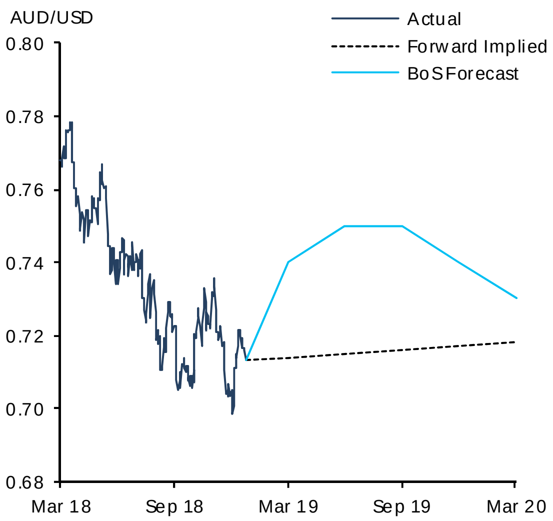
Political turbulence in the UK has seen GBP/EUR move sharply from its range lows (below 1.10) towards its range highs (around 1.15). Counterintuitively, the record defeat of PM May's withdrawal agreement in the House of Commons buoyed sterling. The seemingly firm commitment of Parliament to avoid 'no deal' has seen the implied chance of such a scenario (by 29 March) fall to around 10%. Even with MPs scheduled to vote on the PM's 'plan B' on 29 January, Parliament's preferred route to Brexit remains unclear - a change in the government's 'red lines', a general election, a delay of Article 50 or a second referendum are all possible. Market 'pricing' implies GBP/EUR may decline towards 1.09 or rally to 1.17 by 1 April. Political risks mean that the BoE will leave policy unchanged for now. The ECB has suggested policy rates are likely to be on hold "through the summer." Depressed activity measures and subdued 'core' inflation have dented confidence that it will be able to tighten policy this year. The market is not expecting a rise in the deposit rate until mid-2020. In the near term, we expect GBP/EUR to remain range bound, however, Brexit-related uncertainty leaves us with low conviction.

Fundamental Views – G10 FX



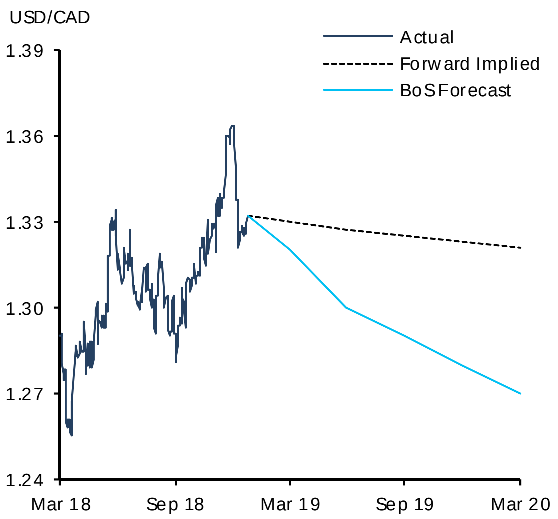
USD/JPY

The yen has experienced a turbulent start to the year. On 3 January, following a repatriation of funds from Japanese retail investors in 'illiquid' market conditions, USD/JPY experienced a 'flash crash'. The currency pair briefly fell below 105 (its lowest level since last March) before subsequently retracing back towards 110. In spite of the recent rally, we still expect the JPY to outperform the USD. Having heard Fed policymakers signal the need for caution, the market has pared back its expectations for further rate hikes. In contrast, given the strength of recent activity and labour market data, we anticipate the FOMC raising the Fed funds rate by 50bps in 2019. Yet, with the Fed funds rate close to 'neutral', US yields may remain under pressure across the curve. Consequently, even if monetary policy in Japan remains 'ultra-loose', there is limited scope for the interest rate differential to drive USD/JPY higher. At the same time, the risks to global growth appear more entrenched. PMI surveys in the US, China, and the Eurozone show confidence in the economic outlook has softened. Considering monetary policy dynamics and the balance of economic risks, we forecast USD/JPY at 106 by year-end.



AUD/USD

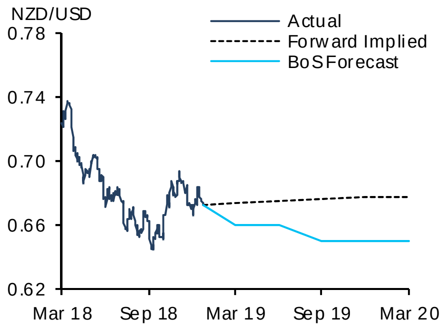
The New Year 'flash crash' saw the Australian dollar briefly fall to its lowest level against the US dollar since Q1 2009. From its low (around 0.6750), however, it rebounded strongly back above 0.71. The prospects for the AUD are typically heavily linked to the health of the Chinese economy. Data shows that Chinese GDP growth (6.4%y/y) rose at its slowest pace since the Financial Crisis and PMI surveys suggest there is a risk that this trend continues. Looser monetary policy and fiscal stimulus, however, should help support activity in China and, as a by-product, the AUD. On the other side of the equation, we believe the USD is likely to soften in the near term. The significant scaling back of US interest rate expectations is likely to translate into 'follow-through' selling of the USD. We forecast two 25bp increases from the Federal Reserve this year, but the peak in rates is close. Accordingly, should market expectations on global growth firm and risk appetite continue to recover, we would expect AUD/USD to extend the rally from its multi-year lows, towards 0.75 by the middle of 2019.



USD/CAD

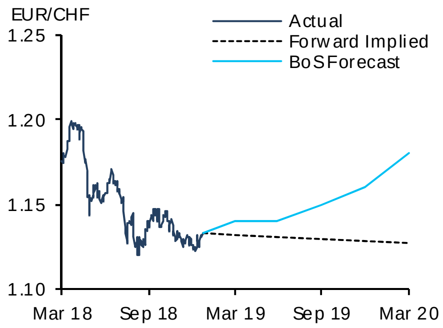
After weakening to a 20-month low at the start of 2019, the Canadian dollar has firmed against the US dollar. Ultimately, the sharp fall (to $50/bbl) and subsequent recovery in Brent Crude prices drove USD/CAD from 1.32 to 1.36 and back. From current levels, we see moderate downside risks to the currency pair. Oil prices have rebounded and looking ahead are likely to support the CAD. Elsewhere, in spite of CPI inflation rising to 2.0% (from 1.7%) and an unemployment rate (5.6%) at multi-decade lows, communications from Bank of Canada officials continue to be 'dovish'. Even so, the change in language from the Federal Reserve (particularly the use of "patience") has caused the 2-year US-Canadian interest rate differential to pull back from recent 'wides'. Should this theme continue, it argues for further CAD strength. Moreover, the market still holds a significant 'net short' position in the Canadian dollar. As it slowly starts to reduce this position, the risks from a positioning perspective remain skewed towards CAD buying. Given the fundamental and technical outlooks, we remain bearish on USD/CAD, forecasting 1.28 at end-2019.

Fundamental Views – Other Developed Market FX



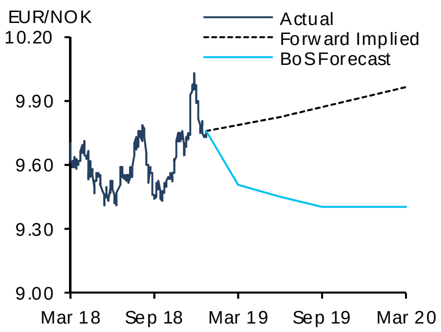
NZD/USD

Given the recent volatility in financial markets, the rally in the New Zealand dollar from its 'flash crash' low against the US dollar has been impressive. The NZD benefitted from an improvement in sentiment as equity markets recovered from their December 'tantrum', however, the fundamentals are rooted against the currency. GDP growth in Q3 slowed to 2.6%y/y (from 3.2% in Q2), and while the unemployment rate declined sharply to 3.9% (from 4.4%), there remains some slack in the labour market. There is little sign of domestic inflationary pressures building, with headline CPI still below 2%. Following last November's RBNZ meeting, Governor Orr removed direct reference to the possibility of cutting interest rates in his policy statement. But, the market is unconvinced, 'pricing' a 40% chance of a 25bp reduction by June. At the same time, the Fed has suggested it will be 'patient' in moving interest rates towards 'neutral'. From current levels, we expect a fall in NZD/USD.



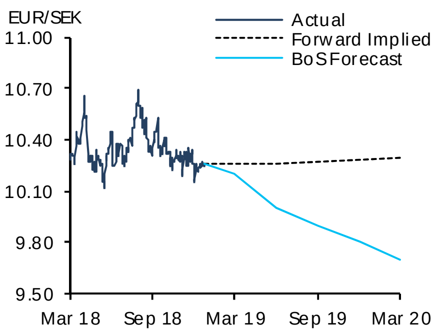
EUR/CHF

Concerns around a slowdown in the global economy, ongoing trade tensions between the US and China and heightened volatility in equity markets have driven demand for the 'safe haven' Swiss franc. Currently hovering around its medium-term range lows, we expect EUR/CHF to rally to 1.15 by end-2019. The domestic fundamentals appear supportive of our view. Q3 GDP growth fell sharply and inflation in December dropped by more than expected. Given the SNB still believes the franc is "overvalued", these developments leave it unlikely to change its policy stance over the coming months. Hampered by stubbornly low 'core' inflation, market rate expectations for the Eurozone have been pushed back, with a 10bp increase in the deposit rate not 'fully priced' until mid-2020. Even so, we are likely to see interest rate rises from the ECB before the SNB. That, combined with a recovery in global growth and risk sentiment should see EUR/CHF trade higher.



EUR/NOK

Over the past few weeks the Norwegian krone has been particularly volatile. Through December, EUR/NOK rallied from 9.65 to 10.05 (its highest level since 2008). However, it has subsequently fallen back below 9.75. The sharp moves have largely been driven by gyrations in the price of oil. However, looking through this near-term volatility, there remains a strong case for the Norges Bank to continue raising interest rates. December CPI inflation remained at 3.5%, well above the central bank's target, and Governor Olsen reiterated the next hike could come as soon as March. The ECB, meanwhile, does not expect to tighten policy rates until after "the summer" and, although 'core' inflation in the euro area is still subdued, we expect a 10bp rise in the deposit rate in December. Given that the Norges Bank currently has a more hawkish policy stance than the ECB, the interest rate outlook may pressure EUR/NOK. In addition, we believe oil prices will continue to be a supportive factor for the krone and forecast EUR/NOK to fall towards 9.40 by end-2019.



EUR/SEK

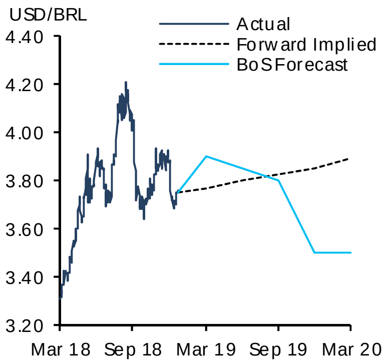
Since the middle of October the Swedish krona has oscillated in a narrow range against the euro (between 10.10 and 10.45). Fundamentally, little has changed in the last month to alter our bias for EUR/SEK to decline further over the coming months. While some indicators of activity have softened, the Riksbank felt comfortable enough to raise interest rates by 25bps, to -0.25%, in December. Moreover, the market expects further tightening this year, most likely in Q3. Given that domestic sentiment remains relatively buoyant, an improvement in the external environment could bring forward Swedish rate expectations. Current guidance from the ECB suggests that policy rates will be on hold "through the summer". Beyond that point, it is likely that the central bank will slowly start to raise policy rates. We expect a 10bp increase in the deposit rate in December. Even so, compared to the euro area, Swedish policy normalisation looks likely to occur at a faster pace. As such, we forecast EUR/SEK to fall towards 9.80 by the end of the year.

Developed Markets FX Forecasts

		Current	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
US Dollar	Dollar Index (DXY)	96.4	94.5	93.0	91.8	90.3	90.2	89.6	89.4	89.4	89.3
	USD/GBP	0.78	0.74	0.74	0.75	0.75	0.75	0.75	0.75	0.75	0.75
	USD/EUR	0.88	0.86	0.85	0.83	0.81	0.81	0.81	0.81	0.81	0.81
UK Pound	GBP/USD	1.29	1.35	1.35	1.34	1.33	1.33	1.33	1.33	1.33	1.33
	GBP/EUR	1.14	1.16	1.14	1.12	1.08	1.08	1.07	1.07	1.07	1.07
Euro	EUR/USD	1.14	1.16	1.18	1.20	1.23	1.23	1.24	1.24	1.24	1.24
	EUR/GBP	0.88	0.86	0.87	0.90	0.92	0.92	0.93	0.93	0.93	0.93
Japanese Yen	USD/JPY	109	110	108	106	106	105	105	104	104	104
	GBP/JPY	141	149	146	142	141	140	140	138	138	138
	EUR/JPY	124	128	127	127	130	129	130	129	129	129
Australian Dollar	AUD/USD	0.71	0.74	0.75	0.75	0.74	0.73	0.73	0.73	0.73	0.73
	GBP/AUD	1.81	1.82	1.80	1.79	1.80	1.82	1.82	1.82	1.82	1.82
	EUR/AUD	1.59	1.57	1.57	1.60	1.66	1.68	1.70	1.70	1.70	1.70
Canadian Dollar	USD/CAD	1.33	1.32	1.30	1.29	1.28	1.27	1.26	1.25	1.24	1.23
	GBP/CAD	1.72	1.78	1.76	1.73	1.70	1.69	1.68	1.66	1.65	1.64
	EUR/CAD	1.51	1.53	1.53	1.55	1.57	1.56	1.56	1.55	1.54	1.53
New Zealand Dollar	NZD/USD	0.67	0.66	0.66	0.65	0.65	0.65	0.64	0.64	0.64	0.64
	GBP/NZD	1.92	2.05	2.05	2.06	2.05	2.05	2.08	2.08	2.08	2.08
	EUR/NZD	1.69	1.76	1.79	1.85	1.89	1.89	1.94	1.94	1.94	1.94
Norwegian Krone	USD/NOK	8.60	8.19	8.01	7.83	7.64	7.64	7.58	7.58	7.58	7.58
	GBP/NOK	11.09	11.06	10.81	10.50	10.16	10.16	10.08	10.08	10.08	10.08
	EUR/NOK	9.76	9.50	9.45	9.40	9.40	9.40	9.40	9.40	9.40	9.40
Swedish Krona	USD/SEK	9.03	8.79	8.47	8.25	7.97	7.89	7.74	7.66	7.66	7.66
	GBP/SEK	11.65	11.87	11.44	11.06	10.60	10.49	10.30	10.19	10.19	10.19
	EUR/SEK	10.25	10.20	10.00	9.90	9.80	9.70	9.60	9.50	9.50	9.50
Swiss Franc	USD/CHF	1.00	0.98	0.97	0.96	0.94	0.96	0.96	0.97	0.98	0.98
	GBP/CHF	1.29	1.33	1.30	1.28	1.25	1.28	1.28	1.29	1.30	1.30
	EUR/CHF	1.13	1.14	1.14	1.15	1.16	1.18	1.19	1.20	1.21	1.21

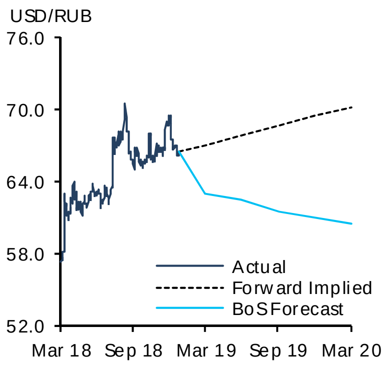
Source: Bloomberg, BoS

Fundamental Views – BRIC FX



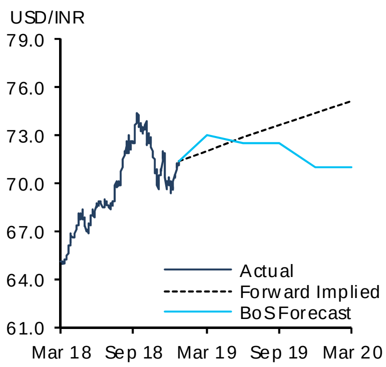
USD/BRL

Like most EM currencies, the Brazilian real found support from both the paring back in Fed interest rate expectations and signs of a possible resolution to US-China trade tensions. The real's strength can also be attributed to faith in Brazil's new president, Jair Bolsonaro, to deliver on promised reforms. Pension reforms are the most critical to reining in the budget deficit. To begin with, Bolsonaro's team unveiled some ambitious proposals; some of which have now been pared back over fears they would lack support from legislators. Looking ahead, there are enough political hurdles to suggest the process, even if successful, won't be seamless or swift. Pension reforms could be further watered down or even fail to pass. Meanwhile, there are no guarantees that external market factors will remain as favourable. Consequently, it's little wonder that foreign investors are only cautiously optimistic, and that we predict a near-term retracement in recent BRL gains.



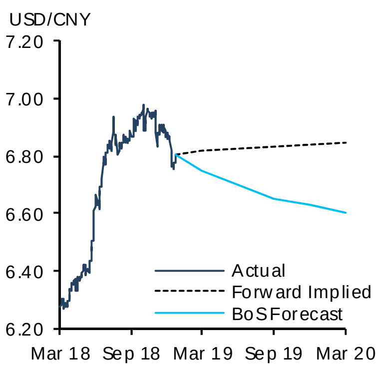
USD/RUB

Favourable external conditions helped the ruble gain against the US dollar over the past month. Higher hydrocarbon prices, particularly crude oil, also aided the ruble; Russia being a major crude oil exporter. More specifically related to Russia, there were indications that US sanctions, which have added significant political risk to doing business, would not be expanded. Such suggestions are important because the main rating agencies have signalled any expansion would have led to a potential credit downgrade. An unexpected interest rate hike by Russia's central bank provided addition support to the currency. At 7.75%, the policy rate provides some of the most attractive returns from a carry perspective. In summary, the outlook for the ruble is looking much brighter than it did in the final quarter of 2018. Yet for all the recent positivity, the risks to our forecasts remain high. This is because geopolitical risk is still elevated, as are the risks of increased FX intervention should the currency appreciate too fast.



USD/INR

The Indian rupee was one of the main underperformers compared to the rest of the EM currencies. India is a major hydrocarbon importer, so the rebound in crude oil prices certainly didn't play favourably for the rupee. Domestic developments in India were also unconstructive. Increased government spending on populist measures ahead of a general election either in April or May (the final date has yet to be decided), has led to subsequent stress on India's twin fiscal and current account deficits. The move followed potential pressures late last year which undermined the independence of the RBI, India's central bank. Looking ahead, political uncertainty is likely to weigh further on the currency as elections draw closer, as will the recent slip in economic activity. GDP decelerated sharply from 8.2% y/y in Q2-2018 to 7.1% in Q3-2018. All of this points to near-term upward pressure on USD/INR from current levels.



USD/CNY

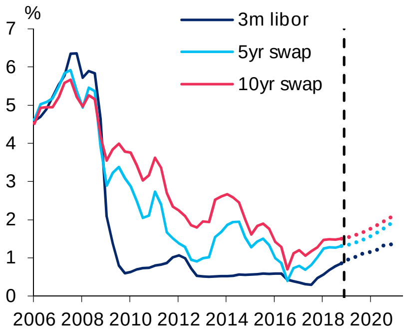
In line with our forecast, more conciliatory noises from US-China trade talks have begun to feed through to the yuan. In actuality though, little tangible progress on the core points of contention has yet been made, and the deadline of 1 March is approaching. A more risk-on environment alongside a more dovish Fed have dented the dollar strength we saw last year. Even considering this, the yuan has outperformed, and we still see the broad fundamentals as being in its favour. However risks to the outlook exist in the near term. For one, the reduction in Fed hikes priced in by the market looks overdone, meaning there is potential for a stronger 'greenback'. Furthermore, continued slowdown in China, and consequent loosening of monetary policy, has reduced US-China rate differentials; the respective interbank rates are now almost equal. In our view, therefore, though the data still support our YE-2019 forecast of 6.59, there is the potential for near-term volatility.

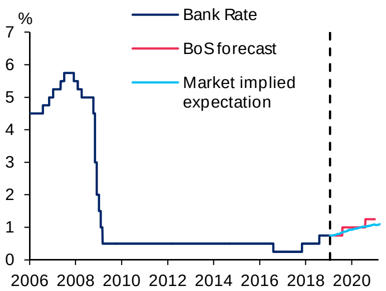
Key EM Currency Forecasts

		Current	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Brazilian Real	USD/BRL	3.75	3.90	3.85	3.80	3.50	3.50	3.50	3.50	3.50	3.50
	GBP/BRL	4.84	5.27	5.20	5.09	4.66	4.66	4.66	4.66	4.66	4.66
	EUR/BRL	4.26	4.52	4.54	4.56	4.31	4.31	4.34	4.34	4.34	4.34
Russian Rouble	USD/RUB	66.5	63.0	62.5	61.5	61.0	60.5	60.0	60.0	60.0	60.0
	GBP/RUB	85.7	85.1	84.4	82.4	81.1	80.5	79.8	79.8	79.8	79.8
	EUR/RUB	75.5	73.1	73.8	73.8	75.0	74.4	74.4	74.4	74.4	74.4
Indian Rupee	USD/INR	71.4	73.0	72.5	72.5	71.0	71.0	71.0	71.0	71.0	71.0
	GBP/INR	92.2	98.6	97.9	97.2	94.4	94.4	94.4	94.4	94.4	94.4
	EUR/INR	81.1	84.7	85.6	87.0	87.3	87.3	88.0	88.0	88.0	88.0
Chinese Renminbi	USD/CNY	6.81	6.75	6.70	6.65	6.63	6.60	6.59	6.59	6.59	6.59
	GBP/CNY	8.78	9.11	9.05	8.91	8.82	8.78	8.76	8.76	8.76	8.76
	EUR/CNY	7.73	7.83	7.91	7.98	8.15	8.12	8.17	8.17	8.17	8.17
Czech Koruna	USD/CZK	22.6	22.1	21.7	21.3	20.5	20.3	20.2	20.2	20.2	20.2
	GBP/CZK	29.1	29.8	29.3	28.5	27.3	27.0	26.8	26.8	26.8	26.8
	EUR/CZK	25.6	25.6	25.6	25.5	25.3	25.0	25.0	25.0	25.0	25.0
Hungarian Forint	USD/HUF	280.1	271.6	264.4	259.9	253.4	253.3	251.2	251.2	251.2	251.2
	GBP/HUF	361.2	366.6	356.9	348.3	337.0	336.8	334.1	334.1	334.1	334.1
	EUR/HUF	318.0	315.0	312.0	311.9	311.7	311.5	311.5	311.5	311.5	311.5
Polish Zloty	USD/PLN	3.77	3.65	3.56	3.48	3.40	3.40	3.37	3.37	3.37	3.37
	GBP/PLN	4.86	4.92	4.81	4.67	4.52	4.52	4.48	4.48	4.48	4.48
	EUR/PLN	4.28	4.23	4.20	4.18	4.18	4.18	4.18	4.18	4.18	4.18
Mexican Peso	USD/MXN	19.19	18.75	18.50	18.50	18.00	18.00	18.00	18.00	18.00	18.00
	GBP/MXN	24.75	25.31	24.98	24.79	23.94	23.94	23.94	23.94	23.94	23.94
	EUR/MXN	21.79	21.75	21.83	22.20	22.14	22.14	22.32	22.32	22.32	22.32
South African Rand	USD/ZAR	13.89	13.75	13.50	13.27	13.30	13.30	13.30	13.30	13.30	13.30
	GBP/ZAR	17.91	18.56	18.23	17.78	17.69	17.69	17.69	17.69	17.69	17.69
	EUR/ZAR	15.77	15.95	15.93	15.92	16.36	16.36	16.49	16.49	16.49	16.49
Turkish Lira	USD/TRY	5.35	5.55	5.52	5.50	5.50	5.50	5.50	5.50	5.50	5.50
	GBP/TRY	6.90	7.49	7.45	7.37	7.32	7.32	7.32	7.32	7.32	7.32
	EUR/TRY	6.08	6.44	6.51	6.60	6.77	6.77	6.82	6.82	6.82	6.82

Source: Bloomberg, BoS

Fundamental Views – UK Interest Rates





UK Pound

The Bank of England's Monetary Policy Committee have repeatedly stated that should the economy continue to perform in line with their expectations, further hikes are likely to be required to bring inflation sustainably back to its 2% target. MPC members have been in broad agreement that this is consistent with one quarter-point rate hike per year over the next couple years, a view in step with the Committee's longstanding mantra that the pace of future hikes is likely to be limited and gradual. The ongoing uncertainty associated with the UK's departure from the EU, however, represents a key risk, which has weighed on market expectations for UK interest rates. At the time of writing, financial markets do not expect (fully price in) the next quarter-point increase until mid-2020, with a follow-up hike not expected until 2023. For now, with Brexit concerns dominant, the Bank of England is unlikely to hike until the UK's future relationship with the EU becomes clearer.

Our central case continues to envisage the next hike occurring in August 2019. This view reflects several factors. First, the UK economy continues to grow. Growth was strong in the third quarter, and while it eased to 0.3% in the three months to November, we expect full-year GDP growth to be around 1.3%. Meanwhile, concerns over the supply-side of the UK economy continue to build. The unemployment rate remains low which, alongside the relative softness of productivity, raises doubts about the pace at which the UK can grow without generating more inflation. Second, underlying inflation remains sticky. Although UK headline CPI has fallen back, driven by fading currency base effects and lower energy prices, domestic price pressures stemming from rising wages and tightening capacity constraints are building. Overall, we expect these forces to result in inflation continuing to hover around the 2% target over the forecast horizon. Furthermore, if the UK and EU eventually negotiate a smooth transition, which would reflect our central case, this would also support a more hawkish Bank of England profile.

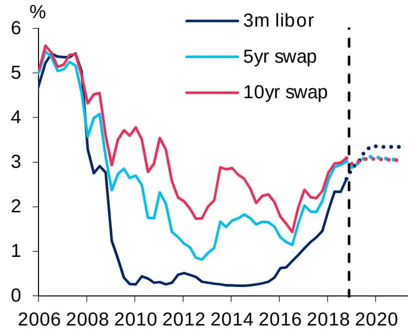
With the economy having no spare capacity, and increases in economic capacity likely to lag behind demand over the forecast horizon, this suggests that the risks of inflation proving stickier than at present have seemingly increased. In fact, in the BoE's latest set of economic projections, it does not envisage inflation returning to the 2% target until Q3 2021. Moreover, those forecasts do not take into account the changes to fiscal policy contained in the Autumn Budget. This suggests that there is some scope for the Bank of England to adopt a more-hawkish tone, perhaps as early as the February Inflation Report.

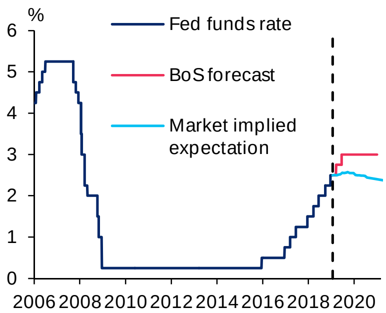
Key Bond and Money Market Forecasts

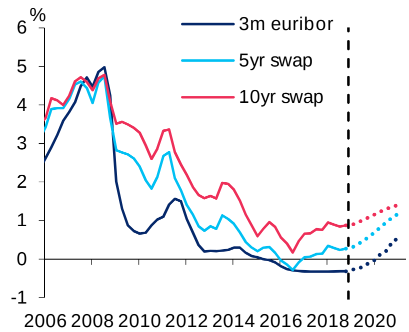
		Current	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
GBP	Key Policy Rate	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25
	3-month interbank rate	0.9	0.9	1.0	1.1	1.1	1.2	1.2	1.3	1.3	1.4
	2-year bond yield	0.8	0.8	0.9	0.9	1.0	1.1	1.2	1.3	1.4	1.5
	10-year bond yield	1.3	1.4	1.5	1.5	1.6	1.7	1.9	2.0	2.1	2.2
	5-year swap rate	1.3	1.3	1.4	1.4	1.5	1.6	1.7	1.8	1.9	2.0
	10-year swap rate	1.4	1.5	1.6	1.6	1.7	1.8	1.9	2.0	2.0	2.1
USD	Key Policy Rate	2.50	2.75	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
	3-month interbank rate	2.8	2.9	3.0	3.2	3.3	3.4	3.3	3.3	3.3	3.3
	2-year bond yield	2.6	2.8	3.0	3.2	3.2	3.2	3.2	3.2	3.1	3.1
	10-year bond yield	2.7	2.9	3.1	3.2	3.2	3.2	3.2	3.2	3.2	3.2
	5-year swap rate	2.7	2.9	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.0
	10-year swap rate	2.8	2.9	3.0	3.1	3.1	3.1	3.1	3.1	3.0	3.0
EUR	Refi rate	0.00	0.00	0.00	0.00	0.10	0.10	0.25	0.25	0.50	0.50
	Deposit rate	-0.40	-0.40	-0.40	-0.40	-0.30	-0.30	-0.20	-0.20	0.00	0.00
	3-month euribor	-0.3	-0.3	-0.3	-0.2	-0.1	0.0	0.1	0.2	0.5	0.5
	2-year bond yield	-0.6	-0.5	-0.5	-0.4	-0.2	-0.1	0.1	0.2	0.4	0.5
	10-year bond yield	0.2	0.3	0.4	0.5	0.6	0.7	0.8	1.0	1.1	1.1
	5-year swap rate	0.1	0.3	0.4	0.5	0.6	0.7	0.8	1.0	1.1	1.2
	10-year swap rate	0.7	0.9	0.9	1.0	1.1	1.2	1.2	1.3	1.4	1.4

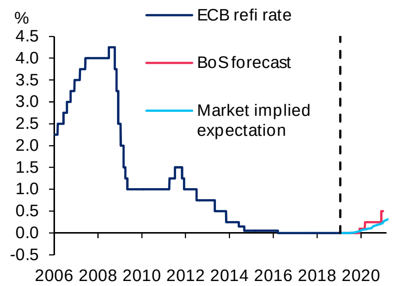
Source: Bloomberg, BoS

Fundamental Views – Interest Rates









US Dollar

The US economy looks to have continued to expand at a decent clip in Q4, although below the 3.4% annualised pace recorded for Q3. The ongoing government shutdown means that some data releases have been postponed. Available evidence points to growth of around 2.5% in Q4, with consumer spending supported by a robust labour market and tax cuts. Going into 2019, GDP growth is forecast to remain above trend, but to moderate as the impact of the fiscal stimulus starts to wane. Concerns about the potential impact of an already protracted government shutdown have risen.

Nonfarm payrolls surged by 312k in December, compared with 176k in November, while annual growth in average hourly earnings increased to 3.2%y/y. However, the unemployment rate rose to 3.9%, led by a higher participation rate, suggesting some labour market slack. Core CPI inflation, excluding food and energy, was steady at 2.2%y/y, although the headline measure fell to 1.9%y/y from 2.2%y/y reflecting lower energy prices. On balance, the evidence indicates that domestic inflation pressures continue to build, but remain relatively well contained.

The Fed raised interest rates by 0.25% to 2.5% (upper bound) at its December meeting and signalled two further hikes in 2019 in its 'dot plot', down from three hikes previously. The published minutes of the meeting indicated that officials felt that they "could afford to be patient about further policy firming" amid muted inflation pressures. That suggests a risk the next hike may be deferred until later in the year, while financial markets attach only a small probability of any increase at all. Our central view remains for two hikes this year to 3%. US 10 year Treasury yields have recovered after falling to a low of 2.54% in early January, but they remain below the 2018 high of 3.26%. Our end 2019 target for the 10 year yield remains 3.2%.

Euro

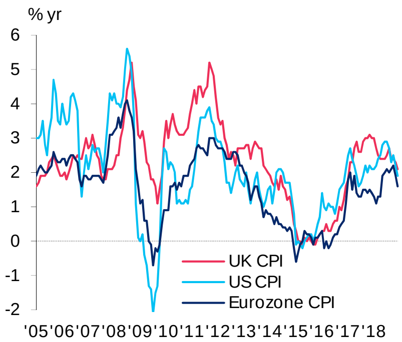
The economic slowdown in the Eurozone is expected to last longer than previously expected, although ECB President Draghi said the economy is not heading for a recession. Nevertheless, the ECB acknowledged that risks to the economic outlook are "moving to the downside". Growth slowed to 0.2%q/q in Q3 and latest indicators point to a similar outturn in Q4. The rebound in German growth following the temporary contraction in Q3 is expected to be modest, while 'yellow vest' protests in France are set to weaken Q4 growth. Italian GDP growth was marginally negative in Q3 and a similar outcome is possible for Q4.

Eurozone headline CPI inflation peaked last year at 2.2%y/y in October, but fell to 1.6%y/y in December. Lower energy prices are expected to reduce headline inflation further in early 2019. Core CPI inflation, excluding food and energy, remained subdued at 1.0%y/y in December. The unemployment rate has fallen to 7.9%, below 8% for the first time since 2008. Signs of a pickup in wage growth underpin forecasts of higher core inflation over the medium term, although policymakers acknowledge the feed through is taking longer than expected.

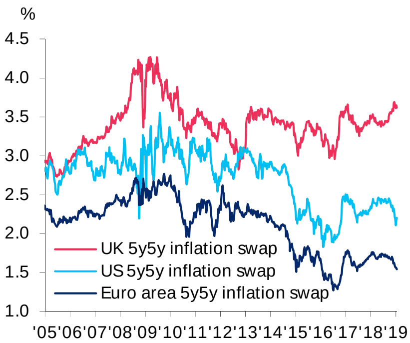
The ECB brought to a close its net asset purchase programme at the end of last year despite a weaker outlook for economic growth and inflation in 2019. It also explicitly linked its reinvestment policy to the first interest rate rise, but left unchanged for now its guidance that rates would remain at their present levels "at least through the summer of 2019", widely interpreted to mean at least until September. It was notable, though, that President Draghi said that financial markets "well understood our reaction function" – markets have pushed out their expectations for the first 10bps rate rise to mid-2020. We maintain our central view for the first 10bps increase in Q4 2019 for the deposit and refinancing rates to 0.3% and 0.1%, respectively. Our end-2019 target for the 10 year bund yield remains 0.6%.

Fundamental Views - Inflation

Inflation Rates



Inflation Expectations



Inflation Trends

Symptomatic of the sharp decline in global oil prices in the fourth quarter of 2018, inflation rates in a number of developed economies have drifted lower into year-end. While oil prices have recovered in the early part of 2019, the residual effect of Q4's sharp decline is likely to see headline inflation rates remain soft over the coming months. However, measures of 'core' inflation have proved stickier, with domestic inflationary pressures building as economic slack continues to be absorbed. If sustained, these should ensure that headline rates of inflation climb over time. However, varying degrees of spare capacity are likely to mean that inflation rates recover at different speeds.

In the UK, lower energy prices saw the annual rate of consumer price inflation drop to 2.1% in December. Ongoing energy-related effects (including the impact of Ofgem's energy price cap) are likely to see the headline rate of UK inflation dip below 2% in Q1, though we expect the 'core' rate of inflation to be little changed (currently just below 2%). Beyond the near term, rising domestic pressures pose upside risks. The combination of no spare capacity, rising wages and lacklustre productivity growth are expected to see domestic inflation pressures increase. We expect inflation to converge back to around 2% over the medium term. This is likely to require further, albeit limited and gradual, rises in interest rates. Meanwhile, a recent House of Lords inquiry on the use of RPI called for changes to be made to the measure to correct for methodological problems.

Similarly, in the Eurozone, inflation eased back in December, dropping to an eight-month low of 1.6%y/y. The prevailing degree of slack in the economy, however, means that underlying price pressures remain constrained, as evidenced by the ongoing weakness in the 'core' rate of inflation, which continues to hold around 1.0%. Nevertheless, an ongoing absorption of slack and firmer pay growth is providing the ECB with greater confidence that domestic inflation will pick up in the future.

Meanwhile, in the US, 'core' CPI inflation remains above 2%, despite the recent move below 2% in the headline rate. Moreover, the Fed's preferred measure of inflation, the personal consumption expenditure deflator, remains just under 2.0%. The US labour market continues to look tight following a sustained period of strong jobs growth, which is putting upward pressure on wages. Since last April, annual earnings growth has gently drifted higher from 2.6% to 3.2%, its highest since April 2009. Notwithstanding the impact of the recent US government shutdown – which is expected to be temporary – rising wages and the feed-through from a resilient economy are expected to push the PCE deflator higher over the coming months, justifying some additional policy tightening.

Inflation Outlook

		Avg since '97	Latest	Period	'19 Q1	'19 Q2	'19 Q3	'19 Q4	'20 Q1	'20 Q2	'20 Q3	'20 Q4
GBP	CPI inflation %	2.0	2.1	Dec-18	1.9	2.1	2.2	2.2	2.1	2.0	2.0	2.1
	Core CPI inflation %	1.6	1.9	Dec-18	1.9	2.1	2.2	2.3	1.8	2.0	2.1	2.1
	RPI inflation %	2.8	2.7	Dec-18	2.5	2.8	2.8	2.8	2.9	2.7	2.7	2.8
	RPI index level		285.6	Dec-18	284.4	288.4	291.3	292.9	292.6	296.2	299.1	301.1
	CPI-RPI wedge	0.8	0.6	Dec-18	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7
USD	CPI inflation %	2.2	1.9	Dec-18	1.8	2.1	2.3	2.5	2.5	2.2	2.0	2.0
	Core CPI inflation %	2.0	2.2	Dec-18	2.1	2.3	2.3	2.3	2.2	2.2	2.2	2.2
EUR	HICP inflation %	1.7	1.6	Dec-18	1.5	1.4	1.4	1.4	1.7	1.6	1.7	1.7
	Core HICP inflation %	1.4	1.0	Dec-18	1.0	1.1	1.3	1.4	1.5	1.5	1.5	1.5

Source: Bloomberg, BoS

Key Economic and Political Events Calendar

2019 Central Bank Meetings

JANUARY

Country	Date	Event
EZ	24	ECB rate decision
US	30	FOMC policy announcement & press conference

FEBRUARY

Country	Date	Event
UK	2	BoE MPC announcement & Inflation Report

MARCH

Country	Date	Event
EZ	7	ECB rate decision
US	20	FOMC policy announcement & press conference*
UK	21	BoE MPC announcement

APRIL

Country	Date	Event
EZ	10	ECB rate decision

MAY

Country	Date	Event
US	1	FOMC policy announcement & press conference
UK	2	BoE MPC announcement & Inflation Report

JUNE

Country	Date	Event
EZ	6	ECB rate decision
US	19	FOMC policy announcement & press conference*
UK	20	BoE MPC announcement

JULY

Country	Date	Event
EZ	25	ECB rate decision
US	31	FOMC policy announcement & press conference

AUGUST

Country	Date	Event
UK	1	BoE MPC announcement & Inflation Report

SEPTEMBER

Country	Date	Event
EZ	12	ECB rate decision
US	18	FOMC policy announcement & press conference*
UK	19	BoE MPC announcement

OCTOBER

Country	Date	Event
EZ	24	ECB rate decision
US	30	FOMC policy announcement & press conference

NOVEMBER

Country	Date	Event
UK	7	BoE MPC announcement & Inflation Report

DECEMBER

Country	Date	Event
US	11	FOMC policy announcement & press conference*
EZ	12	ECB rate decision
UK	19	BoE MPC announcement

Source: Bloomberg, BoS
*includes summary of economic projections

2019 Political Events

JANUARY

Country	Date	Event
ALL	22	Davos World Economic Forum
US	29	President Trump to give 'State of the Union' address

FEBRUARY

Country	Date	Event

MARCH

Country	Date	Event
EU	21/22	EU Summit
UK/EU	29	UK formally leaves the EU

APRIL

Country	Date	Event
WD	12-14	Spring Meetings of the IMF and World Bank Group

MAY

Country	Date	Event
UK	2	UK Local Elections
EZ	23-26	European Parliament Elections

JUNE

Country	Date	Event
EU	20/21	EU Summit

JULY

Country	Date	Event

AUGUST

Country	Date	Event

SEPTEMBER

Country	Date	Event

OCTOBER

Country	Date	Event
EZ	31	ECB President Draghi's term ends

NOVEMBER

Country	Date	Event

DECEMBER

Country	Date	Event

Contacts

Research

Jeavon Lolay
Head of Economics & Strategy
Tel: +44 (0) 20 7158 1742
jeavon.lolay@lloydsbanking.com

Carl Paraskevas
Senior Economist
Tel: +44 (0) 20 7158 1741
carl.paraskevas@lloydsbanking.com

Rhys Herbert
Senior Economist
Tel: +44 (0) 20 7158 1743
rhys.herbert@lloydsbanking.com

Hann-Ju Ho
Senior Economist
Tel: +44 (0) 20 7158 1745
hann-ju.ho@lloydsbanking.com

Nikesh Sawjani
UK Economist
Tel: +44 (0) 20 7158 1749
nikesh.sawjani@lloydsbanking.com

Eric Wand
Rates Strategist
Tel: +44 (0) 20 7158 8231
eric.wand@lloydsbanking.com

Robin Wilkin
Cross Market Strategist
Tel: +44 (0) 20 7158 1637
robin.wilkin@lloydsbanking.com

Gajan Mahadevan
FX Strategist
Tel: +44 (0) 20 8975 5016
gajan.mahadevan@lloydsbanking.com

Henry Occleston
Associate
Tel: +44 (0) 20 7158 1737
henry.occleston@lloydsbanking.com

Jennifer Lee
Designer
+44 (0)20 7158 1744
jennifer.lee@lloydsbanking.com

FDs' Excellence Awards in association with ICAEW and supported by the CBI & Real Business. For more information visit bankofscotland.co.uk/bankoftheyear