COMMERCIAL BANKING

International Financial Outlook

April 2019

BANK OF SCOTLAND

Contents

All historical data sourced from Bloomberg
All forecasts sourced from Bank of Scotland (BoS)
Data sourced 29th April 2019

Overview

Financial market review

Global economic growth has weakened over the past year, but there are tentative signs that it may be stabilising. US-China trade talks remain ongoing, with hopes of a deal in the next few weeks. Despite tight domestic labour markets and signs of higher wage growth in many advanced economies, broader inflationary pressures remain relatively well contained. As a result, and mindful of increased downside risks to global growth, major central banks have adopted an increasingly cautious stance regarding the outlook for monetary policy tightening.

In particular, the US Federal Reserve is no longer signalling any interest rate rises this year and will end its quantitative tightening policy in September. The ECB has, meanwhile, pushed out its forward guidance for its first interest rate rise until next year. Other central banks, including the Bank of Japan, the Bank of Canada and Sweden's Riksbank, have also signalled a more dovish policy outlook. In the UK, the Bank of England is also contending with the uncertainties surrounding Brexit and rate-setters remain in wait-and-see mode for now.

There has been a clear loss of momentum in the Eurozone economy in the second half of 2018, with business surveys suggesting that the underlying trend will remain sluggish this year. UK business confidence has also weakened in recent months, although official GDP growth has performed better than expected, supported by stockpiling in response to Brexit risks. US Q1 GDP growth exceeded expectations, rising by 3.2% on an annualised basis, although underlying demand softened. China's Q1 GDP stabilised at 6.4%y/y, against forecasts for a further slowdown.

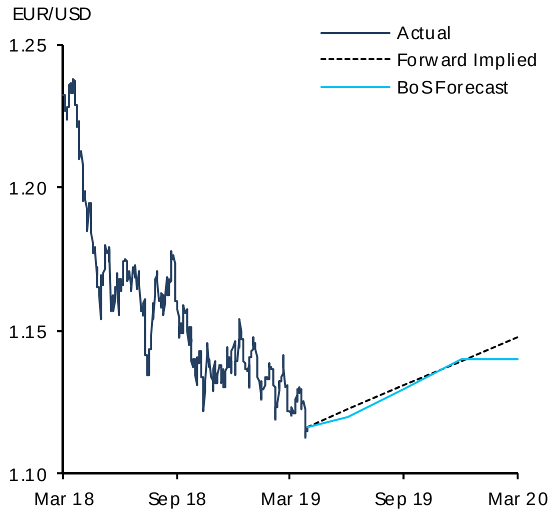
In the financial markets, global equity markets have rebounded this year, boosted by more accommodative monetary policies. Since the start of the year, global equities have risen by about 15% and are back around last September's levels. The benchmark US 10 year Treasury has fallen from a high of 3.2% in late 2018 to around 2.5%. The 10 year UK gilt and German bund yields have also declined to around 1.1% and 0.0%, respectively. Markets anticipate a Fed rate cut later this year, while the next UK quarter-point rate rise is fully priced only in late 2020 and the first 10bps ECB rise in early 2021.

In the currency space, the British pound has outperformed this year, possibly reflecting the market's assessment of a lower risk of an imminent disorderly Brexit. Over the past month, the US dollar has been the strongest performer, as other major central banks follow in the Fed's more dovish footsteps. General market volatility has remained subdued. Brent crude oil, meanwhile, has risen above $70 a barrel, reflecting tighter supply conditions.

Summary of key forecasts

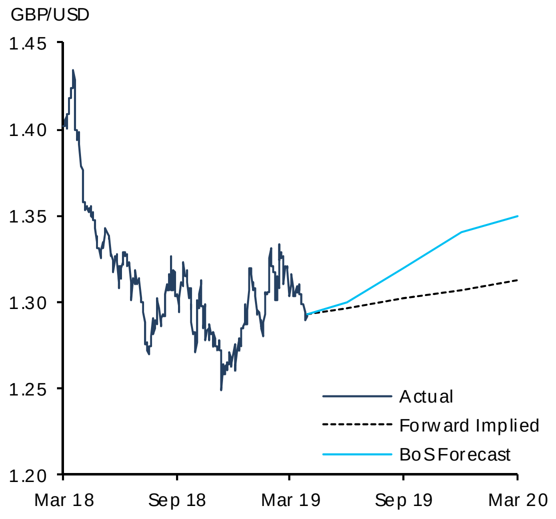
- Our baseline expectation is for global economic growth to stabilise and rebound modestly in the second half of the year. We expect global inflation pressures to remain contained, allowing the main central banks to pursue an accommodative policy stance. The risk to the central view is a further loss of momentum in activity, potentially induced by broader and more intensive global trade tensions.
- Brexit remains the dominant issue in the UK. Our central case is still that a negotiated agreement will be reached later this year. However, a wide range of options are possible and it is not easy to be confident about how and when a resolution will be reached. Domestic political risks remain elevated.
- UK Q1 GDP growth is forecast to have accelerated, partly related to stockpiling, but we expect growth to moderate in subsequent quarters as uncertainties around Brexit return ahead of the 31 October deadline. Overall, we expect the Bank of England to keep policy on hold this year, with one rate hike forecast for next year assuming our central Brexit assumption is borne out.
- We forecast the British pound to strengthen on the expectation and confirmation of an 'orderly' EU withdrawal. Our targets for GBPUSD are 1.34 for end-2019 and 1.36 for end-2020. For GBPEUR, we forecast 1.18 for end-2019 and end-2020. Our 10 year gilt yield targets are 1.5% for end-2019 and 2.0% at end-2020.
- We forecast US policy interest rates to be unchanged at 2.5% through this year and next, with economic data supporting a 'patient' Federal Reserve. That compares with current market expectations for lower rates. Our 10 year Treasury yield targets are 2.6% for end-2019 and 2.9% at end-2020.
- The ECB is predicted to delay its first interest rate rise until June 2020, with only gradual hikes thereafter. Our 10 year German bund yield targets are 0.1% for end-2019 and 0.5% at end-2020. We forecast EURUSD at 1.14 at end-2019 and 1.15 at end-2020.

Fundamental Views – G10 FX



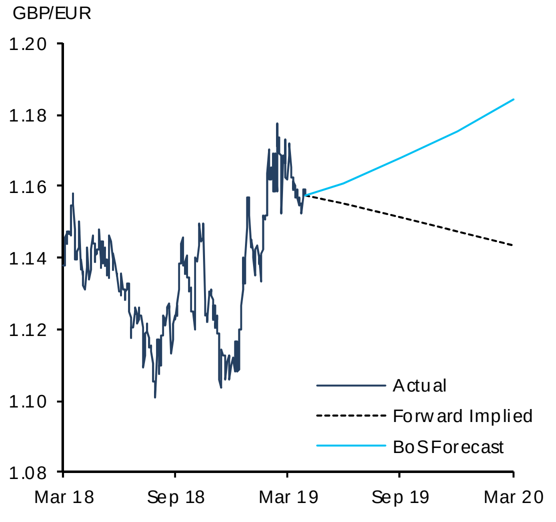
EUR/USD

EUR/USD has trended lower throughout 2019, falling from a high of 1.1572 in January to 1.11 in late April. Given the precipitous collapse in Eurozone sentiment, one might have expected the currency to be under greater pressure against the US dollar but its losses may have been stymied by USD selling following the dovish shift in US interest rate expectations. We are more optimistic about the US economic outlook and forecast policy rates to remain on hold this year and next. At its April meeting, ECB President Draghi indicated that policy rates would be on hold at least until the end of 2019 and revised down outlooks for both growth and inflation. We forecast euro area GDP growth to slow to 1.3% in 2019, from 1.8% in 2018. CPI inflation is predicted at 1.3% this year, rising to 1.5% in 2020, well below the official target of 'close to but below 2%'. However, from here, we see a reasonable chance of EUR/USD moving higher. The market is holding a notable 'net short' euro position and technical studies are biased towards euro strength. Our fair value models suggest EUR/USD is undervalued. We forecast EUR/USD at 1.14 at end 2019, rising to 1.15 at end 2020.



GBP/USD

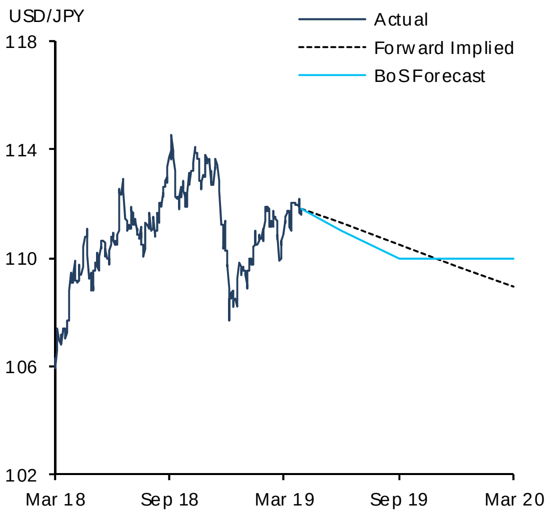
A glance at the fundamentals lends a strong case as to why the GBP should arguably be firmer against the USD. UK economic data have generally beat expectations, defying the weaker global backdrop and elevated domestic uncertainty. The resilience of the consumer in particular has been impressive, helped by the tightness of the labour market and solid real wage growth. But, clearly, the Brexit-related risk premium is playing a role. All Brexit options are still on the table and we are likely to remain shrouded in political uncertainty for some time. The US economy defied expectations again in Q1, growing by a robust 3.2%, despite the record-long government shutdown. However, support for the US dollar is proving elusive as market expectations of a cut in policy interest rates continue to build. This could be tested, if data remain strong and the Fed stays 'patient'. After developing in a narrowing range in recent months (1.34-1.28), GBP/USD has broken lower in recent days. However, with market positioning now neutral, there is scope for trending moves in either direction. While we remain positive on the prospects for the pound, the high degree of uncertainty leaves GBP/USD susceptible to bouts of significant volatility.



GBP/EUR

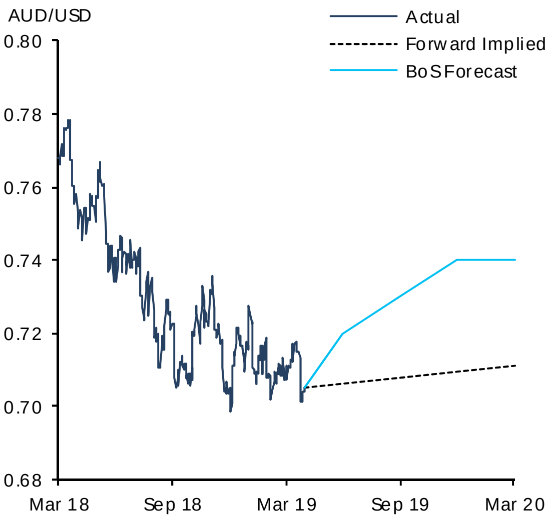
The pound capped a strong start to the year against the euro at 1.18 in mid-March, before selling off more recently to below 1.1550. The GBP has benefitted from the revising down of euro area growth prospects and the pushing back of market implied policy rate hike expectations. In the UK, the risk of an imminent 'no deal' Brexit reduced after the UK and EU agreed an extension to Oct 31st. Even so, all options, ranging from a 'no deal' exit to a 'confirmatory' referendum or revocation of Article 50, remain in play. From an economic perspective, there is arguably a better case for the Bank of England to adopt a more hawkish stance than the ECB. Despite the prevailing uncertainty, the UK labour market remains tight and the consumer relatively resilient. In contrast, the ECB used its April meeting to push back expectations for policy tightening. With major economic and political forces pulling the currency pair in opposing directions, we see little reason for GBP/EUR to decisively break its post EU referendum range (1.10-1.20). That said, the currency pair could experience periods of elevated volatility. We forecast GBP/EUR at 1.18 at end 2019 and end 2020.

Fundamental Views – G10 FX



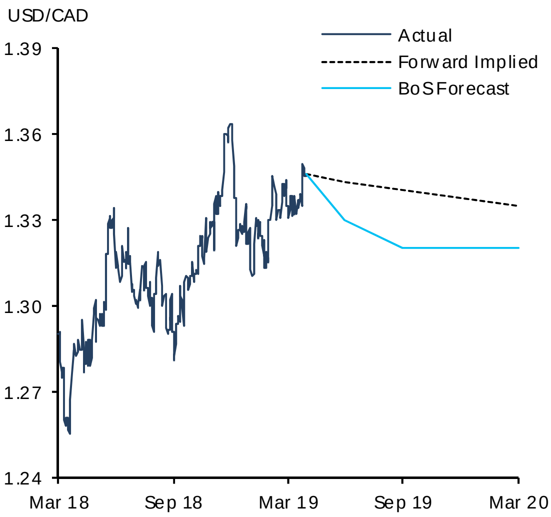
USD/JPY

Following January's 'flash crash', the yen has traded within a narrow 108 to 112 range against the US dollar. In fact, the average of the daily range over a 3-month window currently sits at its lowest level since October 2014. Such muted price action, however, masks some significant moves in the usual key drivers of USD/JPY. Relative monetary policy developments have weighed on the dollar. The Federal Reserve has halted policy tightening, at least temporarily. The 'dot plot' no longer signals any interest rate rises in 2019 and we have revised our forecast to reflect no further increases this year and next. Meanwhile, risk sentiment has firmed following last December's global equity sell-off. Importantly, US equity markets have rallied back towards all-time highs, and in doing so are providing support to USD/JPY. We remain biased for this pair to decline within its recent range. Given the high degree of global political uncertainty and general deterioration in forward-looking PMI sentiment indicators, the market may be displaying some complacency. In addition, given that it already holds a notable 'net short' JPY position, we see asymmetric risks for a move to the downside in USD/JPY.



AUD/USD

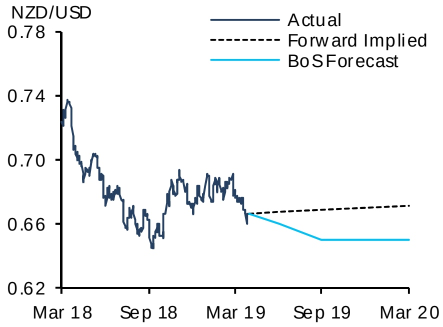
Among developed-market currencies, the Australian dollar is among those that are usually the most sensitive to risk sentiment. It is therefore somewhat at odds to see global equity markets reaching all-time highs, volatility measures falling towards all-time lows, key commodity prices rallying and, at the same time, the AUD/USD trading at its medium-term range lows. While it is a worry that the currency pair has not gained more traction to the topside with such a supportive external environment, we look for these factors to eventually pull the AUD higher. For the time being, however, the market is clearly more concerned with domestic monetary policy expectations, which continue to pressure the currency. Alongside slowing growth prospects, the surprisingly sharp fall in inflation in Q1 has raised the risks of policy easing from the RBA, and interest rate markets estimate a more than 60% chance of 50bps worth of policy rate cuts from the central bank by the end of the year. However, such 'pricing' is premature. The stabilisation of Chinese GDP growth and possible resolution of US-China trade negotiations could boost Australian exports, improve the domestic outlook, and further buoy risk appetite. Were such conditions to prevail, AUD/USD would likely rally.



USD/CAD

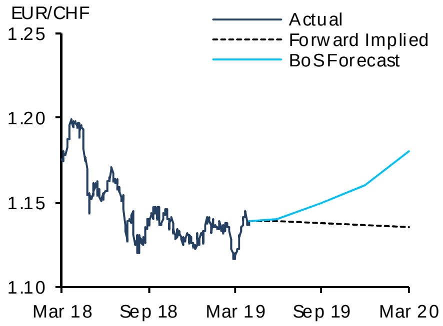
The fact that the Canadian dollar is in the middle of its 2019 range, despite Brent crude prices rallying almost 50% from their recent lows, is out of the ordinary. Given Canada's long-standing status as a major exporter of oil, it is unusual to see its currency fail to build momentum in the backdrop of such a sharp price move. This, however, is a sign of the market's concerns around US and Canadian economic and monetary policy prospects. The waning effects of President Trump's fiscal stimulus saw the rate of growth slow into the end of last year and the Federal Reserve has now paused its policy normalisation process. While, in theory, this should weigh on the USD, concerns over the performance of the US economy also have negative implications for Canada given how significant a trading partner it is. That said, the Canadian economy, at least on the surface, remains buoyant. GDP growth for January beat expectations, the labour market is close to its cyclical lows, and consumer spending is recovering from a subdued finish to 2018. Beyond the economic data, the market holds a sizeable 'net short' CAD position and interest rate markets are 'priced' pessimistically. As such, we expect the Canadian dollar to appreciate.

Fundamental Views – Other Developed Market FX



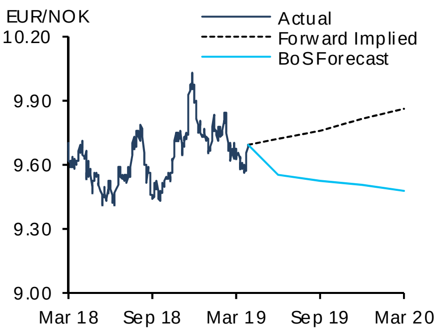
NZD/USD

Having held up well in difficult conditions between November and January, it has been slightly surprising to see the NZD soften by almost 5% against the USD in an environment in which it would usually perform well. With equity markets moving towards all-time highs, global risk sentiment is relatively buoyant. Moreover, the price of milk, which is a key New Zealand export, has rallied close to its highest level since 2017. Despite these developments, monetary policy dynamics are weighing on the currency. While the Federal Reserve has given a firm indication that policy rates are on hold, the 2-year NZ-US interest rate differential has moved 15bps in favour of the USD over the last month, following a gradual deterioration in NZ data and a reinforcement of the RBNZ's 'dovish' stance. These forces are likely to continue to pull NZD/USD in opposing directions, which should leave it around current levels over the coming quarters.



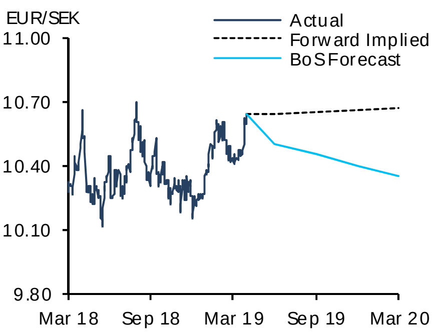
EUR/CHF

Since testing its medium-term low around 1.12 in March, the euro has rallied strongly towards its range highs against the Swiss franc. The positive risk environment has been a key supportive factor. With global equity indices approaching their all-time highs, it seems consistent for the market to sell the 'safe-haven' CHF. Yet, relative monetary policy outlooks and political event risk may drive the currency pair lower. The ECB was unequivocally 'dovish' at its April meeting, altering its forward guidance to suggest that policy rates were likely to stay on hold until the end of the year and sharply revising down its GDP growth forecasts. At the same time, Swiss Q4 GDP fell to 1.4%y/y and sentiment surveys are hovering around the expansion-contraction boundary. Even so, monetary policy is likely to be left unchanged. In the near term, EUR/CHF is likely to remain within its range, however, further out we expect a moderate rally in the currency pair.



EUR/NOK

Having been close to 10.00 at the start of the year, EUR/NOK has trended lower over the past four months. The positive external environment and affirmative action from the Norges bank have given the krone a window of opportunity to extend gains. With CPI close to 3%, and in spite of weaker-than-expected activity data, the central bank raised the deposit rate by 25bps to 1% in March. Importantly, current guidance suggests there is a chance of further policy tightening. Meanwhile, a deteriorating economic outlook for the Eurozone has put the ECB on the back foot. As such, interest rate differentials may favour the krone in the coming months. Furthermore, should we continue to see risk appetite hold up and oil prices continue to rise, the demand for NOK may increase. That said, following the ECB and Riksbank adopting surprisingly 'dovish' positions, we are wary of the risk that the Norges bank may follow suit, even if such a move isn't currently justified. Nonetheless, at this stage, we expect EUR/NOK to fall over our forecast horizon.



EUR/SEK

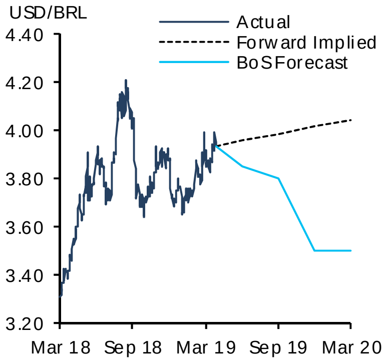
Having opened the year at 10.15 against the euro, the Swedish krona has weakened by almost 5%, making it the worst-performing G10 currency in 2019. Even so, the SEK is unlikely to get a reprieve. The surprise policy about turn from the Riksbank leaves it vulnerable to further weakness. It was only in October that the central bank raised the deposit rate by 25bps (to -0.25%) and signalled further rate rises were likely. Yet, following its April meeting, policymakers pushed out expectations for rate hikes and extended QE to Dec-2020, with Governor Ingves raising the possibility of policy rate cuts by suggesting "-0.5% isn't a lower bound for rates." We believe the Swedish fundamentals do not argue for such a bias. Even though CPIF inflation is below the Riksbank's target, Q4 GDP growth was strong and business confidence remains buoyant. The shift in stance, therefore, may be a reflection of external pressures, primarily the slowdown in the Eurozone. Given we believe euro area activity will recover, it may not be too long before the Riksbank is in a position to reconsider its guidance. Beyond the near-term volatility, there is scope for EUR/SEK to fall.

Developed Markets FX Forecasts

		Current	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
US Dollar	Dollar Index (DXY)	98.0	97.5	96.5	95.8	95.8	95.6	94.9	94.7	94.0	93.8
	USD/GBP	0.77	0.77	0.76	0.75	0.74	0.74	0.74	0.74	0.74	0.74
	USD/EUR	0.90	0.89	0.88	0.88	0.88	0.88	0.87	0.87	0.86	0.86
UK Pound	GBP/USD	1.29	1.30	1.32	1.34	1.35	1.35	1.36	1.36	1.36	1.36
	GBP/EUR	1.16	1.16	1.17	1.18	1.18	1.18	1.18	1.18	1.17	1.17
Euro	EUR/USD	1.12	1.12	1.13	1.14	1.14	1.14	1.15	1.15	1.16	1.16
	EUR/GBP	0.86	0.86	0.86	0.85	0.84	0.84	0.85	0.85	0.85	0.85
Japanese Yen	USD/JPY	112	111	110	110	110	109	108	107	106	105
	GBP/JPY	145	144	145	147	149	147	147	146	144	143
	EUR/JPY	125	124	124	125	125	124	124	123	123	122
Australian Dollar	AUD/USD	0.71	0.72	0.73	0.74	0.74	0.73	0.73	0.73	0.73	0.73
	GBP/AUD	1.83	1.81	1.81	1.81	1.82	1.85	1.86	1.86	1.86	1.86
	EUR/AUD	1.58	1.56	1.55	1.54	1.54	1.56	1.58	1.58	1.59	1.59
Canadian Dollar	USD/CAD	1.35	1.33	1.32	1.32	1.32	1.31	1.31	1.30	1.29	1.28
	GBP/CAD	1.74	1.73	1.74	1.77	1.78	1.77	1.78	1.77	1.75	1.74
	EUR/CAD	1.50	1.49	1.49	1.50	1.50	1.49	1.51	1.50	1.50	1.48
New Zealand Dollar	NZD/USD	0.67	0.66	0.65	0.65	0.65	0.64	0.64	0.64	0.64	0.64
	GBP/NZD	1.94	1.97	2.03	2.06	2.08	2.11	2.13	2.13	2.13	2.13
	EUR/NZD	1.68	1.70	1.74	1.75	1.75	1.78	1.80	1.80	1.81	1.81
Norwegian Krone	USD/NOK	8.68	8.53	8.42	8.33	8.32	8.29	8.19	8.17	8.10	8.10
	GBP/NOK	11.21	11.08	11.12	11.17	11.23	11.19	11.14	11.12	11.02	11.02
	EUR/NOK	9.69	9.55	9.52	9.50	9.48	9.45	9.42	9.40	9.40	9.40
Swedish Krona	USD/SEK	9.53	9.38	9.25	9.12	9.08	9.04	8.96	8.96	8.88	8.88
	GBP/SEK	12.31	12.19	12.21	12.22	12.26	12.20	12.18	12.18	12.08	12.08
	EUR/SEK	10.64	10.50	10.45	10.40	10.35	10.30	10.30	10.30	10.30	10.30
Swiss Franc	USD/CHF	1.02	1.02	1.02	1.02	1.04	1.04	1.04	1.05	1.04	1.04
	GBP/CHF	1.32	1.32	1.34	1.36	1.40	1.41	1.42	1.43	1.42	1.42
	EUR/CHF	1.14	1.14	1.15	1.16	1.18	1.19	1.20	1.21	1.21	1.21

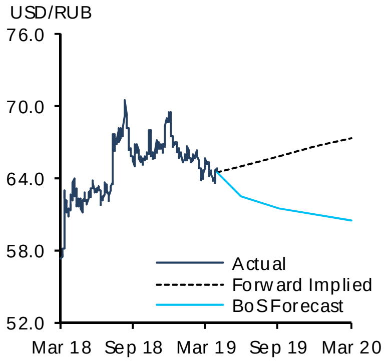
Source: Bloomberg, BoS

Fundamental Views – BRIC FX



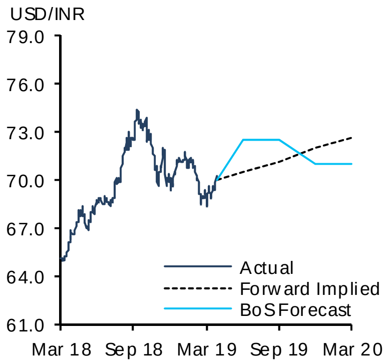
USD/BRL

Economic reforms by Brazil's newly elected government faced new political setbacks. In turn, USD/ BRL reacted, up from a low of 3.63 in February towards the 4.00 level. Anxiety, however, is not limited to the foreign exchange market; the near-term fate of just about every financial market in Brazil appears inextricably linked to the success or failure of badly needed pension reform. So far, progress has been slow and in order to garner support in Congress, the Government has already made big concessions at early stages in the process. With months to go before final approval, there is justifiable nervousness. We assume some version of pension reform is passed leading to a boost in the value of the real, but the risk of failure is high. Even if things go as we expect, support to the currency is likely to be limited. Economic growth in Brazil has been lacklustre, the terms of trade are no longer as favourable as in the past, and Brazil's central bank remains hamstrung by the prospects of higher inflation. We forecast USD/BRL to end the year at 3.50.



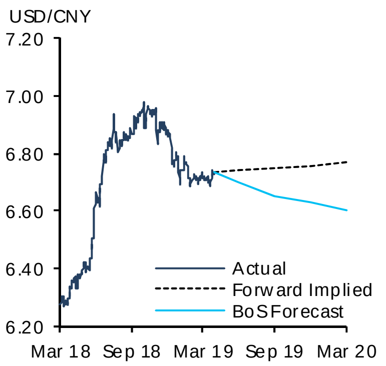
USD/RUB

Higher crude oil prices have helped to lift the value of the Russian ruble. Should crude oil prices continue their assent, the ruble is likely to benefit further. News that the US could not conclusively prove Russian collusion in the 2016 US presidential also came to the aid of the currency. By the same token, economic activity in Russia showed further improvement in 2018, with GDP accelerating to 2.3% (from 1.6% in 2017). This is in sharp contrast to nearly flat growth in 2016 and a sharp contraction in 2015. Yet for all the positives, there are also reasons to expect further upside in the ruble to be somewhat limited. Firstly, economic growth is likely to decelerate somewhat in 2019, partly due to lower hydrocarbon activity related to OPEC+ production cuts. In addition, central bank measures to curb household debt and consumption are likely to also have a negative effect on growth. Secondly, lower inflation expectations could prompt the central bank to cut interest rates. In early April, the Russian central bank lowered its inflation forecast for the end of the year from 5-5.5% to 4.7%-5.2%. We forecast USD/RUB to end the year at 61.



USD/INR

The Indian rupee has come under selling pressure thanks mostly to a broadly stronger US dollar and higher crude oil prices. The results of the general election will not be known until at least May 23rd. Unlike in 2014, when the NDA-BJP won an outright majority in the Lok Sabha, this time we expect the BJP to win the most seats but be forced into a broader coalition. In our opinion, this is likely to be negative for the INR because it is likely to slow reform efforts to boost the economy. If correct, such a shift would come just as signs of slower growth materialise. India's economy is facing slower household consumption, weak credit growth, and higher commodity costs. That said, its performance is still set to be far better than most other economies. So far, this has meant that the RBI has been pressured to cut interest rates twice this year: most recently by 25 bps to 6% in April. At the time of writing USD/INR is around 70, the level at which it started the year. Still, lower interest rates, modestly slower economic activity, and a coalition government point to a modestly weaker rupee from here. We forecast USD/INR to end the year at 71.0.



USD/CNY

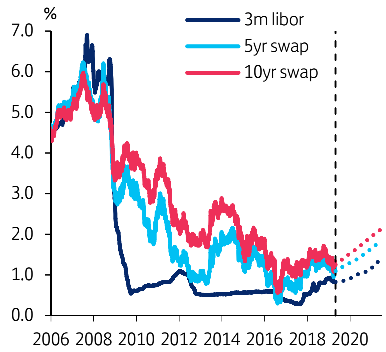
Between expansionary monetary and fiscal measures the Chinese economy has managed to carve out some positive headlines for Q1 2019. GDP growth exceeded forecasts, with industrial production in particular outperforming. In spite of this, there remains concern around the growth of lending, and the consequent risk of over-leverage. In addition, at least part of the activity rise was due to transitory fiscal stimulus rather than firmer underlying conditions. The PBoC, however, remains closer to loosening than tightening monetary policy. This, alongside current overly dovish pricing for Fed funds, provides the potential for the pair to rise. The yuan has nevertheless held up well since February; trading tightly around 6.70 against the dollar. We maintain that the move down from 6.98 since November was in line with reduced trade tensions and continue to expect the pair to track towards 6.59; though the move's timing will likely be determined more by politics than the economy.

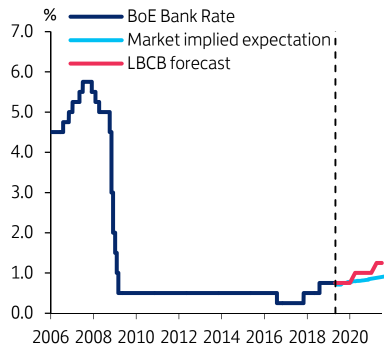
Key EM Currency Forecasts

		Current	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
Brazilian Real	USD/BRL	3.94	3.85	3.80	3.50	3.50	3.50	3.50	3.50	3.50	3.50
	GBP/BRL	5.09	5.01	5.02	4.69	4.73	4.73	4.76	4.76	4.76	4.76
	EUR/BRL	4.40	4.31	4.29	3.99	3.99	3.99	4.03	4.03	4.06	4.06
Russian Rouble	USD/RUB	64.5	62.5	61.5	61.0	60.5	60.0	60.0	60.0	60.0	60.0
	GBP/RUB	83.4	81.3	81.2	81.7	81.7	81.0	81.6	81.6	81.6	81.6
	EUR/RUB	72.0	70.0	69.5	69.5	69.0	68.4	69.0	69.0	69.6	69.6
Indian Rupee	USD/INR	70.0	72.5	72.5	71.0	71.0	71.0	71.0	71.0	71.0	71.0
	GBP/INR	90.5	94.3	95.7	95.1	95.9	95.9	96.6	96.6	96.6	96.6
	EUR/INR	78.0	81.2	81.9	80.9	80.9	80.9	81.7	81.7	82.4	82.4
Chinese Renminbi	USD/CNY	6.73	6.70	6.65	6.63	6.60	6.59	6.59	6.59	6.59	6.59
	GBP/CNY	8.70	8.71	8.78	8.88	8.91	8.90	8.96	8.96	8.96	8.96
	EUR/CNY	7.52	7.50	7.51	7.56	7.52	7.51	7.58	7.58	7.64	7.64
Czech Koruna	USD/CZK	23.0	22.9	22.6	22.1	21.9	21.9	21.7	21.7	21.6	21.6
	GBP/CZK	29.7	29.7	29.8	29.7	29.6	29.6	29.6	29.6	29.3	29.3
	EUR/CZK	25.7	25.6	25.5	25.3	25.0	25.0	25.0	25.0	25.0	25.0
Hungarian Forint	USD/HUF	289.7	283.9	281.4	276.3	276.3	273.7	271.3	270.4	268.1	268.1
	GBP/HUF	374.3	369.1	371.5	370.3	373.0	369.5	369.0	367.8	364.6	364.6
	EUR/HUF	323.4	318.0	318.0	315.0	315.0	312.0	312.0	311.0	311.0	311.0
Polish Zloty	USD/PLN	3.84	3.82	3.76	3.71	3.71	3.67	3.63	3.63	3.60	3.60
	GBP/PLN	4.97	4.97	4.96	4.97	5.01	4.95	4.94	4.94	4.90	4.90
	EUR/PLN	4.29	4.28	4.25	4.23	4.23	4.18	4.18	4.18	4.18	4.18
Mexican Peso	USD/MXN	19.03	18.50	18.50	18.00	18.00	18.00	18.00	18.00	18.00	18.00
	GBP/MXN	24.59	24.05	24.42	24.12	24.30	24.30	24.48	24.48	24.48	24.48
	EUR/MXN	21.24	20.72	20.91	20.52	20.52	20.52	20.70	20.70	20.88	20.88
South African Rand	USD/ZAR	14.31	14.00	13.90	13.80	13.70	13.60	13.50	13.50	13.50	13.50
	GBP/ZAR	18.49	18.20	18.35	18.49	18.50	18.36	18.36	18.36	18.36	18.36
	EUR/ZAR	15.98	15.68	15.71	15.73	15.62	15.50	15.53	15.53	15.66	15.66
Turkish Lira	USD/TRY	5.95	6.00	5.80	5.70	5.70	5.60	5.50	5.50	5.50	5.50
	GBP/TRY	7.70	7.80	7.66	7.64	7.70	7.56	7.48	7.48	7.48	7.48
	EUR/TRY	6.65	6.72	6.55	6.50	6.50	6.38	6.33	6.33	6.38	6.38

Source: Bloomberg, BoS

Fundamental Views – UK Interest Rates





UK Pound

Following the EU's decision to grant the UK a six-month 'flexible extension' to the Article 50 deadline, the immediate risk of a 'no deal' Brexit has been averted. The agreement, which gives the UK until the 31st October to leave with a deal, also allows for an earlier exit if it manages to ratify a withdrawal agreement sooner. Nevertheless, the UK's relationship with the EU could change abruptly if an agreement is not reached by the end of October. The lack of clarity over the timing and nature of the UK's withdrawal from the EU also means an extension of the prevailing uncertainty, something that has already been seen to weigh on the economy, particularly on business investment. Meanwhile, there remains significant uncertainty over what form any future trading relationship with the EU will take, meaning that the range of possible Brexit outcomes remains wide. Against this backdrop, we expect the Bank of England (BoE) to adopt a 'wait-and-see' approach for an extended period. As a result, we are pushing out our expectation for the next hike in Bank Rate from August this year to next February.

Still, based on the expectation that the UK avoids a 'no deal' Brexit, and achieves a 'smooth' transition to a future trading relationship with the EU, we remain of the view that further hikes are likely to be required, in order to sustain inflation around the 2% target over the medium term. This view reflects several factors. First, the UK economy continues to grow at a pace close to its potential rate. Outturns were strong in January and February, leaving the economy on track to have recorded GDP growth of 0.4-0.5% in Q1. Meanwhile, concerns over the supply-side of the UK economy continue to build. The unemployment rate remains low which, alongside the 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 inflation has fallen back, domestic price pressures stemming from rising wages and tightening capacity constraints are building.

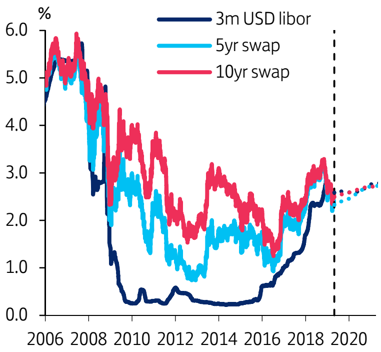
With the economy having no spare capacity, and increases in economic capacity likely to lag behind demand over the forecast horizon, this suggests that the risks of inflation proving stickier have seemingly increased. In fact, in the BoE's February economic projections, inflation is seen persisting above the 2% target at the end of its three-year forecast horizon. This suggests that there is clear scope for the BoE to adopt a more hawkish tone. For now, however, with Brexit concerns dominating, this shift in sentiment is unlikely to occur until the UK's future relationship with the EU becomes clearer.

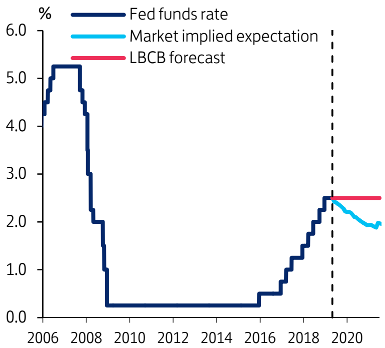
Key Bond and Money Market Forecasts

		Current	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
GBP	Key Policy Rate	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25
	3-month interbank rate	0.8	0.8	0.9	0.9	1.0	1.0	1.1	1.2	1.3	1.3
	2-year bond yield	0.7	0.8	0.8	0.8	0.9	1.0	1.0	1.1	1.2	1.3
	10-year bond yield	1.2	1.2	1.3	1.5	1.6	1.7	1.8	2.0	2.1	2.2
	5-year swap rate	1.1	1.2	1.2	1.3	1.4	1.4	1.5	1.6	1.8	1.9
	10-year swap rate	1.3	1.3	1.4	1.5	1.6	1.7	1.8	1.9	2.0	2.1
USD	Key Policy Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
	3-month interbank rate	2.6	2.6	2.6	2.6	2.6	2.6	2.7	2.8	2.8	2.8
	2-year bond yield	2.3	2.3	2.3	2.4	2.4	2.6	2.7	2.7	2.7	2.8
	10-year bond yield	2.5	2.6	2.6	2.6	2.7	2.8	2.8	2.9	2.9	2.9
	5-year swap rate	2.3	2.4	2.4	2.5	2.5	2.6	2.7	2.7	2.7	2.7
	10-year swap rate	2.5	2.5	2.6	2.6	2.6	2.7	2.7	2.7	2.7	2.7
EUR	Refi rate	0.00	0.00	0.00	0.00	0.00	0.10	0.10	0.25	0.25	0.25
	Deposit rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.30	-0.20	-0.20	-0.20
	3-month euribor	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-0.1	-0.1
	2-year bond yield	-0.6	-0.6	-0.6	-0.5	-0.5	-0.5	-0.4	-0.4	-0.3	-0.2
	10-year bond yield	0.0	0.1	0.1	0.1	0.2	0.3	0.4	0.5	0.6	0.7
	5-year swap rate	-0.1	0.0	0.0	0.1	0.1	0.2	0.3	0.4	0.5	0.6
	10-year swap rate	0.4	0.5	0.5	0.6	0.6	0.7	0.8	0.9	1.0	1.1

Source: Bloomberg, BoS

Fundamental Views – Interest Rates



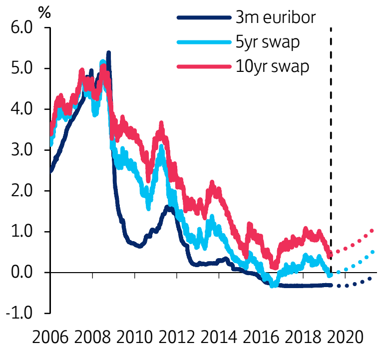


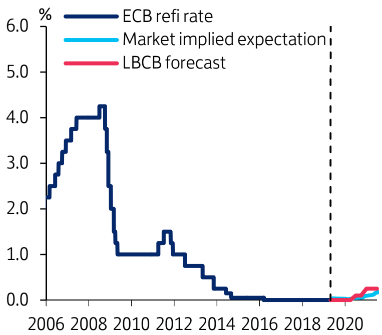
US Dollar

The US economy grew by a faster-than-expected 3.2% (annualised) in Q1, up from 2.2% in Q4 2018. Considering that the 35 day government shutdown and 'faulty' seasonal adjustment was supposed to depress activity that looks like a pretty respectable outturn. We do expect some slowing in GDP growth this year, but the expected outturn of 2.0% still looks fairly strong. Inflation has slowed in recent months due in part to lower oil prices but 'core' inflation has also been subdued. The rebound in oil prices points to higher inflation but overall we expect inflation to be only 1.9% from 2.4% in 2018.

The Federal Reserve's policy guidance has moved significantly over the past few months. In December of last year it was still talking about the likelihood of "further gradual increases" in interest rates. However, it dropped that wording from its press statement in January, a move that was seen by markets as a signal that US interest rates may have peaked. The Committee went further in March when most policymakers revised their interest rate forecasts to indicate that rates will not rise at all this year. Moreover, in another 'dovish' move, the FOMC signalled an earlier than expected end to its asset rundown policy.

The policy tilt has had a marked impact on financial markets interest rate expectations, where a rate cut in 2019 is now seen as likely. Despite some signs of late that economic activity may be holding up, the probability markets place on a rate reduction by the end of 2019 is now more than 60%. This has resulted in a big rally in US Treasuries with 10-year bond yields falling by about 30 basis points since late December to at one point touch their lowest level since 2017. We believe this is probably an overreaction. We expect yields to rise back up to about 2.6% by end-2019 and 2.9% by end-2020 as markets reassess the likelihood of rates cuts given a generally positive economic outlook.





Euro

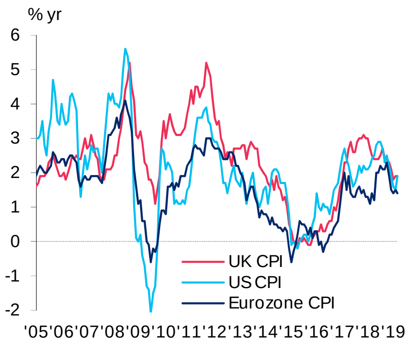
The loss of economic momentum in the Eurozone has become more protracted than initially expected, in part reflecting increasing headwinds to the global economy. Economic growth slowed to 1.8% in 2018 from 2.5% in 2017. We predict a further slowdown this year to 1.3%, reflecting subdued underlying activity, despite signs of a rebound in industrial activity in Q1. Growth in Germany is predicted at only 0.7% this year. Despite signs that wage growth is picking up, supported by lower unemployment, broader domestic inflationary pressures in the Eurozone remain subdued. In particular, core CPI (excluding food and energy) averaged only 1.0% in Q1, the same as a year earlier.

The ECB ended its net asset purchases last year and is not expected to restart them unless there is a further significant deterioration in the economic outlook. The current economic slowdown has instead led the ECB to push out its guidance for the earliest start to interest rate rises to 2020 from its previous signal of the end of this summer. That means that President Mario Draghi will end his tenure this October without having raised interest rates. The ECB also indicated that reinvestments of its current stock of assets will continue in full, while announcing new targeted long-term loans (TLTRO-III) for banks starting in September.

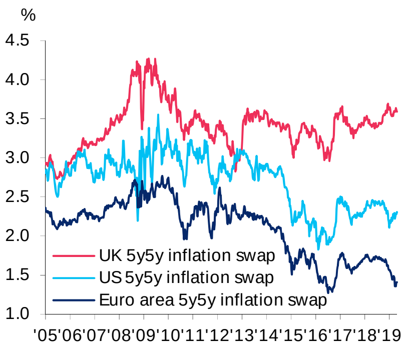
Financial markets anticipate the start of policy tightening (the first 10bps rise) to be deferred until early 2021. Our central expectation of a modest rebound in global economic activity from the second half of this year will provide support for Eurozone growth, particularly Germany. We also anticipate Eurozone core CPI inflation to show some signs of a pickup in the coming quarters. On balance, we expect the ECB to start raising interest rates in mid-2020, including 10bps increases in the deposit and main refinancing rates to 0.3% and 0.1%, respectively. Our targets for German 10 year bund yields are 0.1% at end-2019 and 0.5% at end-2020.

Fundamental Views - Inflation

Inflation Rates



Inflation Expectations



Inflation Trends

Reflecting the sharp decline in global oil prices in the fourth quarter of 2018, headline rates of inflation in a number of developed economies have remained subdued in early 2019. However, oil prices are now broadly similar to levels that prevailed in Q2 of last year, which should remove any further downward impetus to inflation from lower crude prices. Outside of movements in energy prices, however, measures of core inflation have proved stickier. Assuming that economic slack continues to be absorbed, domestic inflationary pressures are expected to build. If sustained, these should ensure that both core and headline rates of inflation climb over time. However, the varying degrees of spare capacity are likely to mean that inflation rates recover at different speeds across countries.

In the UK, recent movements in headline inflation have largely reflected the impact of Ofgem's energy price cap. The introduction of the cap in January saw headline CPI drop below 2% and remain there over the rest of Q1. However, an increase in the cap from April is likely to see the headline rate of CPI move back above 2%. Outside of this, inflation has been remarkably stable, with the 'core' rate little changed over the last seven months (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. This is likely to require further, albeit limited and gradual, rises in interest rates in order to keep inflation around the 2% target over the medium term.

In the Eurozone, meanwhile, the headline rate of inflation remains subdued. Moreover, the prevailing degree of slack in the economy 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.

In the US, 'core' CPI inflation remains around 2%, despite the recent move below 2% in the headline rate. The Fed's preferred measure of inflation, the personal consumption expenditure (PCE) deflator, remains low. Despite this, with the US labour market looking tight following a sustained period of strong jobs growth, upward pressure on wages continues to build. Since last February, annual earnings growth has gently drifted higher, recently rising close to a ten-year high of 3.4% in February. Over the coming months, further increase in nominal wages and the feed-through from a resilient economy are likely to push the PCE deflator higher, which in our view, would do little to justify the market's current view that US interest rates are more likely than not to be cut by year-end.

Inflation Outlook

		Avg since '97	Latest	Period	'19 Q2	'19 Q3	'19 Q4	'20 Q1	'20 Q2	'20 Q3	'20 Q4	'21 Q1
GBP	CPI inflation %	2.0	1.9	Mar-19	2.2	2.2	2.0	2.1	1.9	1.9	2.1	2.0
	Core CPI inflation %	1.6	1.8	Mar-19	1.9	2.0	2.0	1.6	1.8	1.9	1.9	2.0
	RPI inflation %	2.8	2.4	Mar-19	2.8	2.7	2.6	2.7	2.5	2.6	2.8	2.9
	RPI index level		285.1	Mar-19	288.5	291.1	292.3	292.1	295.9	298.6	300.4	300.5
	CPI-RPI wedge	0.8	0.5	Mar-19	0.6	0.5	0.5	0.6	0.7	0.7	0.7	0.8
USD	CPI inflation %	2.2	1.9	Mar-19	2.0	1.9	2.1	2.2	2.0	2.1	2.1	2.1
	Core CPI inflation %	2.0	2.0	Mar-19	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
EUR	HICP inflation %	1.7	1.4	Mar-19	1.4	1.3	1.3	1.5	1.5	1.6	1.6	1.6
	Core HICP inflation %	1.4	0.8	Mar-19	1.1	1.2	1.2	1.3	1.3	1.4	1.4	1.5

Source: Bloomberg, Macrobond, BoS

Key Economic and Political Events Calendar

2019 Central Bank Meetings

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

2019 Political Events

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
UK	31	UK scheduled to leave EU
EZ	31	ECB President Draghi's term ends

NOVEMBER

Country	Date	Event

DECEMBER

Country	Date	Event

Source: Bloomberg, BoS
*includes summary of economic projections

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