COMMERCIAL BANKING

International Financial Outlook

December 2018

BANK OF SCOTLAND

Contents

All historical data sourced from Bloomberg
All forecasts sourced from Bank of Scotland (BoS)
Data sourced 13th December 2018

Overview

Financial market review – past month

Financial markets remained volatile over the past month. Ongoing trade tensions between the US and China continued to weigh on global risk appetite, even though both sides at the G20 meeting agreed not to increase tariffs for ninety days (until 1 March 2019). UK and Europe's main equity indices plumbed new depths for 2018, while their US counterparts tested the year's lows. US 10 year Treasury yields declined from highs above 3.20% towards 2.80%, while UK 10 year gilt yields dropped from the October peak of 1.75% to a low of around 1.20%. Brent crude oil has also fallen sharply from $85/bbl in October to around $60/bbl. The pound underperformed against other major currencies, weighed by rising Brexit uncertainty.

Sterling markets remained focused on Brexit twists and turns. UK and EU negotiators finalised a withdrawal agreement and a political declaration on future relations. However, significant opposition to the deal in the House of Commons eventually led the government to call off a planned 'meaningful' vote on 11 December. The government has indicated the new vote will take place before 21 January, but the political situation remains fluid. PM Theresa May, meanwhile, won a no-confidence vote, although 117 or 37% of Conservative MPs voted against her.

UK economic growth looks set to slow following a robust performance in Q3. Business and consumer confidence levels have fallen since the summer, while official data showed the three-monthly GDP growth rate easing to 0.4% in October, compared with 0.6% for Q3. Latest labour market figures, in contrast, show employment growth regaining momentum in the three months to October, while regular earnings growth rose to 3.3%, the strongest since 2008. Broader October CPI inflation held steady at 2.4%, staying above the 2% target.

US economic data continued to paint a solid picture, although there is evidence of some easing of activity in interest rate sensitive sectors, such as housing. Annualised Q3 GDP growth was confirmed at 3.5%, while latest figures point to growth of around 2.5% in Q4. The economy added 155k jobs in November, while annual growth in average hourly earnings stayed at the cyclical high of 3.1%. Headline CPI inflation, however, fell back to 2.2% in November, reflecting lower energy prices.

While US interest rates are widely expected to rise for a fourth time this year at the 19th December meeting to 2.5% (upper bound), market attention is increasingly focused on policy prospects in 2019, especially in light of the recent rise in financial market volatility. The Fed's September 'dot plot' signalled that policymakers anticipated three further hikes next year to 3.25%. Comments from Fed officials, including Chairman Powell, suggest that such rises will be less automatic and more data dependent. Financial markets are only fully discounting, at most, one hike next year. The short end of the Treasury yield curve, meanwhile, has inverted.

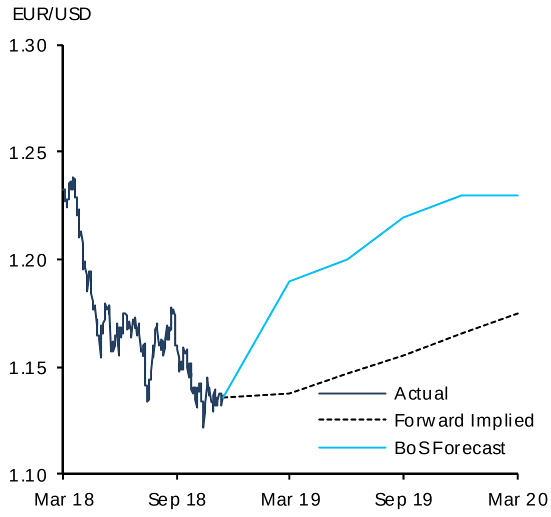
In the euro area, the escalation of protests in France resulted in President Macron unveiling measures that included a hike in the minimum wage. They are likely to lead to a rise in the country's fiscal deficit at a time when the European Commission is negotiating with the Italian government about its budget transgressions. The Bank of France has halved its Q4 growth forecast to 0.2%q/q, while Italy's economy is at risk of a technical recession with survey evidence pointing to the possibility of another contraction in Q4. For the euro area as a whole, survey evidence points to continued falls in underlying economic momentum.

On the euro area inflation front, headline CPI fell to 2.0% in November from 2.2%. Core inflation, excluding food and energy, edged down to 1.0% from 1.1%. At its December meeting, the ECB confirmed that net asset purchases will come to an end, despite downward revisions to its growth and inflation forecasts. It also left its guidance unchanged, indicating no rise in interest rates "at least through the summer of 2019". The main clarification was on the ECB's reinvestment of maturing assets, which will continue "in full" for an extended period past the date of the first interest rate rise.

Summary of key forecasts

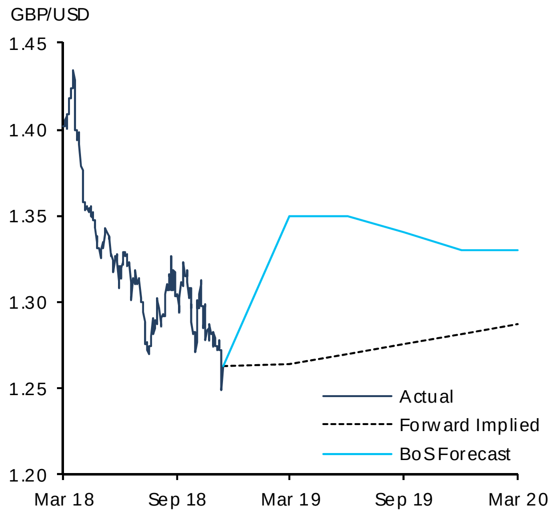
- Our central view remains that it is more likely than not that the UK leaves the EU with a withdrawal agreement and a transitional period. The risks surrounding this modal view have increased, given the prevailing political and economic uncertainties. For now, we have left unchanged our central forecast for UK Bank rate to rise to 1.00% in Q3 2019. Financial markets have pushed out the next rate rise to late 2020.
- The US Federal Reserve is on course to raise rates in December to 2.5%. We continue to see two further increases next year to 3%.
- In the euro area, with confirmation that the ECB's net asset purchases will come to a close this year. We have pushed out our central view for the first rate rise by a quarter to Q4 2019. Financial market expectations for the first 10bps rise have been deferred to early 2020.
- We have revised down our UK and German 10-year gilt yield targets for end-2019 to 1.6% from 1.9% and 0.7% from 0.9%, respectively. US 10 year Treasury yield forecasts have been lowered to 3.2% from 3.3% 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



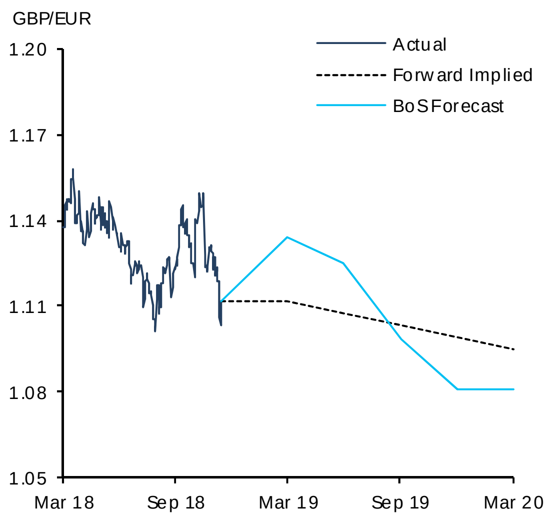
EUR/USD

Over the past month, the euro has oscillated within a contracting range against the US dollar. Fundamental drivers appear to have moved slightly in favour of the single currency. Having peaked around 3.25%, the 2-year US-German interest rate differential has tightened by around 20bps, driven by a paring back of US policy rate expectations. The Federal Reserve does look set to raise interest rates, by 0.25%, on 19 December, however, comments from Chair Powell suggest that further rises next year may be less automatic and more data dependent. We expect policymakers to raise the Fed funds rate by 50bps in 2019. The ECB, meanwhile, reaffirmed its intention to raise policy rates next year, although it did acknowledge stubbornly low 'core' inflation as a risk to its outlook. Signs of political instability across the Eurozone are also arguably preventing EUR/USD from gaining more ground. Following protests in Paris, French parliament has triggered a vote of no confidence in President Macron's government. In addition, the dispute between the new Italian government and the EU, relating to the former's budget proposal remains a concern. Should this political uncertainty subside, the market's 'net short' euro position leaves it vulnerable to a sharp move higher in EUR/USD.



GBP/USD

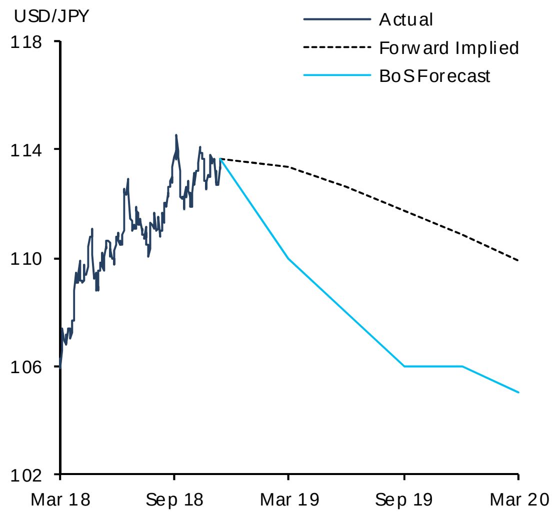
The increase in political uncertainty in the UK has weighed heavily on the pound in recent weeks, so much so that GBP/USD briefly fell below 1.25 for the first time since April 2017. Despite PM May finalising her withdrawal agreement with Europe, limited support across the House of Commons and a lack of unity in the Conservative party mean ratifying 'a deal' before the March 2019 deadline is not certain. The rise in the market's political risk premium has pushed 3-month GBP/USD implied volatility to its highest level since shortly after the 2016 referendum. And, with risk reversals (a relative measure of sentiment) notably in negative territory, investors are expressing a greater willingness to pay for protection against GBP/USD downside, in essence bracing themselves for further weakness in the pound. While politics has been at the forefront of the market's mind, data shows the UK economy is holding up relatively well. Q3 GDP growth rose to 1.5%y/y and the unemployment rate (4.1%) is at its cyclical low. The tightness in the labour market is putting upward pressure on wages. Clearly, the journey towards Brexit remains crucial for sterling's prospects. With political developments very fluid, best highlighted by events over recent weeks, there remains a high degree of uncertainty over where GBP/USD may trade in the near term.



GBP/EUR

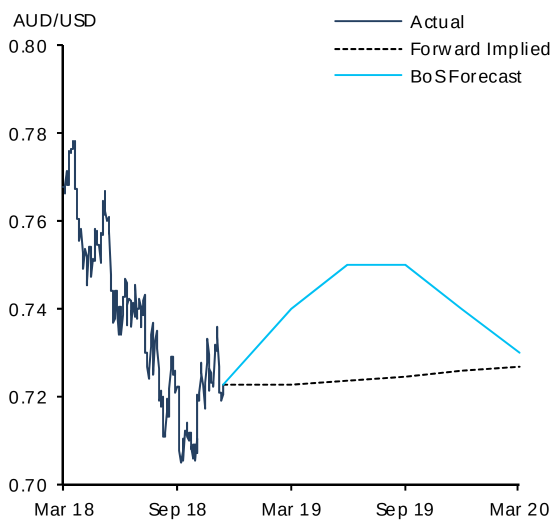
The rise in political uncertainty in the UK has pushed GBP/EUR from its range highs (near 1.16) back towards its range lows (around 1.10). While PM May returned from Europe with a withdrawal agreement, the lack of support in Parliament and discord within the Conservative party mean that ratifying a deal before next March is far from certain. The market is reflecting this increase in uncertainty by pushing implied volatility higher. At the same time, risk reversals (a gauge of relative market sentiment) show investors are willing to pay a higher price to protect against further GBP weakness. Yet the euro area is far from problem free. French President Macron faces a vote of no confidence and the Italian government has still not agreed its 2019 budget with the EU. Recent data suggests the UK economy continues to hold up well. Q3 GDP growth rose by 1.5%y/y and the labour market tightened further, triggering the sharpest acceleration in wage growth in over a decade. Euro area growth, meanwhile, measured 1.6%y/y in Q3, but the subdued level of 'core' inflation remains a concern. Considering the factors in play, we expect GBP/EUR to remain range bound over the coming months. However, elevated Brexit-related uncertainty leaves us with relatively low conviction.

Fundamental Views – G10 FX



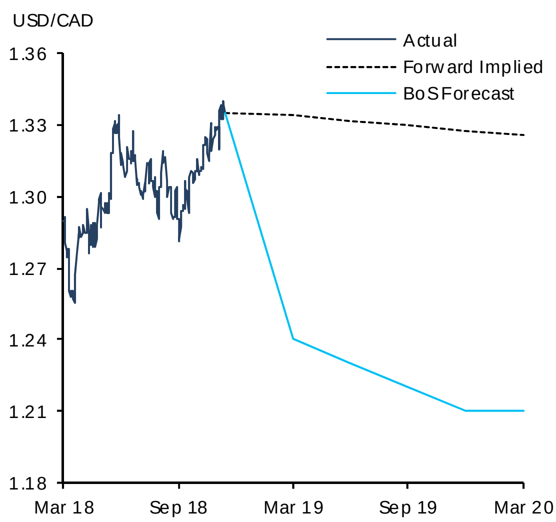
USD/JPY

Ordinarily, in the face of a paring back of US interest rate expectations and weakness in global equity markets the US dollar would be under pressure against the Japanese yen. Yet, even as 2-year US yields have fallen over 20bps from their November highs and major equity bourses have suffered losses in excess of 5% since the start of the month, USD/JPY remains near its range highs. This price action has been surprising to us. Nevertheless, at this stage, we remain bearish on the currency pair. Our forecast that the FOMC will continue to raise the Fed funds rate towards 3% and the Bank of Japan will leave its interest rate lever unchanged appear to be arguments against this view. However, with the 2-year US-Japanese interest rate differential at its widest since the Great Recession we believe it may lend only limited further support to the USD. Moreover, given the plethora of geopolitical and economic risks, most notably trade tensions between the US and China, the yen may, eventually, benefit from 'safe haven' led demand. This is even more important to be aware of in the backdrop of the market's sizeable 'net short' JPY position, which leaves it vulnerable to a sharp move lower in USD/JPY.



AUD/USD

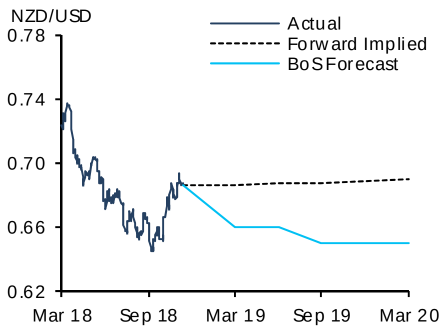
Heightened concerns around an ever-increasing range of geopolitical uncertainties, 'frothy' equity market valuations, and risk of an economic slowdown in China pressured the Australian dollar down to new year-to-date lows against the US dollar in late October. While the currency pair has reversed from there, fundamental forces are likely to cap rallies in the near term. The fall in Australian Q3 GDP growth, to 2.8%y/y, has perhaps been the most disappointing economic development. While the RBA delivered an upbeat assessment after December's policy meeting, the combination of falling house prices, muted wage growth, and slowing consumer expenditure suggests the outlook may not be so clear. And, with industrial metals prices rooted to their lows, there seems little chance of a move higher in Australian policy rates over the next year. At the same time, it now seems less likely that the Federal Reserve will be able to raise its benchmark rate in line with its 'dot plot' expectations, by 75bps in 2019. Recent changes to Australian and US monetary policy dynamics have and are likely to continue to pull AUD/USD in opposing directions. As such, we expect the currency pair to remain within its medium-term range.



USD/CAD

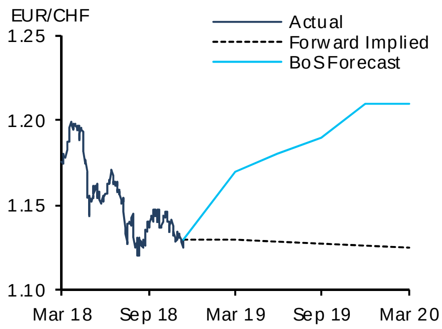
Up until October, domestic and external fundamental forces had supported the Canadian dollar against the US dollar. Since then, however, the shifting economic backdrop – including the sharp decline in Brent Crude prices and more 'dovish' comments from the BoC – has seen USD/CAD rally, from 1.28, to a new year-to-date high above 1.34. Despite the downbeat assessment from Governor Poloz, inflation has pushed higher, to 2.4%, and the labour market continues to tighten, with the unemployment rate unexpectedly falling to 5.6% in November. Such developments reinforce the case for a gradual tightening of Canadian monetary policy. At the same time, the market has started to question whether, given the prevailing uncertainty, the Fed will be able to follow its 'dot plot' trajectory in 2019, reflected in the fall in 5-year US yields (from 3.10% to 2.75%). Clearly, the risks to our forecast, for a 50bp rise in the Fed funds rate in 2019, have risen. Dependant on the move in Brent Crude prices, and aligned to our view that there is limited scope for US-Canadian interest rate differentials to widen further, against current market 'pricing', we anticipate CAD strength in the coming months.

Fundamental Views – Other Developed Market FX



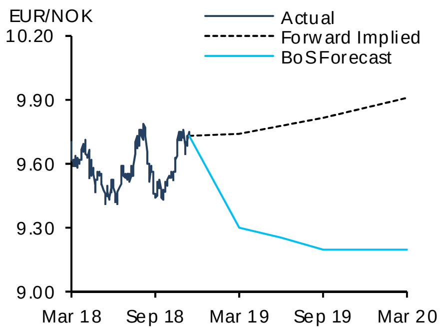
NZD/USD

From its year-to-date lows, around 0.64, the New Zealand dollar has rallied sharply against the US dollar. Data from New Zealand for Q3 show an improving economic climate - CPI inflation has risen to 1.9%y/y (from 1.5%) and the unemployment rate has fallen sharply to 3.9% (from 4.5%). Following November's RBNZ meeting, Governor Orr removed direct reference to the possibility of cutting interest rates in his policy statement, further supporting the NZD. Yet, even with a less dovish tilt, it seems unlikely that the central bank will raise interest rates imminently, and the market is not expecting a change in policy rates, in either direction, any time soon. Elsewhere, the Federal Reserve is set to raise the Fed funds rate in December. However, a series of dovish statements from FOMC members has triggered a significant scaling back of US rate expectations for 2019. We still expect policymakers to tighten US interest rates by 50bps next year. Overall, such economic and monetary policy developments lend support to our range bound forecast.



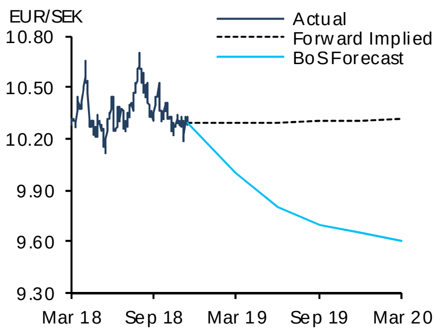
EUR/CHF

Geopolitical risks, most significantly the escalation of trade tensions between the US and China, continue to trouble global equity markets. The associated deterioration in risk sentiment has seen the Swiss franc strengthen against the euro, with EUR/CHF falling towards its recent lows. However, the fundamentals suggest that, perhaps, the currency pair should be moving in the other direction. Q3 GDP growth in Switzerland fell sharply to 2.4%y/y (from 3.4%) and inflation in November dipped back below 1.0%. Combined with the SNB's view that the Swiss franc is "overvalued", these economic developments leave Governor Jordan and co. unlikely to alter their policy levers over the coming months. The picture in Europe is slightly different. In spite of the mixed economic picture, ECB communications suggest policy normalisation is imminent, with the first interest rate hike possibly occurring by end-2019. Should geopolitical risks subside and monetary policy divergence materialises, we expect EUR/CHF to rally above 1.20 over our forecast horizon.



EUR/NOK

In recent weeks, EUR/NOK has rallied from its medium-term range lows (around 9.40) back towards its September highs (at 9.80). The sharp decline in Brent Crude prices, which have fallen over $20 per barrel in just two months, has been the key driver of the move in the currency pair. Domestically, there remains a strong case for the Norges bank to continue raising interest rates. At 3.5%, CPI inflation is still well above the central bank's target, while monthly GDP for October showed a firming in economic activity. In contrast, the ECB does not expect to tighten its policy rates until at least H2 2019 and, with 'core' inflation in the euro area still subdued, if anything, the risks to European rates may be skewed to the downside. Even with the 2-year German-Norwegian interest rate differential close to multi-year lows, there is scope for it to fall further, which would put pressure on EUR/NOK. In addition, we believe oil prices could soon be a supportive factor for the NOK. Should such tailwinds aid the krone, EUR/NOK is likely to reverse its recent rally.



EUR/SEK

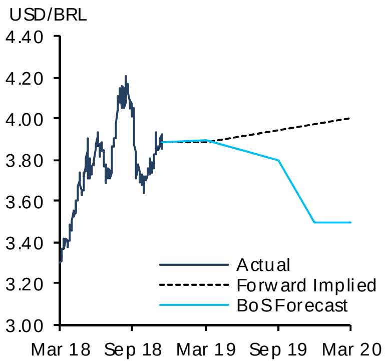
The Swedish krona is little changed against the euro over the last month, still hovering around 10.30. Fundamentally, we continue to favour EUR/SEK to move lower over the medium term. While it is true that some indicators of economic activity have softened, the Riksbank is still likely to start raising interest rates soon, having suggested the fall in GDP growth in Q3 was driven by temporary factors. Certainly, December and February must be considered 'live' meetings. The recent decline in CPI inflation leaves the latter as the more likely choice. Even so, in terms of policy normalisation, such a timeline would put the Riksbank ahead of the ECB. While the Governing Council remains committed to ending net asset purchases this year, it is unlikely to raise policy rates until late 2019. Moreover, given that 'core' inflation in the euro area remains low, the risks to European rates are asymmetrically skewed to the downside. Even with the 2-year German-Swedish interest rate differential at multi-year lows, the spread has room to move further in favour of SEK.

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)	97.0	92.4	91.6	90.4	89.9	89.8	89.2	89.1	89.1	89.1
	USD/GBP	0.79	0.74	0.74	0.75	0.75	0.75	0.75	0.75	0.75	0.75
	USD/EUR	0.88	0.84	0.83	0.82	0.81	0.81	0.81	0.81	0.81	0.81
UK Pound	GBP/USD	1.27	1.35	1.35	1.34	1.33	1.33	1.33	1.33	1.33	1.33
	GBP/EUR	1.11	1.13	1.13	1.10	1.08	1.08	1.07	1.07	1.07	1.07
Euro	EUR/USD	1.14	1.19	1.20	1.22	1.23	1.23	1.24	1.24	1.24	1.24
	EUR/GBP	0.90	0.88	0.89	0.91	0.92	0.92	0.93	0.93	0.93	0.93
Japanese Yen	USD/JPY	113	110	108	106	106	105	105	104	104	104
	GBP/JPY	144	149	146	142	141	140	140	138	138	138
	EUR/JPY	129	131	130	129	130	129	130	129	129	129
Australian Dollar	AUD/USD	0.72	0.74	0.75	0.75	0.74	0.73	0.73	0.73	0.73	0.73
	GBP/AUD	1.75	1.82	1.80	1.79	1.80	1.82	1.82	1.82	1.82	1.82
	EUR/AUD	1.57	1.61	1.60	1.63	1.66	1.68	1.70	1.70	1.70	1.70
Canadian Dollar	USD/CAD	1.34	1.24	1.23	1.22	1.21	1.21	1.20	1.20	1.20	1.20
	GBP/CAD	1.69	1.67	1.66	1.63	1.61	1.61	1.60	1.60	1.60	1.60
	EUR/CAD	1.52	1.48	1.48	1.49	1.49	1.49	1.49	1.49	1.49	1.49
New Zealand Dollar	NZD/USD	0.69	0.66	0.66	0.65	0.65	0.65	0.64	0.64	0.64	0.64
	GBP/NZD	1.84	2.05	2.05	2.06	2.05	2.05	2.08	2.08	2.08	2.08
	EUR/NZD	1.66	1.80	1.82	1.88	1.89	1.89	1.94	1.94	1.94	1.94
Norwegian Krone	USD/NOK	8.56	7.82	7.71	7.54	7.48	7.48	7.42	7.42	7.42	7.42
	GBP/NOK	10.85	10.55	10.41	10.10	9.95	9.95	9.87	9.87	9.87	9.87
	EUR/NOK	9.74	9.30	9.25	9.20	9.20	9.20	9.20	9.20	9.20	9.20
Swedish Krona	USD/SEK	9.06	8.40	8.17	7.95	7.85	7.80	7.70	7.66	7.66	7.66
	GBP/SEK	11.47	11.34	11.03	10.65	10.43	10.38	10.24	10.19	10.19	10.19
	EUR/SEK	10.30	10.00	9.80	9.70	9.65	9.60	9.55	9.50	9.50	9.50
Swiss Franc	USD/CHF	0.99	0.98	0.98	0.98	0.98	0.98	0.98	0.98	0.98	0.98
	GBP/CHF	1.26	1.33	1.33	1.31	1.31	1.31	1.30	1.30	1.30	1.30
	EUR/CHF	1.13	1.17	1.18	1.19	1.21	1.21	1.21	1.21	1.21	1.21

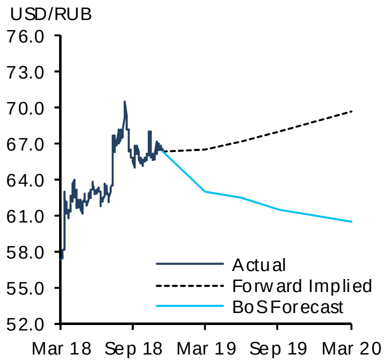
Source: Bloomberg, BoS

Fundamental Views – BRIC FX



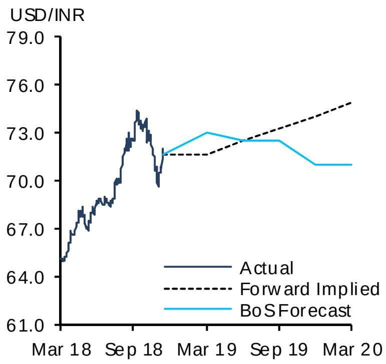
USD/BRL

There are definitive signs the post-election shine on Brazilian assets is wearing off. The Ibovespa, Brazil's benchmark equity index, has eased off its early December highs. After a sharp move lower, local-currency bond yields have consolidated across the curve. Meanwhile, the Brazilian real has also retraced some of its earlier recent gains. Still, the way local assets and the exchange rate are priced, confidence in President-elect Bolsoanro quickly delivering on fiscal and economic reform remains high. Yet this leaves serious room for disappointment, both in terms of timing and delivery. External factors, such as portfolio outflows due to further Fed tightening or reduced confidence around global growth conditions, could likewise weigh heavily on the Brazilian real in the coming months. Our baseline forecasts assume either of the two is likely to push USD/BRL higher from current levels, before underlying conditions re-favour the Brazilian real.



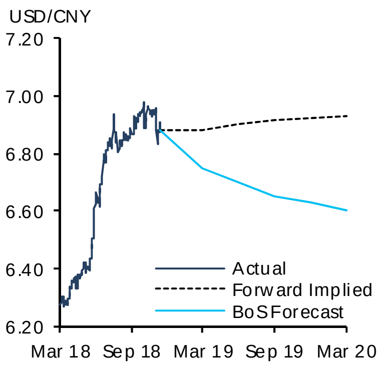
USD/RUB

Bets that Russia has managed to avoid the heaviest of US sanctions underpinned the Russian ruble against the US dollar over the past month. This was despite the sharp drop in crude oil prices over the period. Should crude oil prices retrace some of their recent losses, it would likely to provide an additional boost to the ruble in the coming months. The prospects for the ruble, however, are not wholly optimistic with an unfavourable geopolitical backdrop likely to keep outward pressure on capital flows. Russia saw $58.5bn capital outflows in the first eleven months of 2018; on track to be the largest since 2014. Furthermore, the ruble is unlikely to benefit from another interest rate hike. Prospects for tighter monetary policy continue to be tempered by sluggish economic growth. Also, the central bank, in conjunction with the Russia's finance ministry is set to resume foreign exchange purchases after a temporary suspension in September.



USD/INR

Lower crude oil prices proved favourable for the Indian rupee over the past month. But the resignation of Urjit Patel, the RBI governor, adds to already serious concerns about the central bank's independence. At the heart of the dispute is the desire of the government to drain equity from the central bank to lower the fiscal deficit, force greater liquidity into the shadow banking sector, end restrictions on lending by state-run banks, and allow for generally looser monetary policy. Alone, these overtures go a long way to unravelling the work done in recent years to establish a more credible central bank. But even more concerning is the government's possible motive. On the surface, India's economy has been performing well. Real GDP soared by a better-than-expected 8.2% y/y in Q2 – its fastest growth rate in two years. Alas, the dispute would leave some to question whether the government knows that the outlook may not be as rosy. The risks to our USD/INR forecasts have certainly risen as a result.



USD/CNY

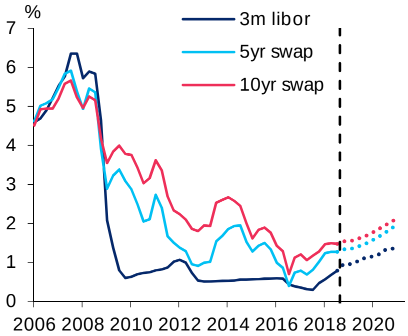
Our forecast of future yuan strength reflects expectations for the reduction of US-China trade tensions. Though these tensions are proving quite persistent, even relatively minor conciliatory remarks at the end of November saw the yuan strengthen 1.85% in two days. Nevertheless, broader concerns around a Chinese economic slowdown are certainly not unfounded, with various recent economic indicators underperforming market expectations. PBoC monetary policy loosening is starting to show some positive effects on the domestic economy, but may also be a drag on the currency. Both 1yr and 5yr repo rates continue to slide, and the spread of 3-month Shanghai interbank rate against US LIBOR has stabilised close to its lowest level since 2009. Nevertheless, with the potential for the Fed to pause hiking next year, the dollar may come under pressure. Our forecast for USD/CNY for March 2019 remains at 6.75, with a further fall back to 6.59 by the end of 2019.

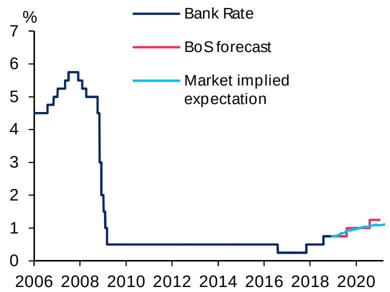
Key EM Currency Forecasts

		Current	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Brazilian Real	USD/BRL	3.87	3.90	3.85	3.80	3.50	3.50	3.50	3.50	3.50	3.50
	GBP/BRL	4.91	5.27	5.20	5.09	4.66	4.66	4.66	4.66	4.66	4.66
	EUR/BRL	4.41	4.64	4.62	4.64	4.31	4.31	4.34	4.34	4.34	4.34
Russian Rouble	USD/RUB	66.3	63.0	62.5	61.5	61.0	60.5	60.0	60.0	60.0	60.0
	GBP/RUB	84.1	85.1	84.4	82.4	81.1	80.5	79.8	79.8	79.8	79.8
	EUR/RUB	75.5	75.0	75.0	75.0	75.0	74.4	74.4	74.4	74.4	74.4
Indian Rupee	USD/INR	71.7	73.0	72.5	72.5	71.0	71.0	71.0	71.0	71.0	71.0
	GBP/INR	90.7	98.6	97.9	97.2	94.4	94.4	94.4	94.4	94.4	94.4
	EUR/INR	81.6	86.9	87.0	88.5	87.3	87.3	88.0	88.0	88.0	88.0
Chinese Renminbi	USD/CNY	6.88	6.75	6.70	6.65	6.63	6.60	6.59	6.59	6.59	6.59
	GBP/CNY	8.72	9.11	9.05	8.91	8.82	8.78	8.76	8.76	8.76	8.76
	EUR/CNY	7.83	8.03	8.04	8.11	8.15	8.12	8.17	8.17	8.17	8.17
Czech Koruna	USD/CZK	22.7	21.5	21.3	20.9	20.5	20.3	20.2	20.2	20.2	20.2
	GBP/CZK	28.8	29.0	28.8	28.0	27.3	27.0	26.8	26.8	26.8	26.8
	EUR/CZK	25.8	25.6	25.6	25.5	25.3	25.0	25.0	25.0	25.0	25.0
Hungarian Forint	USD/HUF	284.0	264.7	260.0	255.7	253.4	253.3	251.2	251.2	251.2	251.2
	GBP/HUF	359.9	357.4	351.0	342.6	337.0	336.8	334.1	334.1	334.1	334.1
	EUR/HUF	323.1	315.0	312.0	311.9	311.7	311.5	311.5	311.5	311.5	311.5
Polish Zloty	USD/PLN	3.77	3.55	3.50	3.43	3.40	3.40	3.37	3.37	3.37	3.37
	GBP/PLN	4.78	4.80	4.73	4.59	4.52	4.52	4.48	4.48	4.48	4.48
	EUR/PLN	4.29	4.23	4.20	4.18	4.18	4.18	4.18	4.18	4.18	4.18
Mexican Peso	USD/MXN	20.12	18.75	18.50	18.50	18.00	18.00	18.00	18.00	18.00	18.00
	GBP/MXN	25.49	25.31	24.98	24.79	23.94	23.94	23.94	23.94	23.94	23.94
	EUR/MXN	22.88	22.31	22.20	22.57	22.14	22.14	22.32	22.32	22.32	22.32
South African Rand	USD/ZAR	14.16	13.75	13.50	13.27	13.30	13.30	13.30	13.30	13.30	13.30
	GBP/ZAR	17.94	18.56	18.23	17.78	17.69	17.69	17.69	17.69	17.69	17.69
	EUR/ZAR	16.11	16.36	16.20	16.19	16.36	16.36	16.49	16.49	16.49	16.49
Turkish Lira	USD/TRY	5.36	5.55	5.52	5.50	5.50	5.50	5.50	5.50	5.50	5.50
	GBP/TRY	6.80	7.49	7.45	7.37	7.32	7.32	7.32	7.32	7.32	7.32
	EUR/TRY	6.11	6.60	6.62	6.71	6.77	6.77	6.82	6.82	6.82	6.82

Source: Bloomberg, BoS

Fundamental Views – UK Interest Rates





UK Pound

Following the rate hike in August, the collective judgement of the Bank of England's Monetary Policy Committee has remained that as long as the economy continues 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 three 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, has weighed significantly on market expectations for UK interest rates over the past month. At the time of writing, financial markets do not expect (fully price in) the next quarter-point increase until Q1 2020, with a follow-up hike not expected until mid-2024. For now, with Brexit concerns dominating, sentiment is unlikely to turn until the UK's future relationship with the EU becomes clearer.

Still, our central case continues to envisage the next hike occurring in August 2019. This view reflects several factors. First, the UK economy continues to hold up well. Growth was strong in the third quarter, and while it eased to 0.4% in the three months to October, we expect full-year GDP growth to be around 1.3%. Meanwhile, concerns over the supply-side of the UK economy continue to grow. 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 inflationary pressure. Second, inflation remains sticky. Although UK headline CPI has fallen back as currency base effects have faded, domestic price pressures stemming from rising wages and tightening capacity constraints are building. Overall, we expect these forces to result in inflation only gradually declining towards the 2% target over the forecast horizon. Furthermore, if the UK and EU negotiate a smooth transition, which would reflect our central case, this would further support a more hawkish Bank of England profile.

With the economy having no spare capacity remaining – and increases in economic capacity likely to lag behind demand over the forecast horizon, this suggests that the risks of an even more gradual fall in inflation 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 recent changes to fiscal policy, contained in the Autumn Budget. This suggests that there is scope for the Bank of England to adopt a more-hawkish tone in the future.

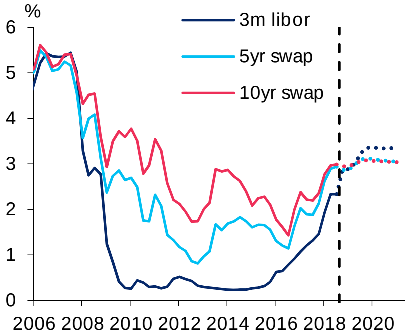
Key Bond and Money Market Forecasts

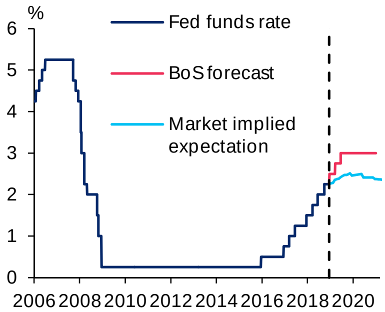
		Current	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
GBP	Key Policy Rate	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25
	3-month interbank rate	0.9	0.9	0.9	1.0	1.1	1.1	1.2	1.2	1.3	1.3	1.4
	2-year bond yield	0.8	0.8	0.8	0.9	0.9	1.0	1.1	1.2	1.3	1.4	1.5
	10-year bond yield	1.3	1.4	1.4	1.5	1.5	1.6	1.7	1.9	2.0	2.1	2.2
	5-year swap rate	1.3	1.3	1.3	1.4	1.4	1.5	1.6	1.7	1.8	1.9	2.0
	10-year swap rate	1.4	1.5	1.5	1.6	1.6	1.7	1.8	1.9	2.0	2.0	2.1
USD	Key Policy Rate	2.25	2.75	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	2.9	3.0	3.2	3.3	3.4	3.3	3.3	3.3	3.3
	2-year bond yield	2.8	2.8	2.8	3.0	3.2	3.2	3.2	3.2	3.2	3.1	3.1
	10-year bond yield	2.9	2.9	2.9	3.1	3.2	3.2	3.2	3.2	3.2	3.2	3.2
	5-year swap rate	2.9	2.9	2.9	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.0
	10-year swap rate	2.9	2.9	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	0.00	0.10	0.10	0.25	0.25	0.50	0.50
	Deposit rate	-0.40	-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	-0.3	-0.2	-0.1	0.0	0.1	0.2	0.5	0.5
	2-year bond yield	-0.6	-0.6	-0.5	-0.5	-0.4	-0.2	-0.1	0.1	0.2	0.4	0.5
	10-year bond yield	0.3	0.3	0.3	0.4	0.5	0.6	0.7	0.8	1.0	1.1	1.1
	5-year swap rate	0.2	0.2	0.3	0.4	0.5	0.6	0.7	0.8	1.0	1.1	1.2
	10-year swap rate	0.8	0.8	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



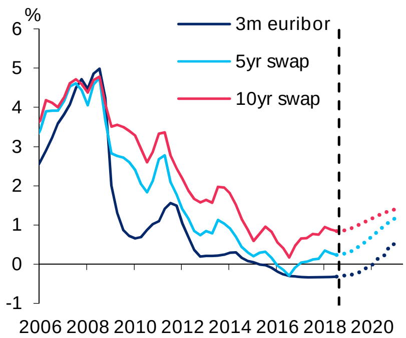


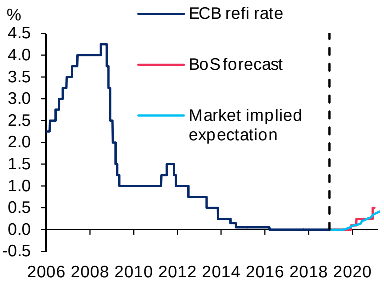
Strong annualised GDP growth of 3.5% for Q3 was confirmed in the second estimate. The outturn was driven by strong consumer spending, which grew by 3.6%, supported by a robust labour market and tax cuts. Inventories also added to overall GDP growth. However, while business investment growth was revised up, it still showed a slowdown after vigorous rises in the first half of the year, while net exports subtracted from overall growth. Early indicators point to a moderation in Q4 growth to around 2.5% which would still be a creditable outcome. Going into 2019, GDP growth is forecast to remain above trend, but to moderate as the impact of the fiscal stimulus starts to wane.

Nonfarm payrolls increased by 155k in November, down from 237k in October. The unemployment rate stayed at the cyclical low of 3.7%, while annual growth in average hourly earnings held at the post-crisis high of 3.1% with further pressures expected to build over the medium term. The broader core personal consumer expenditure (PCE) deflator, however, fell to 1.8% in October, the lowest since February. Headline CPI inflation for November fell to a nine-month low of 2.2% from 2.5%, but the core CPI (excluding food and energy) edged up to 2.2% from 2.1%.

Despite the rise in financial market volatility, the Fed remains on course to raise interest rates on 19 December by a quarter point to 2.5% (upper bound), the fourth increase this year. Fed Chairman Powell's recent comments that interest rates are "just below" the neutral range suggest that further rises in 2019 will be less automatic and more data dependent. Our central view remains for two hikes next year to 3%, compared with the September 'dot plot' signalling three rises. Markets are currently discounting, at most, only one hike next year, while the short end of the Treasury yield curve has inverted. US 10 year Treasury yields have fallen towards 2.8% during October. Our end-2019 target for the 10 year yield has been lowered to 3.2% from 3.3%.

Euro





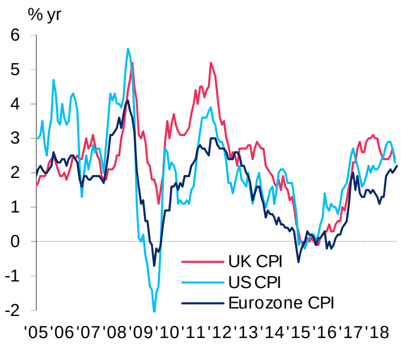
Euro area Q3 economic growth was confirmed at 0.2%q/q, the weakest in four years. The slowdown reflected contractions in Italy and Germany. Survey evidence for Italy points to the possibility of another contraction in Q4, while a rebound is anticipated for Germany following the temporary disruption to the country's car sector. In France, meanwhile, the escalation of protests has led the Bank of France to halve its Q4 growth forecast to 0.2%q/q. For the euro area as a whole, survey evidence points to continued falls in underlying economic momentum, even if Q4 GDP growth improves.

Headline CPI in the euro area fell to 2.0% in November from 2.2%. Core inflation, excluding food and energy, remained subdued at 1.0%. The ECB confirmed an end to net asset purchases at its December meeting, but downward revisions to growth and inflation forecasts mean that policy will remain accommodative for some time. The ECB clarified that the reinvestment of maturing assets will continue "in full" for an extended period past the date of the first interest rate rise. The interest rate guidance was left unchanged for now to indicate no change "at least through the summer of 2019". Markets, though, are not fully discounting the first 10bps rise until early 2020.

French President Macron's new policy measures in response to the protests, including a higher minimum wage, are estimated to increase the country's budget deficit above the 3% threshold next year. French/German 10 year spreads have increased above 40bps, while Italian/German 10 year spreads are much wider but have fallen below 300bps on signs of compromise between Italy and the European Commission on budget deficit targets. We have pushed out our central view for the first 10bps interest rate increases in the deposit and refinancing rates to 0.3% and 0.1%, respectively, to Q4 2019, compared with Q3 previously. Our end-2019 target for the 10 year bund yield has been lowered to 0.7% from 0.9%.

Fundamental Views - Inflation

Inflation Rates



Inflation Trends

Since hitting a near four-year high above $86/bbl in October, front-month Brent crude oil prices have eased back sharply in recent weeks. While oil prices have moved away from their year-to-date lows – reached at the end of November – at their current levels they are broadly unchanged from a year ago and, as such, should provide little upside impetus to near-term inflation. In fact, that softness in oil prices has already fed through to reduced forecourt fuel prices, which look set to weigh on headline inflation into year-end.

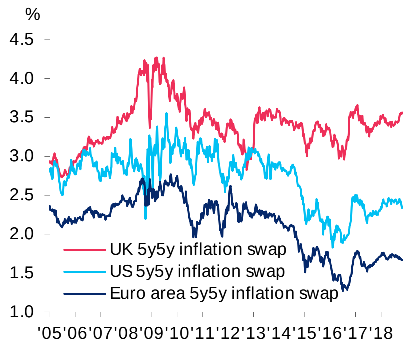
In the UK, headline inflation continues to ease. Having started the year at 3.0%, the annual rate of consumer price inflation dropped to 2.4% in October, and should fall further over the coming months. This partly reflects the recent move lower in oil prices, but also as favourable base effects since the post-referendum fall in the pound.

Still, while these effects should continue to bear down on UK inflation, rising domestic pressures pose upside risks. The combination of no spare capacity, rising wages and lacklustre productivity growth are expected to limit the extent and speed of the fall in the inflation rate over the coming quarters. While 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. We forecast the next hike in UK Bank Rate in August 2019.

In the Eurozone, inflation has risen since the start of the year, reflecting higher food and energy prices. Consequently, the annual rate of headline inflation has picked up to around 2%. However, given the prevailing degree of slack in the economy underlying price pressures remain constrained, as evidenced by the ongoing weakness in the 'core' rate of inflation, which eased back to 1.0% in November. Nevertheless, an ongoing absorption of slack and firmer pay growth is providing the ECB with greater confidence that domestic inflation will pick up.

Meanwhile, in the US, both headline and core CPI inflation remain well above 2%. Moreover, the Fed's preferred measure of inflation, the 'core' personal consumption expenditure deflator, remains around 2.0%. The US labour market continues to look tight following a sustained period of strong jobs growth, and this now appears to be putting upward pressure on wages. Since April, annual earnings growth has risen from 2.4% to 3.1%, its highest since April 2009. Rising wages and the feed-through from a strong economy are expected to push the PCE deflator higher over the coming months, justifying additional policy tightening.

Inflation Expectations



Inflation Outlook

		Avg since '97	Latest	Period	'18 Q4	'19 Q1	'19 Q2	'19 Q3	'19 Q4	'20 Q1	'20 Q2	'20 Q3
GBP	CPI inflation %	2.0	2.4	Oct-18	2.3	2.0	2.2	2.0	2.0	2.2	2.0	2.0
	Core CPI inflation %	1.6	1.9	Oct-18	1.8	1.9	2.0	1.9	2.0	1.9	2.0	2.1
	RPI inflation %	2.8	3.3	Oct-18	3.3	3.0	3.3	3.1	3.0	3.1	2.9	2.9
	RPI index level		284.5	Oct-18	285.4	285.8	289.8	292.0	293.9	294.7	298.2	300.5
	CPI-RPI wedge	0.8	0.9	Oct-18	1.0	1.0	1.0	1.0	1.0	1.0	0.9	0.9
USD	CPI inflation %	2.2	2.2	Nov-18	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
	Core CPI inflation %	2.0	2.2	Nov-18	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
EUR	HICP inflation %	1.7	2.0	Nov-18	2.0	1.8	1.8	1.7	1.7	1.7	1.7	1.7
	Core HICP inflation %	1.4	1.0	Nov-18	1.1	1.3	1.5	1.7	1.8	1.8	1.8	1.8

Source: Bloomberg, BoS

Key Economic and Political Events Calendar

2018 Central Bank Meetings

DECEMBER

Country	Date	Event
EZ	13	ECB rate decision
US	19	FOMC policy announcement & press conference*
UK	20	BoE MPC announcement

2018 Political Events

DECEMBER

Country	Date	Event
EU	13/14	EU Summit
US	21	Deadline to prevent Government shutdown

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
UK	21	Deadline for UK government to present a withdrawal agreement

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

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