COMMERCIAL BANKING

International Financial Outlook

August 2019

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All historical data sourced from Bloomberg
All forecasts sourced from Bank of Scotland (BoS)
Data sourced 6th August 2019

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Overview

Financial market review – past month

The global economic outlook remains uncomfortably uncertain, with slowing growth and escalating political tensions underlying an uneasy backdrop for financial markets. Global trade and manufacturing represent the key areas of concern but broader sentiment is vulnerable to a range of risks, particularly ongoing US – China trade negotiations and Brexit. In a surprise move, President Trump recently escalated global trade tensions by threatening tariffs on a further $300bn of Chinese goods in early September. Meanwhile, the perceived risk of a no deal Brexit has ratcheted higher ahead of the revised 31 October deadline.

Primarily reflecting the more fragile international backdrop, the Federal Reserve cut its policy rate in July for the first time in a decade, by 25bp, to a range of 2.00 - 2.25%. It was notable that two members of the FOMC voted against the reduction. The Fed's policy communication was more balanced on the outlook for further easing but financial markets currently predict an additional 100bp of cuts in the year ahead. While domestic data remains resilient, Q2 GDP growth slowed to 2.1%, from 3.1% in Q1, and non-farm payrolls are rising less briskly than in 2018.

Possibly reflecting its more open nature, risks to the euro area economic outlook have intensified. Euro area Q2 GDP growth slowed to 0.2%, from 0.4% in Q1. However, more worrying is the ongoing deterioration in the more timely survey data, signalling downside risks to activity. Meanwhile, price pressures remain muted. Core inflation slowed to just 0.9% in July, from 1.1% in June. The ECB set the platform for a package of policy easing measures at its forthcoming September meeting. A cut to its deposit rate looks almost assured, likely alongside new measures to help banks mitigate deeper and more prolonged negative rates. The restart of asset purchases will also be considered. Next month's meeting represents Mario Draghi's swansong as ECB president. Christine Lagarde has been nominated to replace him.

Other major global central banks echoed the dovish tone, with notably the Reserve Bank of Australia cutting its policy rate to a record low 1% in July. In the UK, as expected, the Bank of England left policy unchanged at its August MPC meeting. However, it had a challenging task explaining the inconsistency between the 'smooth' Brexit conditioning assumption that underpins its economic forecast and the rising perception of 'no deal' that significantly influenced the prevailing market prices on which its forecasts are also conditioned. Its previous outlook for modestly higher rates was dented somewhat by a weaker UK forecast. Financial markets predict a 25bp cut by next year.

Rising domestic political uncertainty is increasingly weighing on the UK economic outlook. The government's position on Brexit has hardened, both in terms of its negotiating position with the EU and its stated commitment to leave – with or without a deal – at the end of October. The situation is fluid and further complicated by the range of possible paths to a series of potentially very different outcomes to break the deadlock. The return of parliament after its summer recess on 3 September represents a key focus for markets, with rising speculation of 'no deal' and a possible early general election. The UK composite PMI index edged higher to 50.7 in July, from 49.7 in June (below 50 signals contraction). Underlying activity is likely to remain subdued until political uncertainty subsides.

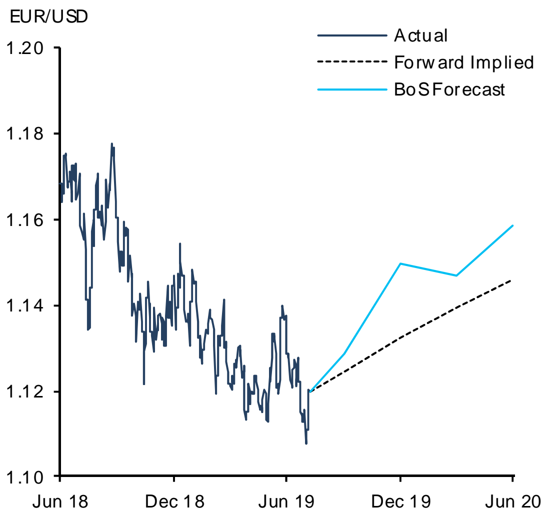
In financial markets, global bond markets rallied further as rising geopolitical risks underpinned a 'safe-haven' bid and central bank communications signalled looser monetary policy. US 10-year treasury yields sank below 1.75%, the lowest since 2016. In Germany, the 10-year bund yield declined to a record low -0.5%, with the entire bund yield curve (to 30 years) turning negative for the first time. In the UK, the 10-year gilt yield also fell to a record low below 0.5%, significantly below current bank rate at 0.75%.

In currencies, the British pound struggled against the perceived increased risk of 'no deal' in the markets, taking the broad trade-weighted exchange rate near record lows. Implied volatility has also picked up sharply in recent weeks. Globally, USD/CNY breached 7.0 for the first time since 2008 after the threat of fresh trade tariffs. Safe-haven currencies, led by the yen and Swiss franc have rallied recently, with EM currencies bearing the brunt.

Summary of key forecasts

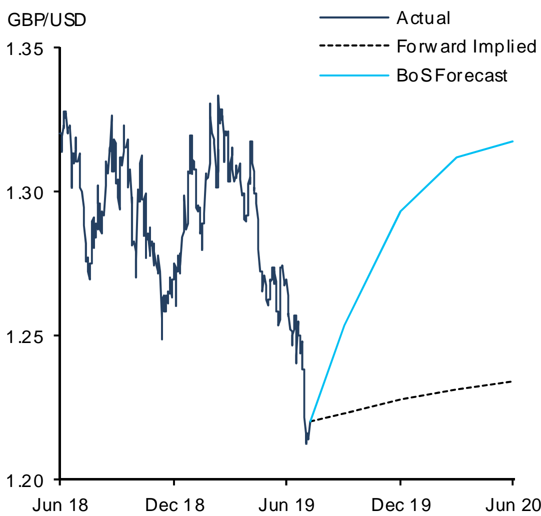
- Our baseline expectation is for global growth to stabilise but recover only modestly in the coming year, aided by looser financial conditions, but buffeted by global political uncertainty. Recent events highlight that risks to this view are significant and a further loss of growth momentum cannot be ruled out.
- Brexit overshadows the UK, with the outcome still extremely difficult to predict. Our base case is conditioned on a negotiated withdrawal agreement later this year. However, a wide range of scenarios are still possible and it is hard to be confident about how and when a resolution will be reached.
- Assuming our base case scenarios for the UK and global economy are borne out, we now expect the Bank of England to hike its policy rate by 25bp next August and also forecast less dovish than current market predictions for the other major global central banks. We forecast US policy rates to be cut next month to 1.75%-2.00%. The ECB is predicted to reduce its deposit rate by 20bp to -0.6% by end-2019.
- Our 10 year Treasury yield targets are 2.0% for end-2019 and 2.3% at end-2020. Our 10 year gilt yield targets are 0.9% for end-2019 and 1.8% at end-2020. Our 10 year German bund yield targets are -0.3% for end-2019 and -0.2% at end-2020.
- We forecast the British pound to strengthen on confirmation of an 'orderly' EU withdrawal. Our targets for GBPUSD are 1.29 for end-2019 and 1.33 for end-2020. For GBPEUR, we forecast 1.12 for end-2019 and 1.14 at end-2020. EURUSD is forecast at 1.15 at end-2019 and 1.16 at end-2020.

Fundamental Views – G10 FX



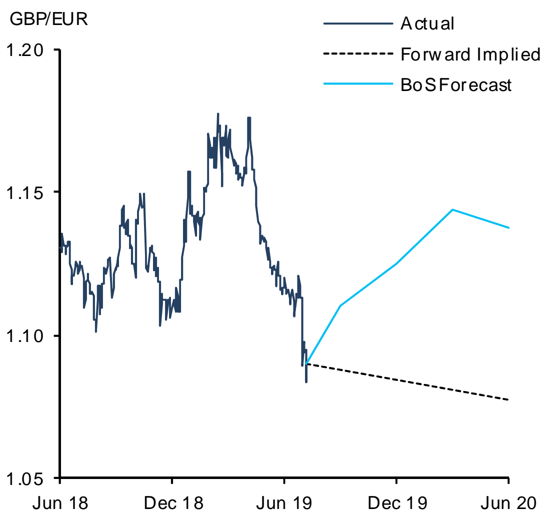
EUR/USD

The EUR has spent most of 2019 fluctuating between 1.10 and 1.15 against the USD. However, recent developments have led to a pickup in volatility (to its highest level since April) and perhaps increased the downside risks that the currency pair faces. It began with a shift in stance from the ECB, which used its July meeting to prepare the market for an imminent reduction in the deposit rate and indicated additional easing measures, including fresh asset purchases, were being considered. Then, the Fed cut policy rates by 25bps, to 2.00-2.25%, but suggested this was only a "mid-cycle" adjustment, reducing expectations of an extensive easing cycle. As a result, EUR/USD fell to its lowest level since May 2017. However, we believe concerns of a deeper decline in the euro are a little overdone. Trade tensions between the US and China, exacerbated by President Trump's latest announcement to place 10% tariffs on an additional $300bn worth of goods, may drive a deterioration in the global outlook that forces the Fed's hand. We anticipate another cut in the Fed funds rate in September. At the same time, we believe the market is overly excited about the prospect of stimulus from the ECB. We agree that policy rate cuts are forthcoming, however, do not expect a new QE package this year. As such, we favour EUR/USD to gradually appreciate over the next two years.



GBP/USD

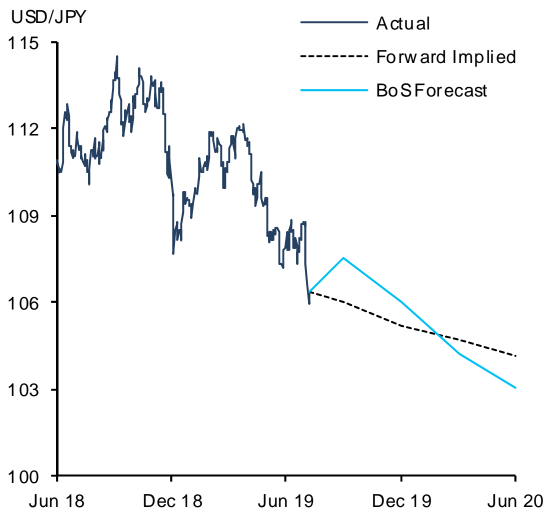
Without doubt, it has been a turbulent few months for the GBP. Having been as high as 1.32 against the USD in early May, political forces have pushed the currency pair towards 1.20 - a decline of over 8%. Following Boris Johnson's ascension to Prime Minister, sentiment quickly deteriorated as he and his key advisors started to sound the alarm on a 'no deal' Brexit. The PM indicated he was willing to pull the UK out of the EU by 31 October come what may. Moreover, Cabinet member Michael Gove revealed that the government is "working on the assumption" of a 'no deal' exit. Volatility in the pound has risen, market participants are increasingly favouring further GBP weakness, and there is a higher implied chance of outsized moves (in either direction) in the currency pair. Until the UK and EU come back to the negotiating table, an extended rally in the pound would appear unlikely. However, perhaps the current levels of pessimism are too high. Based on option market pricing, there is less than a 15% chance that the GBP/USD recovers back above 1.30 at year-end. This looks a little low given that the path to Brexit remains unclear. We continue to believe that the UK will leave the EU in an orderly manner and in such a scenario we would expect the GBP to rally strongly to 1.29 by end-2019.



GBP/EUR

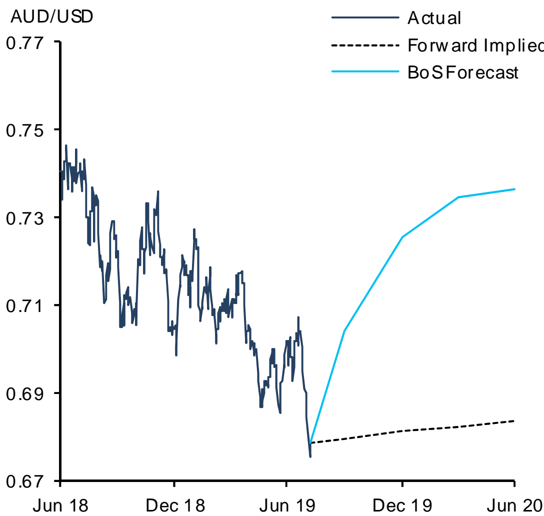
The pound has suffered against the euro in recent weeks, falling to a 22-month low (1.0810), after the UK government ramped up its rhetoric and preparation for a 'no deal' exit from the EU. PM Johnson has committed to leaving by 31 October and financial markets have responded by marking up the chance of a disorderly Brexit. Measures of volatility in GBP/EUR are rising, while market participants show a clear bias towards a further fall in the GBP. Away from politics, the ECB took steps to prepare the market for a fresh round of policy stimulus. At its July meeting, President Draghi hinted that there may be cuts to the deposit rate and added that the Governing Council were considering options for further asset purchases. Meanwhile, the BoE maintained its position that so long as the economic outlook evolves as it expects, gradual rate rises would likely be appropriate. In theory, these central bank updates should have led to a widening in the UK-German interest rate differential. However, it has narrowed, putting additional downward pressure on the currency pair. Based on an assumption of an orderly Brexit, we expect GBP/EUR to rise over our forecast horizon.

Fundamental Views – G10 FX



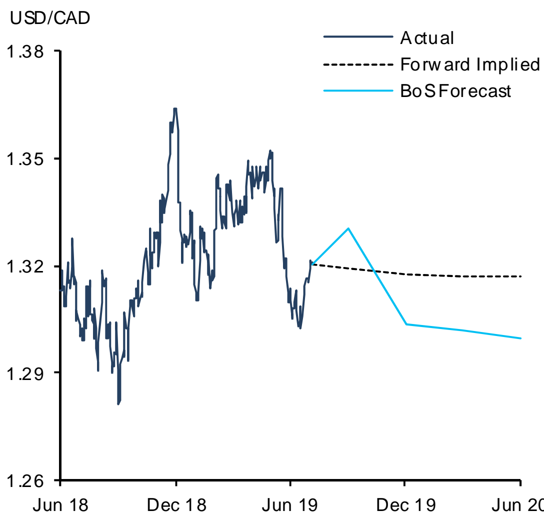
USD/JPY

The USD has been under significant pressure against the JPY in recent months, falling from a high in April above 112 to a low below 106. The fortunes of currency pair have been closely linked to US monetary policy developments and the evolving global risk outlook. US interest rate expectations had oscillated significantly before the FOMC decided to reduce policy rates by 25bps, to 2.00-2.25% at July's meeting. Meanwhile, in spite of a subdued growth outlook, the BoJ left interest rates unchanged at its policy meeting last month. Compared to the Fed, it has much less room to manoeuvre, with the Balance Rate already in negative territory and the central bank engaged in a large asset purchase programme. That said, Governor Kuroda suggested policymakers stand ready to act if downside risks materialise. Meanwhile US-China trade tensions are on the rise again. Given the risks in play, it is perhaps surprising to see cross-asset volatility, albeit rising, still relatively low. A further deterioration in sentiment would likely see the 'haven' JPY appreciate. As such, the potential paths of US and Japanese monetary policies and risks to global growth could lead to volatility in USD/JPY. Overall, we expect the currency pair to drift lower by end-2020.



AUD/USD

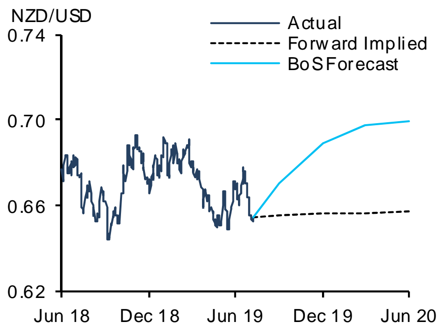
Given the economic environment, it is not surprising to see the AUD continue to decline against the USD, falling back towards its January 'flash-crash' lows. Domestic conditions have softened since the start of the year. Q1 GDP growth fell to 1.8%y/y and the unemployment rate rose to 5.2% in May. With headline inflation below the RBA's target range, there was a case for easing. However, the back-to-back 25bp cuts in policy rates were perhaps more than expected. The external backdrop was also likely a key consideration in the central bank's decision. The trade dispute between the US and China rumbles on, weighing down risk sentiment. Both economies have already slowed, with the latter's Q2 GDP growth declining to 6.2%y/y. However, from here there are reasons to be bullish on the AUD/USD. The market is 'pricing' a further 50bps worth of monetary loosening from the RBA by the end of Q1 2020. If that turns out to be too aggressive, a paring back of expectations could provide some support to the AUD. Moreover, should the US and China resolve their differences, equity markets are likely to rally and such positivity would assist the AUD. We expect AUD/USD to appreciate modestly over the next few quarters.



USD/CAD

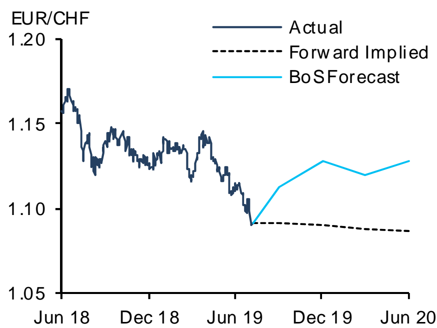
Among the developed-market commodity currencies, the CAD has been the best performer. Having traded to a high above 1.35 in May, USD/CAD has fallen back towards 1.30. While the 10% rally in oil prices (from below \$60/bbl in June to \$65/bbl in mid-July) helped spur some CAD strength, the greater proponent of the move is likely to have been the 50bp narrowing in the 2-year US–Canadian bond yield spread. As expected, the Federal Reserve cut policy rates (by 25bps) at its July meeting to 2.00-2.25%, with the accompanying statement suggesting the FOMC is likely to maintain its easing bias for the time being. In contrast, the BoC has suggested it sees no need for a "precautionary" cut in interest rates. When questioned on the matter, in contrast to other central banks, Governor Poloz and Deputy Governor Wilkins replied that the economic outlook still looks "balanced". While the respective policy outlooks suggest a further narrowing in the interest rate differential is possible, we are less convinced that this will happen due to the degree of monetary loosening already 'priced' into the US curve. There is therefore a case for USD/CAD to stay close to current levels in the near term, particularly if oil prices remain within their recent range.

Fundamental Views – Other Developed Market FX



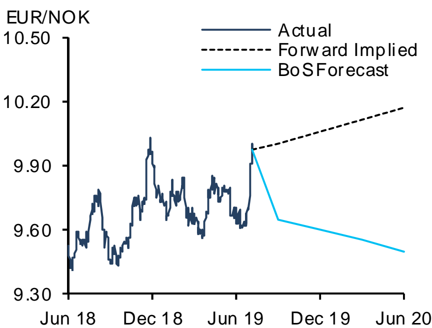
NZD/USD

A combination of better-than-expected US economic data and widening of US-NZ interest rate differentials have applied downward pressure to the NZD/USD. From its near-term high, the NZD has depreciated by almost 4% against the USD. There is a risk that this trend continues. Although it did cut interest rates by 25bps at its July policy meeting, the Federal Reserve suggested this was a "mid-cycle" adjustment, leading the market to re-evaluate its 'pricing' for an extensive cutting cycle. At the same time, the RBNZ, which reduced its policy rates in May, is expected to maintain an easing bias. Such policy paths could lead to a further widening in interest rate differentials compounding matters for the NZD. This would be made worse if trade tensions worsen. However, in our central scenario we expect some positive progress to be made on that front. As such, the risk environment should eventually support the currency. Given these potentially opposing forces, we do not expect the NZD/USD to deviate too far from current levels over the coming quarters.



EUR/CHF

Given the disappointing performance of the Eurozone economy, the shift in policy stance from the ECB and global developments, it is not surprising that the euro has fallen against the Swiss franc. Euro area growth in Q2 was only 1.1% and inflation remains low, with 'core' CPI falling below 1% in July. This, combined with a deterioration in Eurozone business sentiment, led the ECB to adopt an easing bias, preparing the market for an imminent cut to the deposit rate and possibly further asset purchases. The EUR has come under pressure as a result. At the same time, US President Trump's decision to place 10% tariffs on $300bn worth of goods imported from China has boosted demand for the 'safe-haven' CHF. However, we expect risk sentiment to recover and global growth to remain relatively robust. Therefore, this strength in the franc may fade fairly soon. In addition, we believe that the market may have got ahead of itself, particularly in anticipating QE from the ECB as early as September. As such, we see scope for EUR/CHF to rally.



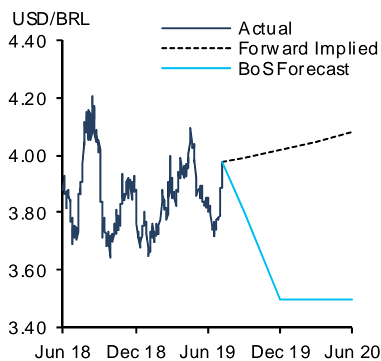
EUR/NOK

Lately, the NOK has come under pressure against the EUR, with EUR/NOK swinging from a low below 9.60 to a high above 10.00. Even at these elevated levels, it is still within its year-to-date range. Following the Norges Bank's decision to raise interest rates in June by 25bps (to 1.25%), economic data has tended to the weaker side. The manufacturing PMI survey showed a decline in sentiment, with the measure again falling below the key 50 expansion/contraction boundary. Furthermore, the unemployment rate rose to 2.4% (from 2.1%) and retail sales for May significantly disappointed. These, combined with the sharp fall in headline inflation in June (from 2.5% to 1.9%), has led to scepticism about whether the central bank will deliver another interest rate hike this year as indicated by its forward guidance. Even so, with its preferred measure of core inflation well anchored near target, a cut seems unlikely. In contrast, the ECB is poised to ease. Given these policy expectations and assuming oil prices do not fall further, the NOK should find support soon.

EUR/SEK

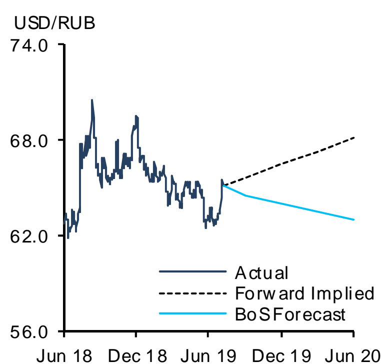
The EUR has risen back towards its 10-year high against the SEK (around 10.85). As Q2 GDP growth showed, Sweden, a significant global exporter, has not been unaffected by recent global trade tensions and a slowdown in activity in the euro area. GDP contracted by 0.1%, its second quarterly contraction in the last four. Likewise, leading indicators point to slower activity in Q3. Given inflation is at the central bank's target, recent growth momentum makes it highly unlikely that the Riksbank will lift interest rates by late 2019 or early 2020 as pledged. Even so, there is no clear sign that it will ease either. In contrast, the ECB has committed to providing stimulus, perhaps as soon as September. The direction of policy rates may therefore help the krona. In addition, Sweden is well placed to benefit from any improvement in global trade conditions. As such, we expect a gradual fall in EUR/SEK over the next two years. That said, the risks to our forecast are skewed to the upside given the sensitivity of the pair to any shift in Riksbank policy.

Fundamental Views – BRIC FX



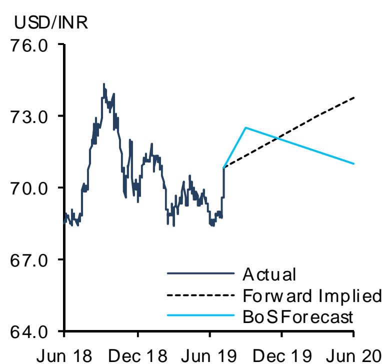
USD/BRL

Much of the past three months proved positive for the Brazilian real. Signs that badly needed pension reforms stood a better chance of passing Congress pushed USD/BRL lower from a high of 4.12 in May. Subsequently, the easing of external pressure on Brazil, in the form of looser monetary policy signals from the Fed and a stay of execution in terms of additional US tariffs of Chinese goods, both aided USD/BRL to a low of 3.71 in July. Alas, since then the real's fortunes have once again soured. Below target inflation in Brazil, reflecting weak economic growth prospects, led the central bank to cut interest rates by 50bps to 6%, with more easing expected down the line. To compound matters, trade tensions with the US and China have re-escalated, to the deficit of commodity exporters like Brazil. Meanwhile, pension reforms are still not guaranteed to pass Congress. As a result, we believe there is every possibility USD/BRL could shift higher from recent levels before resettling lower further down the line. We forecast USD/BRL to end the year at 3.50, but the risks to this outlook are skewed to the upside.



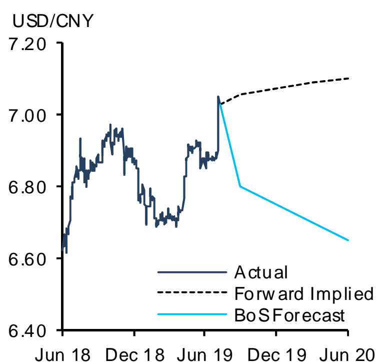
USD/RUB

Lately, upward pressure on USD/RUB has returned. From a low of 62.49 back in June, the pair recently broke back above 65. Lower crude oil prices may explain some of the recent weakness, but other factors are also at work. For one, Russia's commitment to curb oil output is taking its toll on export income. In addition, broader growth in Russia's economy disappointed in Q1. GDP is estimated to have contracted by 0.8% on the quarter – the worst performance since mid-2015. This, rather than above-target inflation, prompted Russia's central bank to cut interest rates by 25bps twice in two months to 7.25%, with every chance of another reduction. High inflation and lower interest rates don't lend to rouble strength. Nor do current, unresolved global trade tensions. Regardless, should crude oil prices once again rise from current levels, then the rouble will benefit. At the same time, further loosening of Fed monetary policy should ease some of the pressure on portfolio flows out of Russia even as its central bank eases policy.



USD/INR

USD/INR fell below 68.5 in July, a marked shift from the high of 70.51 in May, just before the results of India's election. A definitive victory for the economic reform minded incumbent government was perceived as a positive for the rupee. At the same time, lower crude oil prices provided additional relief; India is a major importer of crude oil and natural gas. Like other EM currencies, however, the rupee has suffered from a re-escalation of trade tensions between the US and China. Whilst the recent softness in the rupee could be overlooked, the fact that India's economy grew by 5.8% y/y in Q1 – its slowest pace in five years – also tempers our optimism. Meanwhile, we expect India's central bank to cut interest rates by an additional 25 bps in August to 5.50%. Lower interest rates and anticipated higher inflation could put pressure on the rupee just as easily as higher crude oil prices over our forecast horizon. Nevertheless, India's $427bn store of foreign exchange reserves leaves the currency well insulated from a sharp devaluation.



USD/CNY

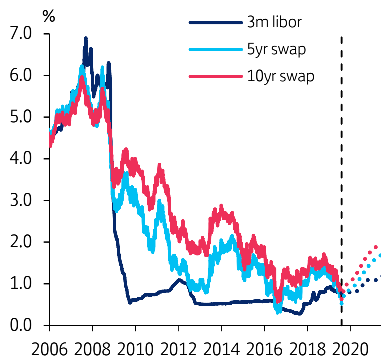
USD/CNY continues to be dominated by political developments. Consequently, while the marked decline through 6.70 in March occurred in line with our view, May's collapse in US/China trade talks has driven market sentiment against the yuan. The recent break above 7.0 (a more-than-decade high) following US threats of tariff rises has further raised risks that the PBoC is willing to use the currency to insulate its economy; something they have since denied. Fundamentally, the Fed is more 'dovish' than 6 months ago, while the PBoC (for now) focusses more on bank credit structures and leverage ratios. This divergence, which has bounced the SHIBOR/LIBOR spread back from its near-decade low, should support relative CNY strength. That being said, clearly we are in a dollar-hungry market on account of trade tensions and a broad global slowdown. Consequently, though our 'fair-value' estimate of USD/CNY continues to call for a stronger yuan, political volatility in the near term remains highly likely and so there is a risk of further weakness; a heavy caveat for these forecasts.

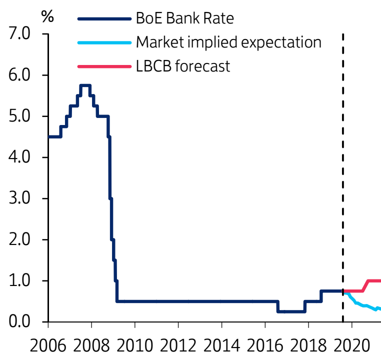
Developed Markets FX Forecasts

		Current	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
US Dollar	Dollar Index (DXY)	97.5	96.9	95.1	94.8	94.0	93.8	93.4	92.5	92.8	92.7
	USD/GBP	0.82	0.80	0.77	0.76	0.76	0.75	0.75	0.75	0.74	0.74
	USD/EUR	0.89	0.89	0.87	0.87	0.86	0.86	0.86	0.85	0.86	0.86
UK Pound	GBP/USD	1.22	1.25	1.29	1.31	1.32	1.32	1.33	1.34	1.34	1.34
	GBP/EUR	1.09	1.11	1.12	1.14	1.14	1.14	1.14	1.14	1.15	1.15
Euro	EUR/USD	1.12	1.13	1.15	1.15	1.16	1.16	1.16	1.17	1.17	1.17
	EUR/GBP	0.92	0.90	0.89	0.87	0.88	0.87	0.87	0.88	0.87	0.87
Japanese Yen	USD/JPY	106	108	106	104	103	102	101	100	99	99
	GBP/JPY	130	135	137	137	136	135	134	134	133	133
	EUR/JPY	119	121	122	120	119	118	117	117	116	115
Australian Dollar	AUD/USD	0.68	0.70	0.73	0.73	0.74	0.73	0.73	0.73	0.72	0.72
	GBP/AUD	1.80	1.78	1.78	1.79	1.79	1.81	1.82	1.84	1.85	1.87
	EUR/AUD	1.65	1.60	1.58	1.56	1.57	1.58	1.59	1.61	1.61	1.62
Canadian Dollar	USD/CAD	1.32	1.33	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
	GBP/CAD	1.61	1.67	1.69	1.71	1.71	1.72	1.72	1.74	1.74	1.74
	EUR/CAD	1.48	1.50	1.50	1.49	1.51	1.50	1.50	1.52	1.52	1.51
New Zealand Dollar	NZD/USD	0.65	0.67	0.69	0.70	0.70	0.70	0.69	0.69	0.69	0.68
	GBP/NZD	1.86	1.87	1.88	1.88	1.88	1.90	1.92	1.94	1.95	1.97
	EUR/NZD	1.71	1.68	1.67	1.64	1.66	1.66	1.68	1.70	1.70	1.71
Norwegian Krone	USD/NOK	8.90	8.55	8.35	8.33	8.20	8.21	8.14	8.05	8.10	8.10
	GBP/NOK	10.87	10.72	10.80	10.92	10.81	10.87	10.82	10.78	10.88	10.89
	EUR/NOK	9.97	9.65	9.60	9.55	9.50	9.50	9.45	9.45	9.45	9.45
Swedish Krona	USD/SEK	9.60	9.39	9.18	9.15	9.02	8.98	8.92	8.77	8.83	8.83
	GBP/SEK	11.72	11.77	11.87	12.01	11.89	11.90	11.85	11.75	11.86	11.87
	EUR/SEK	10.75	10.60	10.55	10.50	10.45	10.40	10.35	10.30	10.30	10.30
Swiss Franc	USD/CHF	0.97	0.99	0.98	0.98	0.97	0.97	0.97	0.97	0.97	0.97
	GBP/CHF	1.19	1.24	1.27	1.28	1.28	1.29	1.29	1.30	1.30	1.31
	EUR/CHF	1.09	1.11	1.13	1.12	1.13	1.13	1.13	1.14	1.13	1.13
Brazilian Real	USD/BRL	3.98	3.80	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
	GBP/BRL	4.85	4.76	4.53	4.59	4.61	4.64	4.65	4.69	4.70	4.70
	EUR/BRL	4.45	4.29	4.02	4.01	4.05	4.05	4.06	4.11	4.08	4.08
Russian Rouble	USD/RUB	65.2	64.5	64.0	63.5	63.0	62.5	62.0	61.5	61.0	61.0
	GBP/RUB	79.5	80.8	82.8	83.3	83.0	82.8	82.4	82.4	81.9	82.0
	EUR/RUB	73.0	72.8	73.6	72.8	73.0	72.4	72.0	72.2	71.2	71.1
Indian Rupee	USD/INR	70.8	72.5	72.0	71.5	71.0	71.0	71.0	71.0	71.0	71.0
	GBP/INR	86.4	90.9	93.1	93.8	93.6	94.1	94.4	95.2	95.4	95.4
	EUR/INR	79.3	81.8	82.8	82.0	82.2	82.2	82.4	83.4	82.8	82.8
Chinese Renminbi	USD/CNY	7.03	6.80	6.75	6.70	6.65	6.60	6.60	6.60	6.60	6.60
	GBP/CNY	8.58	8.52	8.73	8.79	8.76	8.74	8.77	8.85	8.87	8.87
	EUR/CNY	7.87	7.67	7.76	7.68	7.70	7.64	7.66	7.75	7.70	7.70

Source: Bloomberg, BoS

Fundamental Views – UK Interest Rates





UK Pound

Amid continued signs of ebbing global growth momentum and escalating trade tensions, sovereign bond yields in most major economies, including the UK, have fallen back sharply. Since the turn of the year, 10-year UK gilt yields have more than halved, dropping from 1.20% to around 0.50%, while 2yr gilt yields have fallen by about 30bps to around 0.45% as perceptions of the next move in UK Bank Rate have shifted. In fact, forward money market rates currently imply that the next move in UK Bank Rate is more likely to be a cut rather than a hike. This contrasts with the BoE's current view, which conditioned on a smooth and orderly Brexit, remains consistent with some modest increases in Bank Rate.

In part, these market moves have also reflected the persistence of domestic political uncertainty, particularly with PM Johnson pledging that the UK will leave the EU by 31st October 2019, "do or die". While official government policy is still to exit the EU with some form of Withdrawal Agreement, these comments have seen the perceived probability of a 'no-deal' exit from the EU rise, with bookmakers' odds attaching a c.35% probability to such an outcome. The situation is fluid and further complicated by a range of possible paths to a series of potentially very different outcomes to break the deadlock.

Our base case assumes that the UK avoids a 'no deal' exit from the EU and, in time, achieves a 'smooth' transition to a future trading relationship. Under this scenario, Bank Rate should rise gradually as the need for a less accommodative monetary policy stance increases. This view reflects several factors. First, the UK economy is likely to return to a pace of growth around its potential rate as the immediate uncertainties abate. Second, concerns over the supply-side of the UK economy are expected to continue building. The unemployment rate remains low, which alongside the softness of productivity, will raise doubts about the pace at which the UK can grow without generating inflation. As a result, domestic price pressures stemming from rising wages and tightening capacity constraints are expected to continue building.

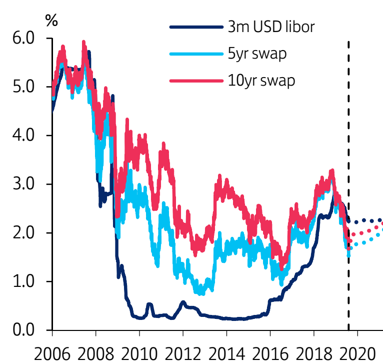
In the near term, however, political uncertainty is expected to persist, holding back spending on large items, particularly investment. This uncertainty, together with the weaker near-term global outlook, will weigh on the UK economy and consequently we have lowered our GDP growth forecasts for both this year and next (see Appendix). Accordingly, we have also pushed out the likely timing of the next increase in Bank Rate (to 1.00%) by six months to August 2020. Still, assuming our base case holds, 10-year gilt yields are expected to end the year at 0.9%, before rising to 1.8% at the end of 2020.

Key Bond and Money Market Forecasts

		Current	Sep-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
GBP	Key Policy Rate	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
	3-month interbank rate	0.8	0.9	0.8	0.8	0.8	0.9	1.1	1.1	1.1	1.2	1.4
	2-year bond yield	0.4	0.8	0.8	0.9	1.1	1.4	1.6	1.8	1.9	1.9	2.0
	10-year bond yield	0.5	1.4	0.8	0.9	1.1	1.4	1.6	1.8	1.9	1.9	2.0
	5-year swap rate	0.5	1.3	0.8	0.9	1.0	1.2	1.4	1.5	1.6	1.7	1.8
	10-year swap rate	0.6	1.5	1.0	1.0	1.2	1.4	1.7	1.8	1.9	2.0	2.0
USD	Key Policy Rate	2.25	2.75	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.25	2.25
	3-month interbank rate	2.2	2.9	2.2	2.2	2.3	2.2	2.2	2.3	2.3	2.4	2.5
	2-year bond yield	1.6	2.8	1.7	1.7	1.9	2.1	2.3	2.4	2.5	2.6	2.6
	10-year bond yield	1.8	2.9	2.0	2.0	2.1	2.1	2.2	2.3	2.3	2.4	2.5
	5-year swap rate	1.5	2.9	1.8	1.8	1.8	1.8	1.9	2.0	2.1	2.2	2.3
	10-year swap rate	1.7	2.9	2.0	2.0	2.0	2.0	2.1	2.1	2.2	2.3	2.3
EUR	Refi rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Deposit rate	-0.40	-0.40	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60
	3-month euribor	-0.4	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
	2-year bond yield	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
	10-year bond yield	-0.5	-0.4	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.1	0.0
	5-year swap rate	-0.5	-0.4	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1
	10-year swap rate	-0.2	0.0	0.1	0.1	0.2	0.2	0.3	0.3	0.3	0.4	0.4

Source: Bloomberg, BoS

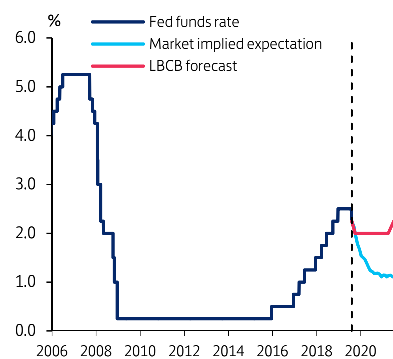
Fundamental Views – US & Euro Interest Rates



US Dollar

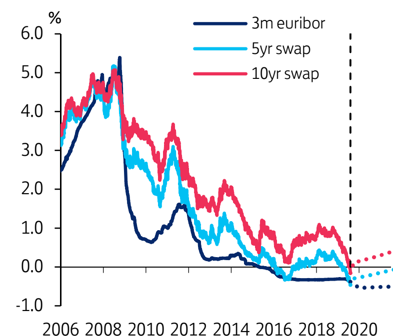
US economic growth slowed to 2.1% (annualised) in Q2 2019, down from 3.1% in Q1. However, final demand was supported by rapid consumer spending growth, while employment growth was still described by the Federal Reserve as "strong". Despite that the Fed cut its policy interest rate by 25 basis points at its July meeting. It also ended its balance sheet reduction programme two months earlier than previously planned. The rate cut had been well signalled beforehand, after the FOMC adopted an easing bias at its June meeting and subsequent comments from key policymakers confirmed the likelihood of action.

There had been some speculation that the Fed might cut by 50 basis points. Markets were somewhat reassured by the Fed's maintenance of an easing bias. However, that was offset by Fed Chair Powell's claim that he saw the move as a mid-cycle adjustment rather than the start of a major easing cycle. In all the immediate Treasury market response was muted. Ten-year yields which had previously fallen from 2.6% in mid-March to 2.05% ahead of the meeting, in anticipation of slower economic growth and looser monetary policy, were little changed. However, within a couple of days 10-year yields had fallen below 1.80%, their lowest since late 2016, as a further escalation of trade tensions between the US and China boosted expectations of further US rate cuts. Markets are now priced for a further 100 basis points of rate cuts over the next 12 months.



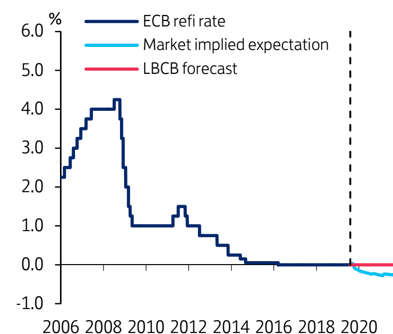
We think that concerns about downside risks will push the Fed into taking further action in September through another 25 basis point rate cut. However, we also see this as mid-cycle insurance rather than the start of a series of cuts. So unless US economic growth proves to be unexpectedly weak we would expect this to be the last decrease for some time. This suggests that the fall in Treasury market yields is probably overdone and that they are likely to back up as it becomes apparent that economic conditions remain solid. We look for a rise back to 2.0% by end 2019 and 2.3% by end 2020.

Euro



The loss of economic momentum has become protracted, primarily reflecting the impact of elevated global trade tensions. That has affected manufacturing activity, in particular, although services has been more resilient. Eurozone GDP growth is forecast to slow to a six year low of 1.2% this year from 1.9% in 2018. The outlook, according to ECB President Mario Draghi, is getting "worse and worse", although the risk of recession is "pretty low". Underlying inflation pressures remain subdued, with core CPI (excluding food and energy) averaging 1.0% so far this year, which is no higher than in 2018. The decline in market-based measures of inflation expectations to record lows in June has also raised concerns among policymakers. Officials have said that they are committed to "symmetry in the inflation aim", which could be interpreted as supporting an easier policy stance.

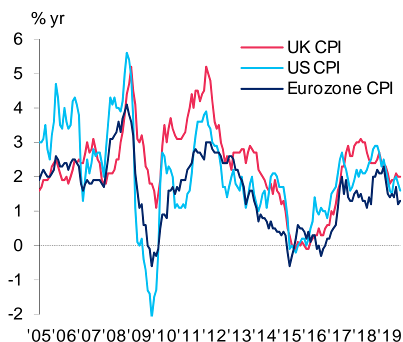
The ECB changed its forward guidance on interest rates at its July meeting to signal an explicit easing bias. The guidance states that policymakers expect rates to "remain at their present or lower levels at least through the first half of 2020". That paves the way for interest rates to be reduced as soon as the next policy meeting in September. In addition, 'relevant committees' have been tasked to examine further policy options, including reinforcing its rates guidance, designing a tiered system for deposit rates to mitigate the side effects on banks of negative rates (a signal that rates could fall much further) and looking at the size and composition of potential new asset purchases (QE).



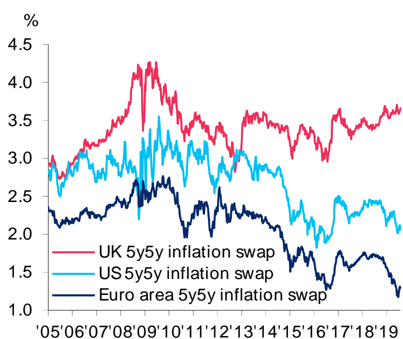
Our central view is for the ECB to reduce the deposit rate by 10bps to -0.5% in September and then again in December to -0.6%, combined with the introduction of tiering. We expect the refinancing rate to be left at 0%. It has prepared the markets for a resumption of QE, which we think will take place in early 2020, although the risk is an earlier restart. German 10 year bund yields have fallen to record lows below -0.5% this year. Our targets are -0.3% at end-2019 and -0.2% at end-2020.

Fundamental Views - Inflation

Inflation Rates



Inflation Expectations



Inflation Trends

Symptomatic of the moderation in global GDP growth, headline rates of inflation across a number of developed economies have continued to edge lower in 2019, moving away from the highs set last year. Moreover, despite supply issues – linked to Iranian tensions and OPEC+ production cuts – global oil prices have eased back as on-going China/US trade tensions, and weaker-than-expected demand have dominated sentiment. With Brent crude and West-Texas Intermediate prices still some 15-20% below levels that prevailed around the middle of last year, lower crude oil prices should continue imparting a downward influence on headline measures of inflation.

For the Eurozone, the negative downdraft from lower oil prices is combining with a weak underlying inflation dynamic. Eurozone core inflation (excluding the volatile food and energy components) remains stubbornly lower than the "close to, but below, 2%" goal. It is currently only 1.1%. Meanwhile, market-based measures of inflation expectations sit close to their record lows, stoking concerns that investors may be losing faith in the ECB's ability to raise inflation. At its July Council meeting, the ECB declared that there was a "need for a highly accommodative stance of monetary policy for a prolonged period of time", paving the way for them to ease policy further later this year.

Meanwhile, US 'core' CPI inflation remains around 2% despite the recent move below 2% in the headline rate. Yet, 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 July, annual earnings growth has continued to print at or above 3%. Over the coming months, further increase in nominal wages and the feed-through from trade tariffs are likely to push the PCE deflator higher.

In the UK, movements in headline inflation this year 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 saw 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 little to 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.

Inflation Outlook

		Avg since '97	Latest	Period	'19 Q3	'19 Q4	'20 Q1	'20 Q2	'20 Q3	'20 Q4	'21 Q1	'21 Q2
GBP	CPI inflation %	2.0	2.0	Jun-19	2.0	1.8	1.9	1.9	2.0	2.1	2.1	1.9
	Core CPI inflation %	1.6	1.8	Jun-19	1.8	1.9	1.7	2.0	2.1	2.0	2.1	2.1
	RPI inflation %	2.8	2.9	Jun-19	2.8	2.6	3.0	3.0	3.1	3.2	3.1	3.0
	RPI index level		289.6	Jun-19	291.3	292.4	292.9	297.7	300.4	301.6	302.0	306.6
	CPI-RPI wedge	0.8	0.9	Jun-19	0.8	0.9	1.0	1.1	1.1	1.0	1.1	1.1
USD	CPI inflation %	2.2	1.6	Jun-19	1.9	2.0	2.2	2.0	1.9	2.0	2.0	2.0
EUR	HICP inflation %	1.7	1.1	Jul-19	1.1	1.2	1.5	1.4	1.5	1.5	1.5	1.5

Source: Bloomberg, Macrobond, BoS

Key Economic and Political Events Calendar

2019 Central Bank Meetings

Country	Date	Event
AUGUST		
US	22-24	Jackson Hole Symposium
SEPTEMBER		
EZ	12	ECB rate decision
US	18	FOMC policy announcement & press conference*
UK	19	BoE MPC announcement
OCTOBER		
EZ	24	ECB rate decision
US	30	FOMC policy announcement & press conference
NOVEMBER		
UK	7	BoE MPC announcement & Inflation Report
DECEMBER		
US	11	FOMC policy announcement & press conference*
EZ	12	ECB rate decision
UK	19	BoE MPC announcement

*includes summary of economic projections

Source: Bloomberg, BoS

2019 Political Events

Country	Date	Event
AUGUST		
G7	24-26	G7 Summit
SEPTEMBER		
DE	1	Brandenburg & Saxony regional elections
UK	3	Parliament returns after Summer recess
UK	14-17	Liberal Democrat Party annual conference
UK	21-25	Labour Party annual conference
UK	29-2	Conservative Party annual conference
OCTOBER		
UK	31	UK scheduled to leave EU
EZ	31	ECB President Draghi's term ends
NOVEMBER		
EZ	1	European Commission President Juncker's term ends
EZ	30	European Council President Tusk's term ends
DECEMBER		

Appendices

Main UK Economic Indicators

	2018	2019	2020	2017				2018				2019			
Annual % changes, unless stated otherwise				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (Q/Q)	-	-	-	0.1	0.4	0.7	0.2	0.5	-0.1	0.4	0.1	0.3	0.6	0.4	0.3
GDP	1.4	1.2	1.2	1.2	1.4	1.6	1.4	1.8	1.3	1.0	0.8	0.6	1.3	1.3	1.6
Consumer spending	1.7	1.6	1.2	1.6	1.8	1.6	1.6	1.7	1.5	1.6	1.5	1.1	1.2	1.2	1.3
Fixed investment	0.2	0.6	0.4	2.1	-0.4	0.2	-1.1	0.9	1.2	0.1	0.2	-1.0	0.0	0.9	1.8
- of which business investment	-0.4	-0.6	1.2	1.9	0.2	-1.3	-2.5	-1.5	-0.8	-0.2	0.3	0.1	0.8	1.5	2.4
Government spending	0.4	2.1	2.8	0.8	-0.1	-0.3	1.0	1.6	2.2	2.7	2.0	2.1	2.8	3.2	3.0
Domestic demand	1.6	1.9	0.2	0.9	1.5	1.9	2.0	5.1	1.1	1.0	0.5	-2.8	1.0	1.2	1.5
Trade balance (contrib. to GDP grow	-0.2	-0.8	1.2	0.5	0.0	-0.4	-0.7	-3.4	0.1	-0.1	0.3	3.5	0.2	0.1	0.0
Real h'hold disposable income	2.1	2.1	2.3	2.8	1.5	1.7	2.2	2.5	1.9	2.0	2.1	2.4	2.5	2.4	1.9
ILO Unemployment rate (%)	4.1	3.8	4.1	4.2	4.0	4.1	4.0	3.8	3.8	3.8	3.9	4.0	4.1	4.1	4.2
Whole economy avg earnings	2.9	3.2	3.7	2.5	2.4	3.1	3.5	3.3	3.2	3.1	3.1	3.7	3.7	3.7	3.6
CPI	2.5	1.9	2.0	2.7	2.4	2.5	2.3	1.9	2.1	2.0	1.8	1.9	1.9	2.0	2.1

Key Macroeconomic Forecasts for our G10 & E10 Groupings

	GDP growth %			
	2018	2019f	2020f	2021f
US	2.9	2.3	1.6	1.7
Japan	0.8	1.1	0.4	0.6
UK	1.4	1.2	1.2	1.3
Canada	1.9	1.4	1.8	1.9
Eurozone	1.9	1.2	1.2	1.3
Germany	1.5	0.8	1.0	1.2
France	1.7	1.3	1.2	1.3
Italy	0.7	0.2	0.8	0.6
Spain	2.6	2.2	1.8	1.8
China	6.6	6.2	6.0	5.9
Brazil	1.1	0.8	2.3	2.4
India	7.3	6.6	7.3	7.4
World	**3.5**	**3.3**	**3.1**	**3.1**

	CPI inflation %			
	2018	2019f	2020f	2021f
US	2.4	1.8	2.0	2.0
Japan	1.0	0.6	1.1	1.3
UK	2.5	1.9	2.0	1.8
Canada	2.2	2.0	2.0	2.0
Eurozone	1.8	1.3	1.5	1.5
Germany	1.9	1.5	1.5	1.4
France	2.1	1.2	1.5	1.5
Italy	1.2	0.8	1.0	1.1
Spain	1.7	1.1	1.6	1.6
China	2.1	2.4	2.3	2.5
Brazil	3.7	3.8	3.8	4.1
India	4.3	4.9	4.6	5.6
World	**3.8**	**3.7**	**3.5**	**3.4**

Source: Bloomberg, BoS

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

Sam Hill
Macro Strategist
Tel: +44 (0) 20 7158 1772
sam.hill@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

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