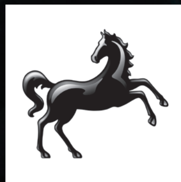
COMMERCIAL BANKING

INTERNATIONAL FINANCIAL OUTLOOK

JANUARY 2016



LLOYDS BANK

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All historical data sourced from Bloomberg
All forecasts sourced from Lloyds Bank Commercial Banking (LBCB)
Data sourced 11th January 2016

Overview

Financial market review – past month

The US Federal Reserve last month successfully navigated the first rise in policy rates in nearly a decade without significant market volatility. The fed funds rate was increased to 0.5% at the upper bound, having stayed at 0.25% since late 2008. The New Year, however, started with sharp declines in Chinese equity markets, which have fallen by more than 10%. Pressure also appears to be building for further renminbi depreciation, driven by uncertainty about the economic outlook and policy intentions. Chinese economic activity remained soft at the end of last year, with the manufacturing PMI survey staying below the key 50 level. Further monetary and fiscal policy easing is likely this year.

Negative market sentiment in China has led to significant declines in equity markets globally, while the benchmark 10-year US treasury yield has fallen towards 2.1%, below levels that prevailed around the time of last month's US policy rate rise. In FX, the Japanese yen has been a beneficiary of safe-haven flows. The US dollar and euro have also outperformed most other main currencies, including the UK pound and major commodity currencies such as the Australian dollar and Canadian dollar. Indeed, global oil prices have continued to tumble on the back of concerns about the outlook for demand, with the Brent crude measure falling close to $30/bbl.

The market turmoil highlights downside risks to US policymakers' central expectation of four further quarter-point interest rate rises this year. This contrasts with market expectations of only two increases. Minutes of the December policy meeting showed that, for some members, the decision to vote for a hike was a 'close call', suggesting some caution about prospects for further tightening, especially if inflation turns out to be weaker than currently projected. US economic growth has probably slowed in Q4 to just below 2% (annualised), with the slight loss of momentum also reflected in the ISM surveys. Nevertheless, if strong employment figures in Q4 2015 are sustained into the New Year, this would increase the risk of the next hike occurring in this quarter, rather than in Q2 in our central view.

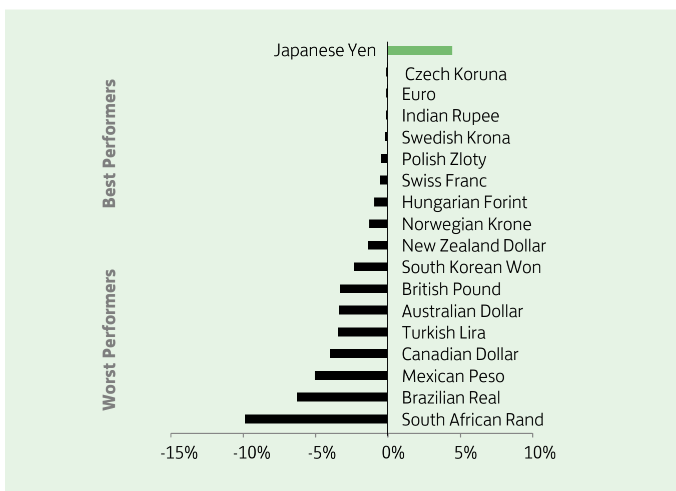
In the UK, GDP growth in both Q2 and Q3 of last year was revised down to 0.5%q/q and 0.4%q/q, respectively, and it looks likely that full-year growth will now be around 2.2% which would be a fairly marked slowdown from the 2.9% posted in 2014. Headline CPI inflation is expected to remain lower for longer, especially with global commodity prices continuing to fall and average wage growth easing off from recent highs. Policymakers, therefore, have leeway to hold off from tightening policy until later in the year.

Euro area headline inflation stayed at only 0.2%y/y in December, held back by weak food and services price inflation. Although euro area inflation is expected to move higher from here, it is nevertheless set to undershoot the ECB's target in 2016 for the fourth consecutive year. There remains the possibility of further policy stimulus later this year, despite more positive indications for the growth outlook. Additional policy stimulus in Japan also remains a risk, especially if the strength of the yen persists.

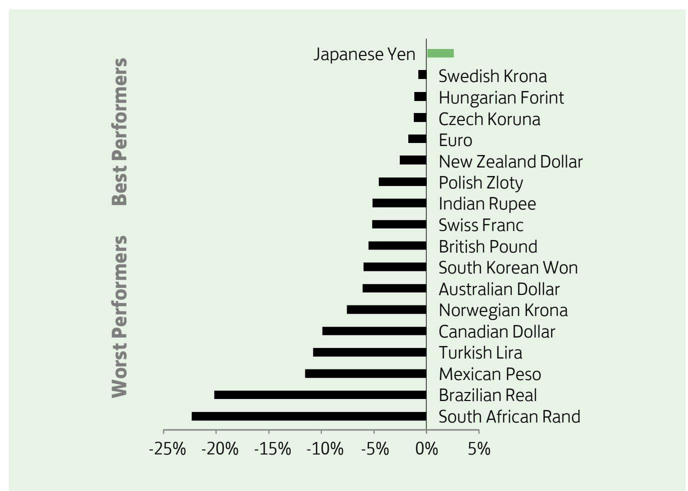
Summary of forecast changes - this month

- We have made no changes to main policy rate forecasts, with two quarter-point hikes in the US this year and one quarter-point rise in the UK in the second half. The risks are skewed to more hikes in the US and a later start to tightening in the UK.
- Our bond yield forecasts are largely unchanged. We have nudged down our year-end target for US 10-year treasury yield to 2.6% from 2.7%. UK and German 10-year yields are still projected to be 2.3% and 0.9%, respectively.
- Our end-2016 forecasts for major FX crosses are unchanged, with EUR/USD at 1.10, GBP/USD at 1.50 and GBP/EUR at 1.36. We have raised EUR/USD at midyear to 1.05 from 1.02 and scope remains for further sterling weakness during the year.

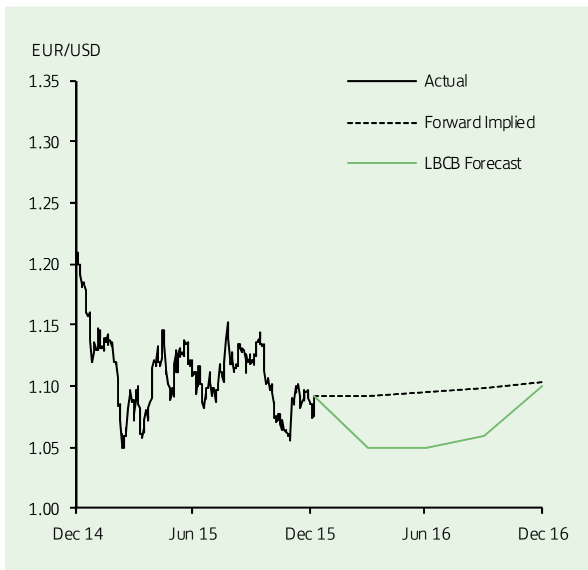
Performance vs. the dollar: One-month spot return vs. USD



Performance vs. the dollar: YTD spot return vs. USD

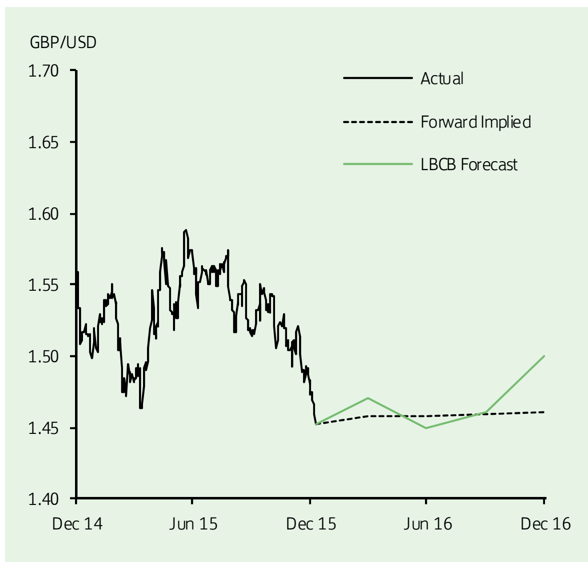


Fundamental Views – G10 FX



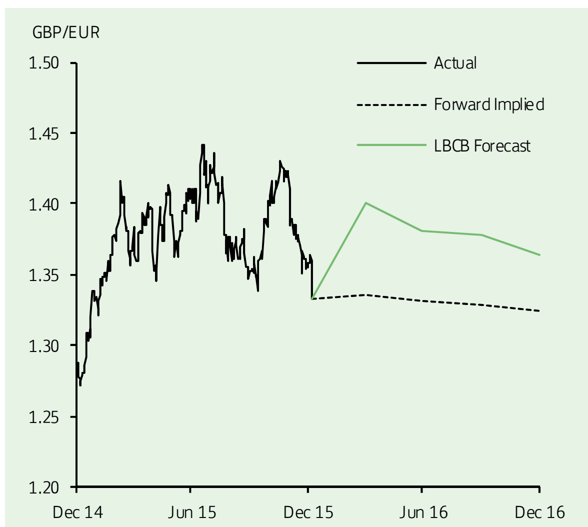
EUR/USD

The market was caught the wrong side of EUR/USD last month, with disappointment over the scale of the ECB's stimulus announcement trumping the widely anticipated 25bp rise in US interest rates. As a result, the euro staged a strong pre-Christmas rally, from a low close to 1.05 to above 1.10. Since then, the turbulent start to the New Year in global equity markets has given the US dollar renewed impetus, while the euro has faced contrasting pressures. Although plunging oil prices have contributed to an improving euro area economy, the associated weakness of inflation has fanned speculation of further ECB stimulus. Near term, we expect the euro to remain caught in a range with a downward bias. The possibility of a US rate rise in March and the weakness of euro area inflation are likely to be key drivers. Over the medium term, however, we expect EUR/USD to stage a strong improvement, supported by a continued narrowing in the gap between US and euro area growth. That said, the euro is unlikely to make any sustained progress until inflation turns higher and/or an end to further policy stimulus is in sight. We target 1.05 by end Q1 and 1.10 by end 2016.



GBP/USD

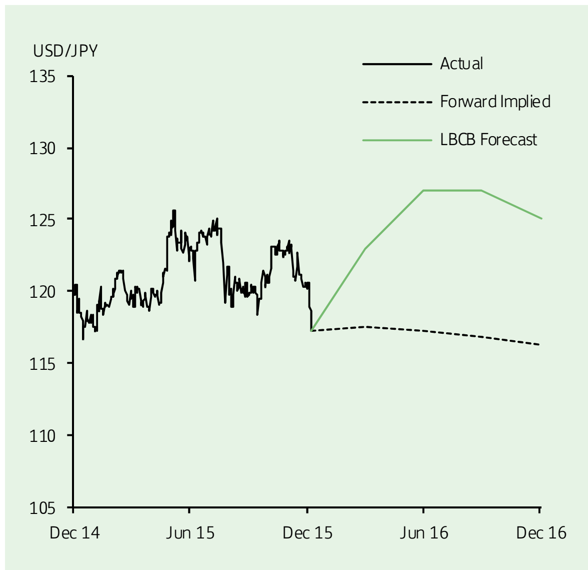
The combination of a generally firm US dollar and a sharply weaker pound has pulled GBP/USD down to multi-year lows just above 1.45. The break lower has occurred against the backdrop of renewed turbulence in global asset markets and further sharp falls in oil prices, both of which have been US dollar supportive. Domestically, downward revisions to UK GDP growth for Q2 and Q3 last year and the weakness of inflation have led to a further scaling back in UK interest rate rise expectations. Judging by forward money market rates, the market now expects the MPC to keep Bank Rate at 0.5% throughout this year. On top of this, rising EU risk premia has dented sterling sentiment, with recent comments by PM Cameron focusing market attention on the possibility of a 2016 EU referendum. Given the extent of the recent drop, we believe cable has overshot on the downside, and should benefit from an anticipated recovery in global risk sentiment. But substantial downside risks remain, with GBP/USD hovering precariously close to key support and next month's BoE Inflation Report and EU negotiations potential flashpoints. We target a move to 1.47 by end Q1, before a renewed pull back to, and possibly below, 1.45 later in the year.



GBP/EUR

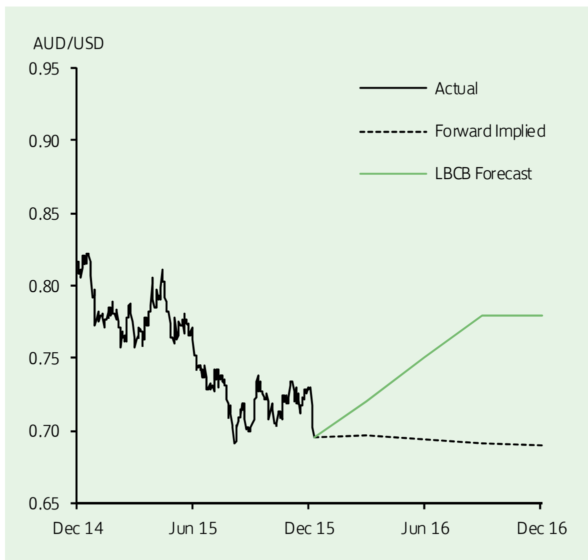
GBP/EUR has plummeted by over 6% since late November to key support at around 1.34 – close to its range low throughout 2015. A combination of factors have weighed on the cross, including the reaction to last month's ECB meeting and a more dovish UK rate backdrop. Heightened Brexit uncertainty also appears to have had an impact. PM Cameron has strongly hinted that he intends to hold the EU referendum this year and, judging by the recent swing in six-month GBP/EUR option prices, the markets now appear to be attaching a higher probability to June. The early emergence of Brexit uncertainty has brought forward some of the weakness of the pound that we had anticipated for later this year. On balance, we believe the extent of the recent drop is overdone and look for a near-term recovery towards 1.40 – mostly driven by a softer euro rather than a stronger pound. Indeed, event risk surrounding the UK currency remains high. That said, the PM returns to Brussels next month in the hope of securing EU concessions, while the February BoE Inflation Report could also be a key market mover.

Fundamental Views – G10 FX



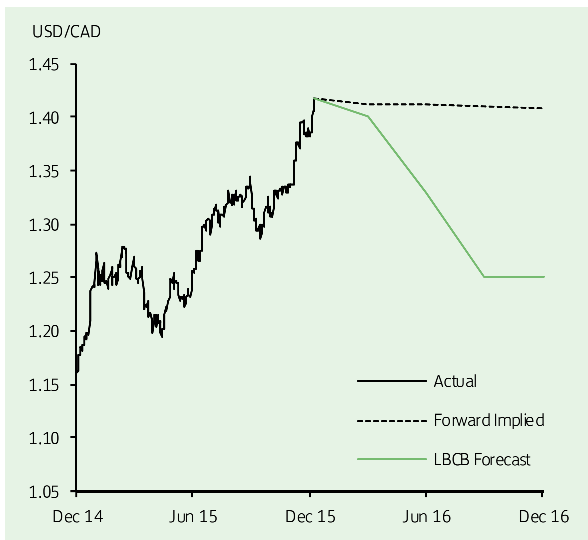
USD/JPY

The yen has experienced a broad rally in recent weeks, as the deterioration in China and escalation of geopolitical tensions in the Middle East have damaged risk sentiment. Recent domestic data have been positive, but international developments pose a threat to exports. Partly in response, we have revised down our 2016 GDP forecast from 1.3% to 1.0%. At its December meeting, the BoJ left headline policy unchanged, with QE expansion remaining at an annual rate of ¥80 trillion. However, operational adjustments to monetary policy were made, including extending the average maturity of bond purchases and increasing ETF purchases. Our central view is that there is unlikely to be any further stimulus this year. However, this cannot be ruled out if the Chinese economy/global equities continue to weaken. Although there is a risk the JPY could continue to strengthen, this would likely be met by verbal intervention. But on balance, we believe the USD/JPY is oversold at current levels. An anticipated improvement in risk sentiment, recovery in the USD and fragile domestic data are expected to lead USD/JPY back toward the top of its current 116 – 125 range over the coming months.



AUD/USD

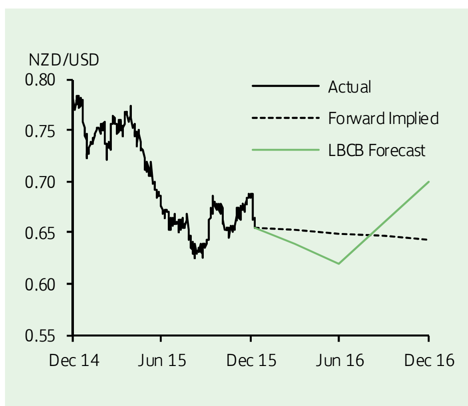
The turn of the year has seen a renewed slide in all commodity currencies and the Australian dollar has fared particularly badly. As a result AUD/USD has touched below 0.70 close to its 6 year low of last September. A further fall cannot be ruled out given ongoing uncertainty about the outlook for commodity prices and the Australian economy's close links to China. Nevertheless, there is a good case for at least a modest rebound in the AUD this year. Growth in the economy outside the resource sector has shown some signs of life on the back of stronger consumer spending and the housing market. As a result, the RBA as of late last year was showing little inclination to initiate further monetary policy stimulus, although this position may change when policymakers meet next in early February. Also, in contrast to the early months of 2015, RBA Governor Stevens has latterly shown less inclination to talk down the currency. This suggests that AUD/USD may now be at, or close to, what the RBA considers to be fair value. This should allow at least a modest rebound if commodity prices start to recover as expected this year. We forecast AUD/USD at 0.78 by end 2016.



USD/CAD

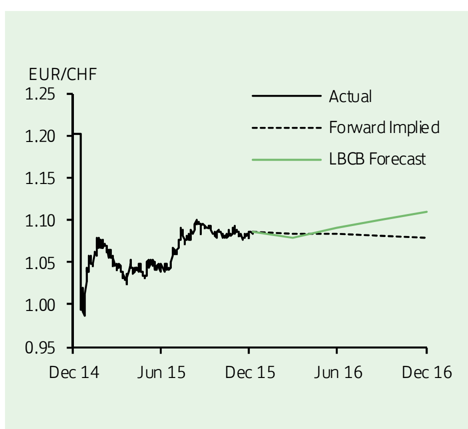
USD/CAD rose to a new multi-year high above 1.41 in early January. The loonie had already sold-off sharply in December and the further slide in the oil price since the turn of the year has added to the selling pressure. Near term, two key forces are expected to act against the Canadian dollar; the slide in the oil price, and the divergence in monetary policy between the Fed, which has started to raise interest rates, and the Bank of Canada which may still cut rates further. The lower oil price has been a sizeable negative 'shock' to the economy and the most recent slide adds to the pressure on economic growth. Consequently, a further fall in the loonie cannot be ruled out, particularly if the BoC decides at its next meeting that further stimulus is appropriate. However, the competitive boost to the economy from the weaker currency is providing an offset to the oil price fall. As a result, growth outside the energy sector looks firmer. If, as we expect, the oil price stabilises and then starts to recover this year, the economy as a whole should start to improve. Given this, we look for a steady recovery in USD/CAD to 1.25 by end 2016.

Fundamental Views – Other Developed Market FX



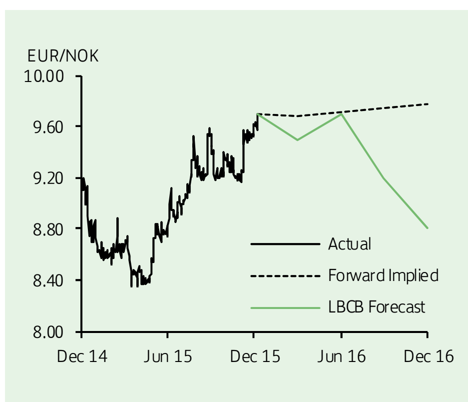
NZD/USD

NZD has fallen since the turn of the year. Concerns over China, pressure on global equities and tension between Saudi Arabia and Iran have weighed on risk appetite. Despite the recent decline, NZD/USD has actually outperformed other developed-market risk-positive currencies, with steadying milk prices a contributory factor. At December's policy meeting, the RBNZ cut interest rates by 25bps to 2.50%, citing fragility in emerging markets (primarily China) as an important factor. We expect the central bank to refrain from further easing at this stage, especially as it has concerns that the Auckland housing market is overheating. However, given that they have room to do so, they could cut interest rates further if the global economy slows and sentiment continues to deteriorate. With the USD expected to appreciate through Q1 and Q2, we forecast NZD/USD to decline to 0.62 by mid-year. We expect it to recover back towards 0.70 at year-end, as momentum in the USD rally fades and commodity prices stabilise.



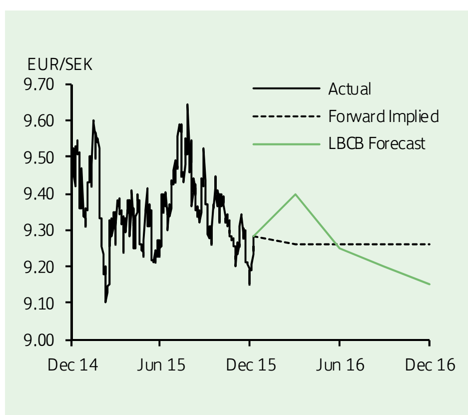
EUR/CHF

After limited easing from the ECB in December, the SNB left interest rates unchanged at its last policy meeting on 10th December – the deposit rate remains at -0.75%. President Jordan outlined his concerns over the inflation outlook and added that CHF remains "overvalued", reinforcing his view on the strength of the currency. According to the OECD, fair value in EUR/CHF is estimated at 1.22. The pair has been contained within a 1.07 – 1.10 range throughout the last quarter. The next policy meeting is on 17th March, and at this stage no changes are expected. However, the SNB is unwilling to see the CHF appreciate significantly, as this would hamper their inflation and growth prospects. Recent rhetoric suggests that they are prepared to intervene in the currency market directly. Given this, we forecast a gradual rise in EUR/CHF over the next year, with the currency ending 2016 at 1.11. With EUR/CHF downside predicted to be limited, USD/CHF should push higher through the first half of the year toward 1.04, before retracing back to 1.01 by Q4 2016.



EUR/NOK

Oil prices have capitulated under significant selling pressure, triggered by the continued supply-demand imbalance, heightened concerns about China and increasing geopolitical friction between Saudi Arabia and Iran. As a result, NOK has depreciated against both the EUR and USD over the last month. At its most recent policy meeting on 17th December, the Norges Bank left interest rates unchanged, despite the challenging environment. However, Governor Olsen did suggest that the policy rate could be reduced in H1 2016 if the central bank's economic projections materialised. Since then conditions have worsened - WTI and Brent have traded down to new multi-year lows below $35/barrel, and both look set to struggle through the next few quarters, before recovering in the second half of 2016. In line with this, we anticipate EUR/NOK trading in a 9.50 – 9.70 range in Q1 and Q2. NOK should subsequently recover in Q3 and Q4, to end the year around 8.80.



EUR/SEK

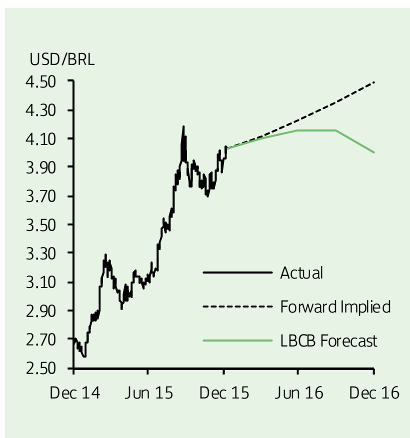
Sweden's economy continues to perform strongly, but inflation remains subdued – highlighted by the decline in CPIF inflation to 1.0%. The Riksbank has reiterated its commitment to reaching its 2.0% inflation target. However, policymakers are restricted in the tools they can use to achieve this objective. They have already mentioned concerns with regard to further cuts in the deposit rate, which would risk stoking the housing market. In addition, their QE programme (currently confined to government bond purchases) has, thus far, had a limited impact in stimulating inflation. In light of this, at a recent emergency meeting on 5th January Governor Ingves was given authority to intervene directly in the FX market. This gives him the scope to depreciate the krona directly to try and boost inflation. Given this, we anticipate mild SEK depreciation against the EUR through the first quarter of this year, before EUR/SEK consolidates in a 9.15 – 9.40 range.

Developed Markets FX Forecasts

		Current	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
US Dollar	Dollar Index	98.7	101.4	101.5	100.2	97.3	94.8	93.3	88.4	88.1
	£ (£ per $)	0.69	0.68	0.69	0.68	0.67	0.66	0.65	0.63	0.63
	€ (€ per $)	0.92	0.95	0.95	0.94	0.91	0.88	0.86	0.80	0.80
UK Pound	$ ($ per £)	1.46	1.47	1.45	1.46	1.50	1.52	1.54	1.60	1.60
	€ (€ per £)	1.34	1.40	1.38	1.38	1.36	1.33	1.33	1.33	1.28
	Effective	89.3	92.4	91.2	91.2	91.3	90.3	90.4	91.7	89.1
Euro	$ ($ per €)	1.09	1.05	1.05	1.06	1.10	1.14	1.16	1.20	1.25
	£ (£ per €)	0.75	0.71	0.72	0.73	0.73	0.75	0.75	0.75	0.78
Japanese Yen	$ (¥ per $)	118	123	127	127	125	124	121	117	115
	£ (¥ per £)	172	181	184	185	188	188	186	187	184
	€ (¥ per €)	128	129	133	135	138	141	140	140	144
Australian Dollar	$ ($ per A$)	0.70	0.72	0.75	0.78	0.78	0.78	0.78	0.75	0.75
	£ (A$ per £)	2.08	2.04	1.93	1.87	1.92	1.95	1.97	2.13	2.13
	€ (A$ per €)	1.56	1.46	1.40	1.36	1.41	1.46	1.49	1.60	1.67
Canadian Dollar	$ (C$ per $)	1.41	1.40	1.33	1.25	1.25	1.25	1.25	1.25	1.25
	£ (C$ per £)	2.06	2.06	1.93	1.83	1.88	1.90	1.93	2.00	2.00
	€ (C$ per €)	1.54	1.47	1.40	1.33	1.38	1.43	1.45	1.50	1.56
New Zealand Dollar	$ ($ per NZ$)	0.66	0.64	0.62	0.66	0.70	0.70	0.68	0.65	0.65
	£ (NZ$ per £)	2.22	2.30	2.34	2.21	2.14	2.17	2.26	2.46	2.46
	€ (NZ$ per €)	1.66	1.64	1.69	1.61	1.57	1.63	1.71	1.85	1.92
Norwegian Krone	$ (Kr per $)	8.87	9.05	9.24	8.68	8.00	7.54	7.37	6.88	6.60
	£ (Kr per £)	12.92	13.30	13.40	12.67	12.00	11.47	11.35	11.00	10.56
	€ (Kr per €)	9.66	9.50	9.70	9.20	8.80	8.60	8.55	8.25	8.25
Swedish Krona	$ (Kr per $)	8.51	8.95	8.81	8.68	8.32	7.98	7.80	7.58	7.28
	£ (Kr per £)	12.39	13.16	12.77	12.67	12.48	12.13	12.01	12.13	11.65
	€ (Kr per €)	9.26	9.40	9.25	9.20	9.15	9.10	9.05	9.10	9.10
Swiss Franc	$ (F per $)	1.00	1.03	1.04	1.04	1.01	0.98	0.97	0.96	0.96
	£ (F per £)	1.45	1.51	1.51	1.52	1.51	1.49	1.50	1.53	1.54
	€ (F per €)	1.09	1.08	1.09	1.10	1.11	1.12	1.13	1.15	1.20

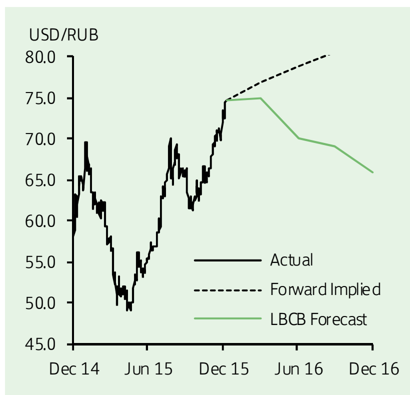
Source: Bloomberg, LBCB

Fundamental Views – BRIC FX



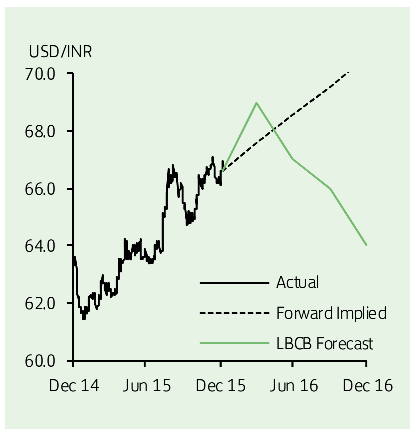
USD/BRL

The Brazilian real has followed most other currencies lower against the USD with USD/BRL breaking above 4 in early January. A retest of last September's high of 4.24 cannot be ruled out in the short term as Brazil struggles with twin fiscal and current account deficits. Immediate focus remains on the lack of political cohesiveness to tackle a fiscal deficit, which ballooned to 9.3% of GDP in the 12 months through November last year. This is made only harder by the Brazil's deep recession and elevated interest rates. remain elevated. High inflation has made it impossible for the central bank to reduce interest rates, which are already at 14.25%. Meanwhile, the capacity to further raise interest rates is also limited by the high debt levels. Unless the Brazilian government addresses the current fiscal situation, the central bank remains hamstrung in terms of what it can do to support the BRL. That, alongside further Fed policy tightening this year, suggests that the BRL is likely to be on the back foot against the USD for much of this year.



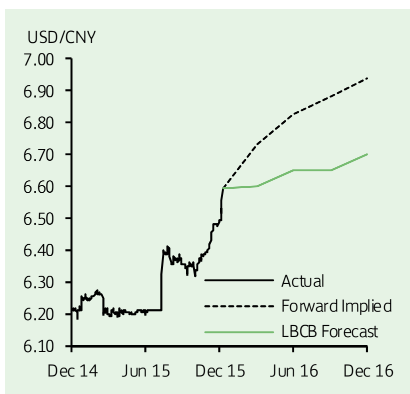
USD/RUB

USD/RUB continued its upward trend over the past month restoring its December 2014 highs. Although we forecast crude oil prices to improve in 2016, that will not be sufficient to either balance Russia's fiscal budget or address deterioration in its current account surplus as a % of GDP this year. High inflation has eroded real domestic incomes with Russia's GDP expected to fall by 0.9% in 2016 – a second consecutive year of contraction. Russia's central bank cut interest rates sharply during the first half of 2015 and further cuts are expect in H2 2016. Meanwhile, long-term investment potential has also been dealt a blow by recent geopolitical events. This combined with declining working age population and lack of domestic reforms suggests that potential growth over the next decade will be far weaker than it has been over the past 10 years. These factors suggest that any crude oil related move downwards in USD/RUB this year will likely be limited.



USD/INR

USD/INR has traded in a tight range of 66.08-67.12 over the past month, proving relatively resilient to both recent geopolitical developments and Fed policy tightening. In addition, it has been a big beneficiary of lower crude oil prices, which have helped to drastically narrow India's current account deficit. Lower external vulnerability suggests that domestic developments will be a key driver behind INR moves. One key factor behind exchange rate stability has been the central bank's vigilance around inflation. The central bank kept interest rates on hold at 6.75% in December after reducing its key policy rate by 50 bps in September. In addition, it has further relaxed capital controls to attract increased portfolio investment. Those, alongside government reform efforts to boost growth and attract foreign investment, have all been supportive of the INR and point to modest INR gains in the future. While recent economic data have been relatively positive, questions marks still remain around India's long-term growth potential, particularly due to underinvestment in infrastructure.



USD/CNY

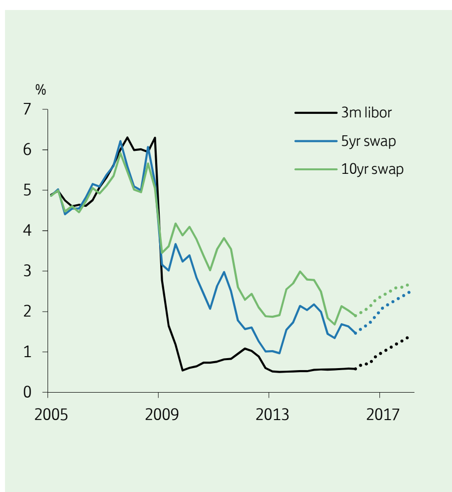
The New Year has ushered in further CNY weakness against the USD with the currency at its lowest levels against the USD since 2011. A record spread between onshore CNY and off-shore CNH implies that further depreciation may be on the cards. Evidence of PBoC intervention to stabilise the exchange rate suggests that shock depreciation similar to that experienced last August remains off the cards. Weaker-than expected survey data from China for December and a sharp fall in domestic equities have sparked renewed concerns that China's economy may once again be floundering. China, however, has ample room for additional stimulus, not only through monetary policy easing but also increased government spending. Nevertheless, China's exports as a share of GDP were estimated at 22% in 2014, important enough to make external exchange rate competitiveness an important area of focus for the PBoC. Therefore, we expect a gradual pace of CNY depreciation to continue against the USD.

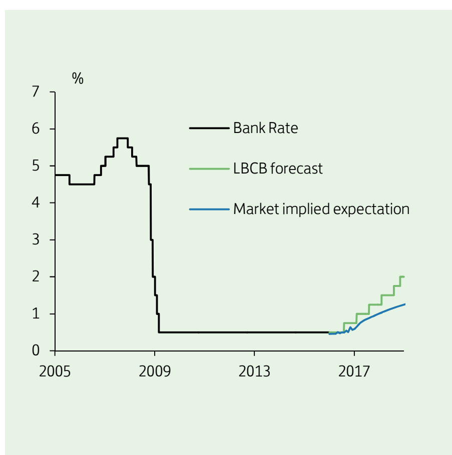
Key EM Currency Forecasts

		Current	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Brazlian Real	$	4.01	4.10	4.15	4.15	4.00	3.90	3.85	3.80	3.80
	£	5.85	6.03	6.02	6.06	6.00	5.93	5.93	6.08	6.08
	€	4.36	4.31	4.36	4.40	4.40	4.45	4.47	4.56	4.75
Russian Rouble	$	75.4	75.0	70.0	69.0	66.0	62.0	60.0	59.0	55.0
	£	110.0	110.3	101.5	100.7	99.0	94.2	92.4	94.4	88.0
	€	82.0	78.8	73.5	73.1	72.6	70.7	69.6	70.8	68.8
Indian Rupee	$	66.8	69.0	67.0	66.0	64.0	60.0	60.0	59.5	59.0
	£	97.3	101.4	97.2	96.4	96.0	91.2	92.4	95.2	94.4
	€	72.8	72.5	70.4	70.0	70.4	68.4	69.6	71.4	73.8
Chinese Renminbi	$	6.57	6.60	6.65	6.65	6.70	6.80	6.60	6.40	6.45
	£	9.59	9.70	9.64	9.71	10.05	10.34	10.16	10.24	10.32
	€	7.16	6.93	6.98	7.05	7.37	7.75	7.66	7.68	8.06
Czech Koruna	$	24.8	25.7	25.7	25.5	24.5	22.8	22.4	20.8	20.0
	£	36.2	37.8	37.3	37.2	36.8	34.7	34.5	33.3	32.0
	€	27.0	27.0	27.0	27.0	27.0	26.0	26.0	25.0	25.0
Hungarian Forint	$	291.5	294.3	292.4	289.6	274.5	263.2	258.6	249.2	239.2
	£	425.4	432.6	424.0	422.8	411.8	400.0	398.3	398.7	382.7
	€	317.4	309.0	307.0	307.0	302.0	300.0	300.0	299.0	299.0
Polish Zloty	$	4.01	4.05	4.00	3.92	3.73	3.55	3.45	2.92	3.00
	£	5.85	5.95	5.80	5.72	5.59	5.40	5.31	4.67	4.80
	€	4.37	4.25	4.20	4.15	4.10	4.05	4.00	3.50	3.75
Mexican Peso	$	17.80	17.00	17.00	16.90	16.30	16.00	16.00	16.00	16.00
	£	25.98	24.99	24.65	24.67	24.45	24.32	24.64	25.60	25.60
	€	19.38	17.85	17.85	17.91	17.93	18.24	18.56	19.20	20.00
South African Rand	$	16.58	15.80	15.70	15.65	15.60	15.00	14.80	14.50	14.00
	£	24.18	23.23	22.77	22.85	23.40	22.80	22.79	23.20	22.40
	€	18.05	16.59	16.49	16.59	17.16	17.10	17.17	17.40	17.50
Turkish Lira	$	3.02	3.05	3.03	3.00	2.99	2.95	2.90	2.85	2.80
	£	4.41	4.48	4.39	4.38	4.49	4.48	4.47	4.56	4.48
	€	3.29	3.20	3.18	3.18	3.29	3.36	3.36	3.42	3.50

Source: Bloomberg, LBCB

Fundamental Views – UK Interest Rates





UK POUND

Amid heightened global risk aversion, UK government bond markets have begun 2016 on a strong note. 10-year gilt yields have fallen by almost 20bp to around 1.80% since the turn of the year. The drop appears to have been driven by a combination of falling oil prices, heightened concerns about China and shifting perceptions about the timing of the first rise in UK interest rates. Forward money market rates now imply no rise in UK Bank Rate until Q1 2017, with only very gradual increases thereafter. Recent dovish comments from various Monetary Policy Committee (MPC) officials, including Martin Weale and Minouche Shafik, suggest that their perception of the balance of risks has shifted. The recent plunge in oil prices, signs of cooling wage growth, downward revisions to UK GDP growth and most recently heightened global asset price volatility, have no doubt weighed on their thinking.

Against this backdrop, the risk that the MPC continues to delay raising interest rates has risen. The policy outlook is further complicated by the uncertainty surrounding the timing and impact of a promised EU referendum. Still, if events unfold as we predict over the coming months, the case for a rise in interest rates later this year is likely to build. In particular, we believe the recent deterioration in global risk sentiment is largely overdone. On top of this, the continued tightening of the labour market and an anticipated rise in commodity prices suggest that there remains a reasonable case for nudging interest rates higher earlier than markets currently expect.

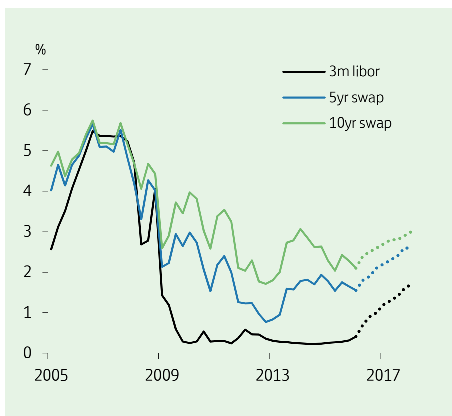
Given this, we maintain our view that UK interest rates will start to rise later this year but remain alert to any shift in the balance of risks. Over the coming month, we will be watching domestic and international events closely, in particular the February Inflation Report and PM Cameron's negotiations in Brussels. More generally, the MPC's narrative of 'limited and gradual' tightening continues to anchor expectations of the pace of interest rate hikes. Assuming an initial move in 2016, we expect a pace of tightening of 50bp per year, leaving Bank Rate at 1.25% at end-2017. As a result, sterling bond yields are expected to drift higher over the course of the year. We look for the 10-year gilt yield to rise from 1.8% currently to around 2.3% by the end of this year and 2.6% by end 2017.

Key Bond and Money Market Forecasts

		Current	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
GBP	Key Policy Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25
	3-month interbank rate	0.6	0.7	0.7	0.9	1.0	1.1	1.2	1.3	1.4
	2-year bond yield	0.5	0.7	0.9	1.1	1.3	1.4	1.5	1.6	1.7
	10-year bond yield	1.8	2.0	2.1	2.2	2.3	2.4	2.5	2.6	2.6
	5-year swap rate	1.4	1.6	1.7	1.9	2.1	2.2	2.3	2.4	2.5
	10-year swap rate	1.8	2.0	2.1	2.3	2.4	2.5	2.6	2.6	2.7
USD	Key Policy Rate	0.50	0.50	0.75	0.75	1.00	1.25	1.25	1.50	1.50
	3-month interbank rate	0.6	0.7	0.9	1.0	1.2	1.3	1.4	1.6	1.7
	2-year bond yield	1.0	1.1	1.3	1.5	1.7	1.7	1.8	2.0	2.1
	10-year bond yield	2.2	2.3	2.4	2.5	2.6	2.7	2.7	2.8	2.9
	5-year swap rate	1.6	1.8	1.9	2.1	2.2	2.3	2.4	2.6	2.6
	10-year swap rate	2.1	2.4	2.5	2.6	2.7	2.8	2.8	2.9	3.0
EUR	Key Policy Rate	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
	3-month euribor	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.1
	2-year bond yield	-0.4	-0.3	-0.3	-0.2	-0.2	-0.1	-0.1	0.0	0.0
	10-year bond yield	0.5	0.7	0.7	0.8	0.9	0.9	1.0	1.0	1.1
	5-year swap rate	0.3	0.3	0.4	0.5	0.6	0.7	0.7	0.8	0.9
	10-year swap rate	0.9	1.0	1.1	1.1	1.2	1.3	1.4	1.5	1.6

Source: Bloomberg, LBCB

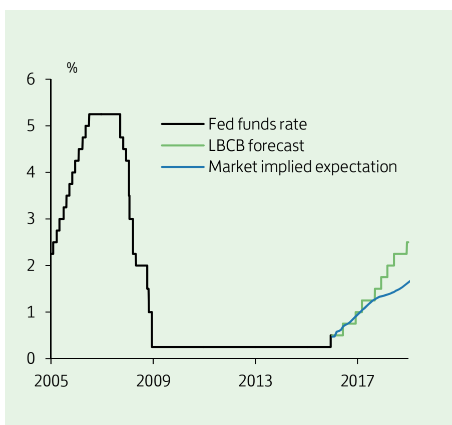
Fundamental Views – Interest Rates



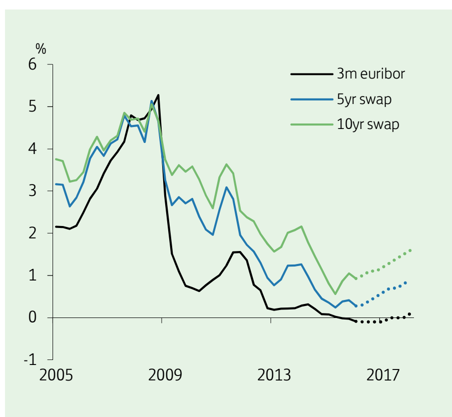
US DOLLAR

The US treasury market reacted relatively calmly to the decision of the US Federal Reserve to raise interest rates for the first time in nearly ten years last month. While 10-year treasury yields initially rose above 2.3% in an immediate response to the announcement, they have since fallen back towards 2.1%. The recent falls have occurred amid sharp declines in global equity markets, precipitated by China, and rising geopolitical tensions in the Middle East. US treasuries have been a key beneficiary of the rise in risk aversion. Meanwhile, the slide in oil prices has reinforced expectations that inflation will remain low.

Still, there remains much uncertainty surrounding the timing and extent of further interest rate increases. Although the Fed has signalled its intention to move rates back to levels that it regards as more 'normal', it is unclear exactly what this means. The forecasts of FOMC participants (the so-called 'dot plot') indicate that the majority of the FOMC expect a further four quarter-point increases this year – a view reinforced by recent comments by various Fed speakers. Despite this, forward money market rates imply that the market expects only two more quarter-point rises. In short, the market does not believe the Fed. How this 'gap' closes will be a key determinant of the performance of the US treasury market this year.



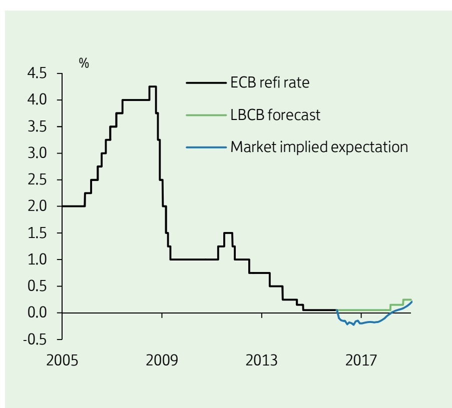
For now, our own central forecast is similar to that of the market. We expect only two quarter point interest rate increases this year, in June and December. We concede, however, that there remains a significant risk that the next move could occur earlier than this if the strength of the Q4 employment data continues into the New Year. Given the extreme market volatility, we have keep our central forecast unchanged for now, but stand ready to bring forward the next move to March if market conditions stabilise. We should have a much better sense of the Fed's near-term policy intentions from the press statement that follows the next FOMC meeting on 27th January. Such action could cause markets to reassess their expectations for both short- and longer-term interest rates. We forecast 10-year treasury yields to end 2016 at 2.6%.



EURO

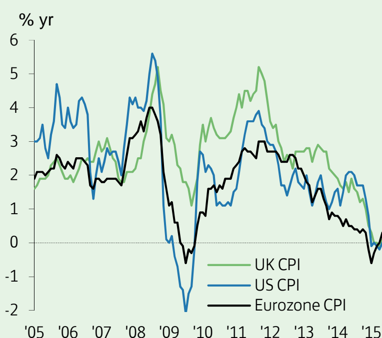
The key focus over the past month has been the broad disappointment to the ECB's QE extension, which pushed 2-year German government bond yields up by around 15bp in the immediate aftermath of the December meeting. Overall, however, the programme has been key in helping to reduce deflation risks, even while further falls in global oil prices have continued to weigh on headline inflation. Looking ahead, positive energy price base effects and the lagged impact of the weaker euro exchange rate should pull headline CPI inflation higher in 2016. The increase, however, will be gradual. The ECB's latest projections are for CPI inflation to average 1.0% and 1.6% in 2016 and 2017 respectively - pointing to a continued undershoot of the 2% target ceiling. Our view remains that the ECB's trajectory remains too optimistic and that the risks remain skewed to the downside.

Unlike the US and the UK, domestic price pressures in the euro area are likely to remain weak, given the greater degree of spare capacity. Euro area GDP growth slowed a little to 0.3%q/q in Q3, but the economy appears to have weathered the softening of global activity, helped by signs of strength in domestic demand. Nevertheless, the pace of overall growth remains moderate and questions remain over the extent to which this will feed through into higher inflation. As such, further easing remains a distinct possibility. While some Governing Council members have expressed concern that further monetary easing could delay the pace at which member states deliver structural reforms, any significant downturn in inflation expectations is likely to reduce such opposition. Possible options include a further reduction in the deposit rate, an extension to the QE programme beyond March 2017 and an increase in the pace of monthly purchases. Consequently, we forecast 2-year benchmark German bond yields to remain in negative territory throughout 2016. Meanwhile, 10-year yields are forecast to steadily trend higher over the course of the year, reaching 0.9% by end-2016 and 1.1% by end-2017.



Fundamental Views – Inflation

Inflation rates

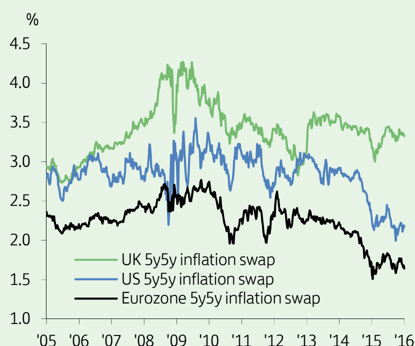


INFLATION TRENDS

Against a backdrop of equity market volatility and signs of a quickening pace of depreciation of the Chinese yuan, the mounting weakness of commodity prices is likely to retard the long-anticipated increase in headline inflation rates in developed markets. Starkly for the near-term disinflationary trend, oil prices are close to 12-year lows, lurching towards $30. Even so, the observed and impending declines in forecourt fuel prices will face challenging comparisons with the sharp declines last year. As such, their main effect should, for now, merely limit the upward push from expected energy base effects. There are already signs of this. While Eurozone inflation has recovered from its recent shallow deflation to 0.2% y/y in December, the pickup has been more modest than anticipated. US headline CPI inflation has also risen in the most recent data, accelerating to 0.5% y/y in November – with trends in 'core' inflation remaining much more resilient – but December's further pickup could likewise prove muted. Overall, while energy base effects should still raise global inflation rates, the extent of the pickup over the next year will be subject to how persistent the recent oil price weakness proves. The anticipation of a prolonged softening has likely underpinned the recent dip in market-based measures of inflation expectations. Meanwhile, evidence of a pronounced pickup in underlying inflationary pressures remains unconvincing – even in the US, where the FOMC expressed 'reasonable confidence' about inflation trends to justify the first policy tightening since 2006.

Global commodity price influences will also play out in UK inflation trends. CPI inflation in November re-emerged from 2015's second bout of shallow deflation, reaching 0.1% y/y. Inflation is still likely to grind higher over 2016 Q1, as energy-related base effects impart an upward push. But in the absence of a marked recovery in oil prices inflation will struggle to be within reach of 1% before 2016 Q4. This is despite gradually firming readings on 'core' inflation, rising to 1.2% in November, which should be supported by the recent softening in sterling. Moreover, confidence that the uptrend in UK inflation is firmly embedded is being called into question by more ambiguous evidence of rising domestic cost pressures. Notably, the ongoing tightening of the UK labour market is not feeding through to wage growth as quickly as expected. Moreover, growth in unit labour costs – taking account of the economy's productivity gains – eased to 2.0% y/y in 2015 Q3 from 2.2% in Q2, seemingly deferring the pickup of underlying cost pressure. Overall, we continue to expect inflation to return slowly towards the 2% target over the next three years, as a gradual firming of 'core' inflation manages to offset falling energy and food prices.

Inflation Expectations



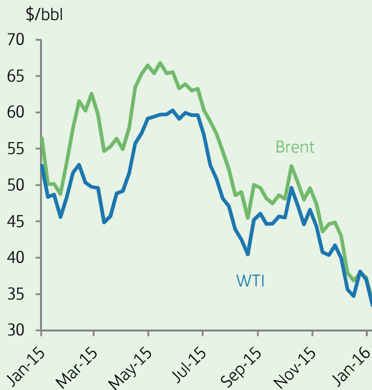
INFLATION OUTLOOK

		Avg since '97	Latest	Period	'15 Q4	'16 Q1	'16 Q2	'16 Q3	'16 Q4	'17 Q1	'17 Q2	'17 Q3	'17 Q4
GBP	CPI inflation %	2.0	0.1	Nov-15	0.1	0.5	0.6	0.7	1.0	1.3	1.5	1.7	1.9
	Core CPI inflation %	1.6	1.2	Nov-15	1.2	1.4	1.5	1.5	1.4	1.5	1.7	1.8	1.9
	RPI inflation %	2.8	1.1	Nov-15	1.0	1.5	1.6	1.9	2.2	2.7	3.0	3.1	3.3
	RPI index level		259.8	Nov-15	260.0	260.2	262.7	264.3	265.7	267.3	270.5	272.5	274.4
	CPI-RPI wedge	0.8	1.0	Nov-15	0.9	1.0	1.1	1.2	1.2	1.4	1.4	1.4	1.4
	Sterling EER	93.3	89.7		92.2	92.5	91.2	91.2	91.4	90.3	90.4	91.7	89.1
	Brent crude (£)	35.2	22.0		28.5	25.2	24.1	30.8	36.7	40.8	42.2	41.9	43.8
USD	CPI inflation %	2.2	0.5	Nov-15	0.4	1.2	0.9	1.1	1.5	2.1	2.1	2.1	2.1
	Core CPI inflation %	2.0	2.0	Nov-15	1.9	1.8	2.0	2.0	2.0	2.1	2.1	2.1	2.1
	PCE deflator %	1.8	0.4	Nov-15	0.4	1.0	0.9	1.1	1.6	1.9	1.9	1.9	1.9
	Core PCE deflator %	1.7	1.3	Nov-15	1.4	1.6	1.6	1.7	1.9	1.9	1.9	1.9	1.9
EUR	HICP inflation %	1.8	0.2	Dec-15	0.2	0.5	0.5	0.9	1.4	1.6	1.6	1.5	1.5
	Core HICP inflation %	1.4	0.9	Dec-15	0.9	1.0	1.1	1.0	1.3	1.4	1.4	1.4	1.4

Source: Bloomberg, Haver Analytics, LBCB

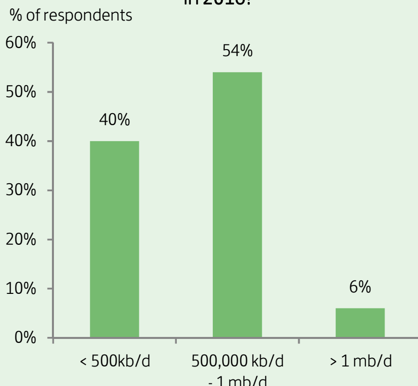
Crude Oil

Crude oil prices fall further



Recent survey underpins Iran uncertainty

How much will Iranian production add in 2016?



OPEC medium-term demand forecast

Increased concern over demand from China in early January drove crude oil prices to their lowest levels since 2003/4. Weaker-than-expected Chinese PMI data, combined with a sharp fall in domestic equities and CNY depreciation overshadowed any positive impact on prices from rising geopolitical risk in the Middle East. Typically events such as rising tensions between Saudi Arabia and Iran, two major global suppliers of crude oil, would have pushed crude oil prices higher. The absence of any price response suggests that without a direct interruption to crude oil production, recent developments are unlikely to have any material effect on markets. Instead, near-term focus in the region is anticipated to fall on the lifting of Iranian crude oil sanctions, possibly by the end of January – faster than previously anticipated. Based on these recent developments we have revised downwards our Brent and WTI forecasts. Brent and WTI are forecast to average $55/bbl and $54/bbl in Q4 2016, respectively, compared with $68/bbl and $62/bbl previously.

Nevertheless, there is a case for crude oil prices to move higher from recent levels by year end. Non-OPEC supply is expected to fall by c. 600 kb/d in Q4 2016 from Q4 2015 levels, largely due to declining US production. Demand growth of c. 1.2 mb/d this year should help elevate immediate oversupply and lead to an eventual drawdown in global crude oil inventories by year end. This even when incorporating the possibility of increased supply from Iran. The price outlook in the short term, however, remains highly uncertain, reinforced by levels of volatility not seen in the crude oil price since the financial crisis. Many of the questions that plagued crude oil markets last year remain unanswered: in particularly: 1) how fast and at what price could US shale production once again pick up after peaking last year; 2) will US dollar strength gradually ebb as the Fed tightens policy; 3) how will OPEC's policy to maximise production play out given recent geopolitical developments; and 4) how will Chinese demand react to evidence of a recent slowdown in activity or the possibility of a hard landing for the economy.

While the short-term risks to our forecast are large, we have greater confidence that prices will move higher in the longer term. Following a 30% reduction in capex levels by global exploration and production companies in 2015, we expect at least another 20% reduction this year and possibly more if prices stay lower for longer. Over the medium term this should help guarantee that the current supply overhang is alleviated. OPEC estimates that crude oil supply will exceed supply by only 200 kb/d in 2017, effectively bringing the market back into balance. In addition, the marginal cost of supplying global crude oil demand at above 95.9 mb/d after 2017, even considering recent cost reductions, is likely to hover near $70/bbl or higher. A better longer-term supply/demand balance should start to filter through to global crude prices towards the close of 2017. Hence, we forecast Brent Crude oil to average $70/bbl in Q4 2017 with our fair value estimate at $80/bbl.

FORECASTS

	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2016 (avg)	2017 (avg)
$/bbl (average)										
Brent	37	35	45	55	62	65	67	70	43	66
WTI	35	34	44	54	60	63	65	68	42	60

Source: Bloomberg, LBCB 8/1/15

Appendices

MAIN UK ECONOMIC INDICATORS

	2015	2016	2017	FORECAST 2015	2016				2017			
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Annual % changes, unless stated otherwise												
GDP (Q/Q)	--	--	--	0.6	0.6	0.6	0.5	0.5	0.6	0.5	0.6	0.6
GDP	2.2	2.2	2.2	2.0	2.2	2.2	2.3	2.2	2.2	2.2	2.2	2.3
Consumer spending	2.9	2.8	2.4	3.1	3.0	3.0	2.7	2.6	2.7	2.4	2.3	2.3
Fixed investment	4.4	3.7	4.0	4.4	4.3	3.4	3.5	3.4	3.7	4.0	4.1	4.1
- of which business investment	6.4	4.1	3.8	7.2	5.3	4.8	3.2	3.0	3.2	3.8	4.1	4.1
Government spending	1.6	0.6	0.0	1.9	1.5	0.6	0.1	0.4	0.3	0.1	0.0	-0.3
Domestic demand	2.4	2.3	2.2	2.2	1.4	3.1	2.3	2.4	2.4	2.2	2.1	2.1
Exports	5.5	3.2	4.3	3.2	3.9	2.0	3.3	3.6	4.1	4.3	4.4	4.5
Imports	5.8	3.5	4.1	3.9	1.4	5.0	3.4	4.2	4.6	4.3	4.0	3.6
Real h'hold disposable income	3.1	2.9	2.7	2.0	3.5	2.6	2.6	3.0	3.0	2.7	2.6	2.6
Saving ratio (% of household income)	4.4	4.3	4.6	3.8	4.3	4.4	4.3	4.2	4.6	4.7	4.6	4.5
ILO Unemployment rate (%)	5.4	5.1	5.0	5.2	5.2	5.1	5.1	5.0	5.0	5.0	5.0	5.0
Whole economy avg earnings	2.5	2.4	4.1	1.9	2.0	2.1	2.5	3.2	3.9	4.1	4.2	4.3
CPI	0.0	0.7	1.6	0.1	0.5	0.6	0.7	1.0	1.3	1.5	1.7	1.9
RPI	1.0	1.8	3.0	1.0	1.5	1.6	1.9	2.2	2.7	3.0	3.1	3.3

Source: Bloomberg, LBCB

KEY MACROECONOMIC FORECASTS FOR OUR G10 & E10 GROUPINGS

	GDP growth %			CPI inflation %		
	2015e	2016f	2017f	2015e	2016f	2017f
World	**3.0**	**3.4**	**3.7**	**2.9**	**3.5**	**3.7**
G10	**1.9**	**2.2**	**2.3**	**0.3**	**1.1**	**2.0**
US	2.4	2.7	2.8	0.1	1.2	2.1
Japan	0.6	1.3	1.0	0.7	0.5	2.1
Germany	1.5	1.9	1.9	0.1	0.9	1.9
UK	2.2	2.2	2.2	0.0	0.7	1.6
France	1.1	1.5	1.7	0.1	1.1	1.6
Italy	0.7	1.3	1.4	0.1	0.5	1.3
Spain	3.2	2.8	2.4	-0.6	0.9	1.7
Canada	1.1	1.7	2.1	1.2	1.8	2.0
South Korea	2.5	3.0	3.3	0.6	1.3	2.2
Australia	2.3	2.5	2.7	1.6	2.2	2.5
Euro Area	1.5	1.8	1.9	0.0	0.8	1.6

	GDP growth %			CPI inflation %		
	2015e	2016f	2017f	2015e	2016f	2017f
E10	**4.1**	**4.4**	**4.7**	**4.3**	**3.8**	**3.8**
China	6.9	6.3	5.8	1.5	1.8	2.2
Brazil	-3.1	-2.0	0.9	8.8	7.2	6.2
India	7.3	7.4	7.2	5.0	5.5	5.6
Russia	-4.0	-0.8	1.2	15.1	7.1	5.6
Mexico	2.3	2.9	3.3	2.9	3.4	3.5
Turkey	2.9	2.9	3.4	7.8	7.4	6.3
Poland	3.5	3.7	3.8	-0.6	1.5	2.4
Indonesia	4.8	5.3	5.8	6.7	4.9	4.4
Thailand	2.5	3.2	3.5	-0.9	0.9	2.5
South Africa	1.5	1.8	2.4	4.7	6.0	5.7

Source: Bloomberg, LBCB

US (Yr % chg unless stated)	2015e	2016f	2017f
Real GDP	2.4	2.7	2.8
Household consumer spending	3.2	3.0	2.8
Fixed Investment	3.8	4.6	4.7
Government consumption	0.4	0.8	0.4
Exports	1.6	3.0	5.0
Imports	5.1	3.8	4.2
Unemployment rate (%, Q4)	5.3	4.5	4.0
CPI	0.1	1.2	2.1
Current account % GDP	-2.5	-2.5	-2.0

Euro zone (Yr % chg unless stated)	2015e	2016f	2017f
Real GDP	1.5	1.8	1.9
Household consumer spending	1.7	1.6	1.6
Fixed Investment	2.2	2.6	3.1
Government consumption	1.5	1.6	1.2
Exports	4.8	3.5	4.1
Imports	5.2	3.9	4.1
Unemployment rate (%, Q4)	10.5	10.1	9.7
CPI	0.0	0.8	1.6
Current account % GDP	3.1	3.3	3.1

Source: Bloomberg, LBCB

Key Economic and Political Calendar

2016

Country	Date	Event
UK	tbc	EU Referendum (possible)
UK	tbc	Budget
UK	tbc	Autumn Statement

JANUARY

Country	Date	Event
UK	14	BoE MPC announcement
CA	20	BoC interest rate decision
UK	21	ECB rate decision
US	27	FOMC rate decision
NZ	28	RBNZ interest rate decision
JN	29	BoJ interest rate decision

FEBRUARY

Country	Date	Event
US	1	Iowa caucus
AU	2	RBA interest rate decision
UK	4	BoE MPC announcement + Inflation Report
US	9	New Hampshire primary
EU	18/19	EU Summit

MARCH

Country	Date	Event
AU	1	RBA interest rate decision
US	1	Super Tuesday (various primaries)
NZ	9	RBNZ interest rate decision
CA	9	BoC interest rate decision
EZ	10	ECB rate decision
JN	15	BoJ interest rate decision
UK	17	BoE MPC announcement
NO	17	Norges Bank rate decision
SZ	17	SNB rate decision
US	16	FOMC rate decision + press conference

APRIL

Country	Date	Event
AU	5	RBA interest rate decision
CA	13	BoC interest rate decision
UK	14	BoE MPC announcement
EZ	21	ECB rate decision
NZ	27	RBNZ interest rate decision
US	27	FOMC rate decision
JN	28	BoJ interest rate decision

MAY

Country	Date	Event
AU	3	RBA interest rate decision
UK	5	Local elections
UK	12	BoE MPC announcement + Inflation Report
NO	12	Norges Bank rate decision
CA	25	BoC interest rate decision

JUNE

Country	Date	Event
EZ	2	ECB rate decision
AU	7	RBA interest rate decision
NZ	8	RBNZ interest rate decision
US	15	FOMC rate decision + press conference
JN	16	BoJ interest rate decision
UK	16	BoE MPC announcement
SZ	16	SNB rate decision
NO	23	Norges Bank rate decision

Source: Bloomberg, LBCB

JULY

Country	Date	Event
AU	5	RBA interest rate decision
CA	13	BoC interest rate decision
UK	14	BoE MPC announcement
US	18-21	Republican Convention (Cleveland, Ohio)
EZ	21	ECB rate decision
US	25-28	Democratic Convention (Philadelphia, Pennsylvan
US	27	FOMC rate decision
JN	29	BoJ interest rate decision

AUGUST

Country	Date	Event
AU	2	RBA interest rate decision
UK	4	BoE MPC announcement + Inflation Report
NZ	10	RBNZ interest rate decision

SEPTEMBER

Country	Date	Event
AU	6	RBA interest rate decision
CA	7	BoC interest rate decision
EZ	8	ECB rate decision
UK	15	BoE MPC announcement
SZ	15	SNB rate decision
JN	21	BoJ interest rate decision
US	21	FOMC rate decision + press conference
NO	22	Norges Bank rate decision
US	26	First Presidential Debate

OCTOBER

Country	Date	Event
AU	4	RBA interest rate decision
US	4	Vice President Debate
US	9	Second Presidential Debate
UK	13	BoE MPC announcement
US	19	Third Presidential Debate
CA	19	BoC interest rate decision
EZ	20	ECB rate decision
NO	27	Norges Bank rate decision

NOVEMBER

Country	Date	Event
JN	1	BoJ interest rate decision
AU	1	RBA interest rate decision
US	2	FOMC rate decision
UK	3	BoE MPC announcement + Inflation Report
US	8	Presidential election

DECEMBER

Country	Date	Event
CA	7	BoC interest rate decision
EZ	8	ECB rate decision
US	14	FOMC rate decision + press conference
UK	15	BoE MPC announcement
NO	15	Norges Bank rate decision
SZ	15	SNB rate decision
JN	20	BoJ interest rate decision

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