COMMERCIAL BANKING

INTERNATIONAL FINANCIAL OUTLOOK

AUGUST 2016

LLOYDS BANK

Contents

All historical data sourced from Bloomberg
All forecasts sourced from Lloyds Bank Commercial Banking (LBCB)
Data sourced 10th August 2016

Overview

Financial market review – past month

Six weeks on from the EU referendum, and some welcome stability has returned to UK financial markets. Having fallen by around 10% in the wake of the result, the pound appears to have found tentative support above €1.15 and around $1.30. Meanwhile, UK bond yields are near record lows and equity markets are buoyant. The FTSE 100 recently rose above 6,800 for the first time this year, from below 5,800 on the day of the referendum result. The more domestically focused FTSE-250 has also more than reversed its post-referendum losses. Corporate spreads have narrowed further as sterling bonds surged after the BoE unveiled its new corporate bond buying programme. In short, UK financial markets have held up remarkably well, and far better than many had initially predicted.

This is despite early signs pointing to a sharp slowdown in UK economic growth. The majority of business surveys since the referendum signal further declines in capital spending and hiring intentions. The July GfK consumer confidence survey and Markit composite purchasing managers' index posted their steepest falls for over twenty years. Nevertheless, surveys have not been uniformly weak, with the British Retail Consortium ("BRC") reporting firmer consumer appetite in July, while our own Business Barometer showed confidence swiftly rebounding. The implications of the referendum vote are expected to impact sectors and firms variably, with many companies reportedly revising their business plans and strategies.

The coming weeks will see the release of the first 'hard' data showing how the economy has actually performed since 23rd June. Previous periods of elevated economic uncertainty have typically been followed by a sharp slowdown in activity. Given the extent of the increase in uncertainty in recent weeks, we doubt this time will be any different. Although the first estimate of Q2 GDP showed the UK economy expanded by a solid 0.6% q/q, faster than in Q1 (0.4%), growth in H2 is likely to be materially weaker.

Given this, further policy stimulus could well be on the cards. After sanctioning a quarter point cut in Bank Rate, alongside other policy easing measures at its August meeting, the BoE held out the strong possibility of further action later in the year – possibly timed to coincide with some fiscal loosening in the Autumn Statement.

At the very least, the downside risks to UK growth and a likely prolonged period of economic uncertainty leave the pound and UK asset prices susceptible to future bouts of volatility. Meanwhile, the political backdrop also remains crucial. For now, however, sterling markets appear to have benefited from some fading of domestic political uncertainty following the appointment of new PM Theresa May.

International developments over the past month have been relatively benign. Across most markets, equity prices have risen and bond yields fallen, fuelled by an apparent continued surplus of global liquidity, mixed growth signals and further monetary stimulus or rising expectations of additional policy support.

Still, doubts are growing about whether central banks will or can continue to ride to the rescue. At its latest policy meeting, the Bank of Japan ("BoJ") surprised markets by keeping its policy rate unchanged at -0.1%, hinting that monetary policy may be near its effective limit. Instead, the focus seems to be shifting to fiscal policy, with PM Abe unveiling a Y28trn (5.6% of GDP) fiscal package. In the UK, the government appears under pressure to build on the BoE's efforts by unveiling some meaningful fiscal stimulus at the coming Autumn Statement. There is growing talk of a coordinated effort, with fiscal stimulus options an evolving theme in many countries.

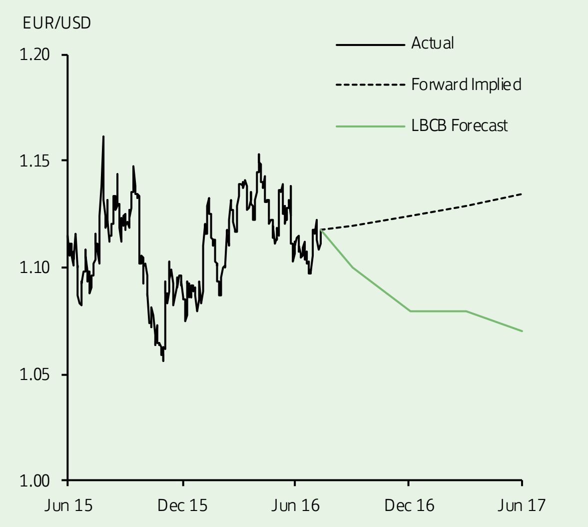
The two main US presidential candidates have fiscal policy in their sights, with infrastructure spending cited as a potential lever to support growth. At the same time, the Fed has left the door open for a further hike in interest rates by the end of the year. At its latest meeting it kept policy unchanged, but sounded slightly more hawkish despite softer-than-expected Q2 GDP. Recent strong payrolls outturns have raised market expectations and focus is sharpening on upcoming Fed communications later this month.

The continued divergence of monetary policy between the US and elsewhere, and the growing importance of fiscal policy tools, are likely to be key themes driving foreign exchange and interest rate movements over the coming year. The underlying picture looks likely to remain one of US dollar strength, although a lot of this policy divergence is already priced in. Still, the ECB and BoJ also look set to underline their dovish positions. However, the resilience of the US dollar could be tested if Donald Trump remains in serious contention for the Presidency.

Summary of forecast changes - this month

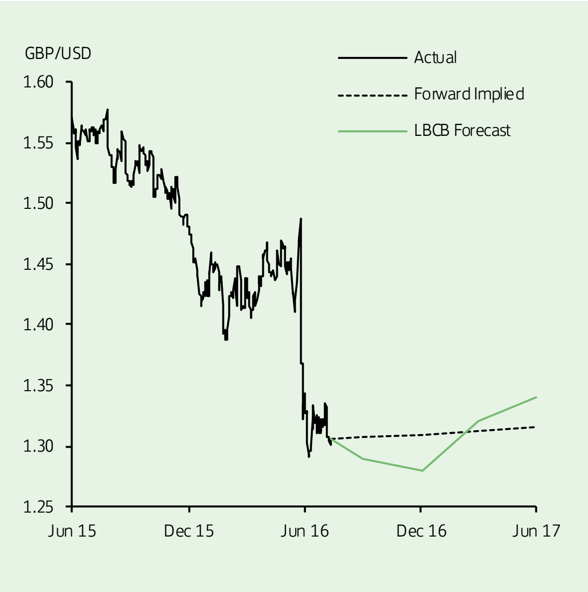
- In the wake of the UK referendum result, we see UK interest rates lower and staying lower for much longer. Bank Rate is predicted to fall to just 0.1% in November and remain at that level for at least the next two years. We believe negative policy interest rates are still highly unlikely.
- We maintain our expectation that US policy interest rates will rise in December. Given heightened global uncertainty and more mixed US data, we no longer expect a rise in September. However, Fed Chair Yellen's comments at the Jackson Hole Symposium and August payrolls will be watched closely.
- Key policy rates in the euro area and Japan are expected to remain unchanged, with the primary focus switching to the implementation and structure of other forms of stimulus.
- Given the sharp falls in recent weeks and more benign policy outlook, we have lowered our global government bond yield forecasts. We expect only a modest rise in 10-yr rates over the next twelve months, to 1.8% in the US and 0.7% in the UK.
- We have revised down our forecast for the sterling exchange rate. At year end, we forecast GBP/USD at 1.28 and GBP/EUR at 1.19. Our bearish bias on the yen has been reassessed in the context of lower global interest rates and a less aggressive BoJ.
- EM currencies have been the best performers against the USD, led by the SA rand and Brazilian real. While we remain broadly optimistic, some pullback appears increasingly justified.

Fundamental Views – G10 FX



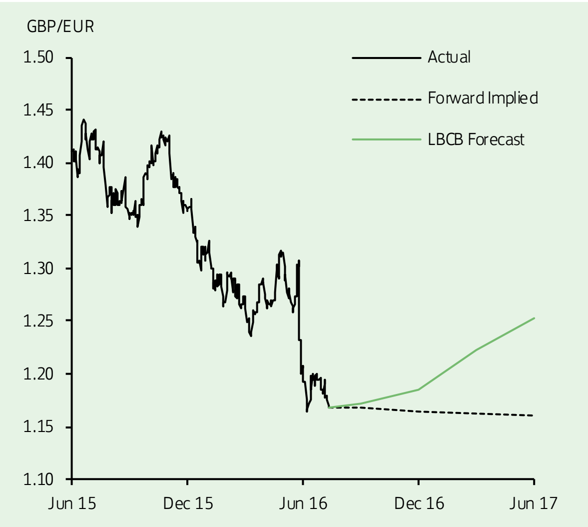
EUR/USD

Over the past few weeks, offsetting expectations around US and euro zone monetary policy have broadly left EUR/USD in a range between 1.0950 and 1.1250. While the prospect of a US rate hike this year has increased, post-EU referendum expectations around looser ECB policy have also been scaled back. Moreover, recent reports suggest that the impact of a UK exit from the EU may have a limited effect on the euro area economy. Thus far, surveys of economic sentiment have remained upbeat. Nevertheless, the recent decline in oil prices casts a further shadow on the inflation outlook, which we suspect is likely to prompt the ECB to extend its QE programme later this year, by a further six months to September 2017. Meanwhile, if as we expect, the US economy rebounds in the second half, jobs growth remains firm and inflation continues rising towards 2%, the Fed is likely to tighten policy before the end of the year. Based on these factors, we expect EUR/USD to drift lower, ending the year around 1.08.



GBP/USD

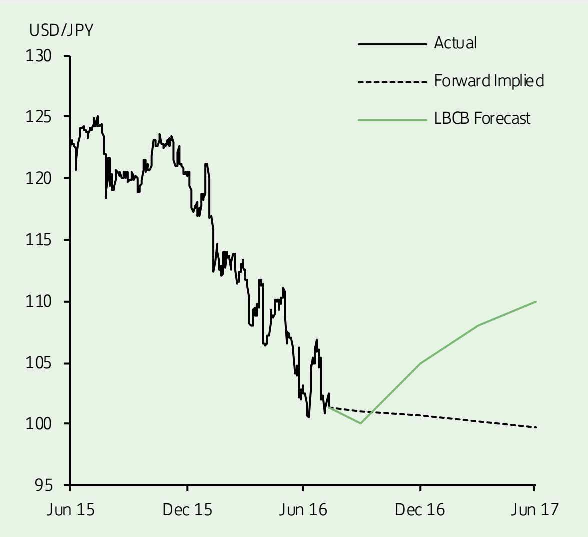
Having posted its sharpest one-day decline on record in the immediate aftermath of the UK EU referendum, GBP/USD has stabilised in recent weeks to trade within a 1.28-1.35 range. Accordingly, implied volatility and the relative cost of insuring against further declines in GBP/USD versus a similar sized rise has fallen back and is close to pre-referendum levels. Yet, GBP/USD remains significantly dislocated from valuations suggested by relative interest rate differentials alone, which point to around 1.38 - some 6% higher than the present level. In part, this divergence reflects continuing political uncertainty and the associated increase in risk premia since the referendum. The overarching uncertainty around the political outlook leaves sterling susceptible to significant bouts of volatility. Notwithstanding this, the limited scope for lower policy interest rates, however, points to less downside for GBP/USD. Near term, the US dollar could benefit from an increase in expectations of a US rate hike in 2016. Assuming a further decline in UK Bank Rate to 0.1% and a US rate hike in Q4, we forecast GBP/USD to edge lower towards 1.28 by year end. Thereafter, we expect GBP/USD to remain relatively range bound between 1.30 and 1.35 through 2017.



GBP/EUR

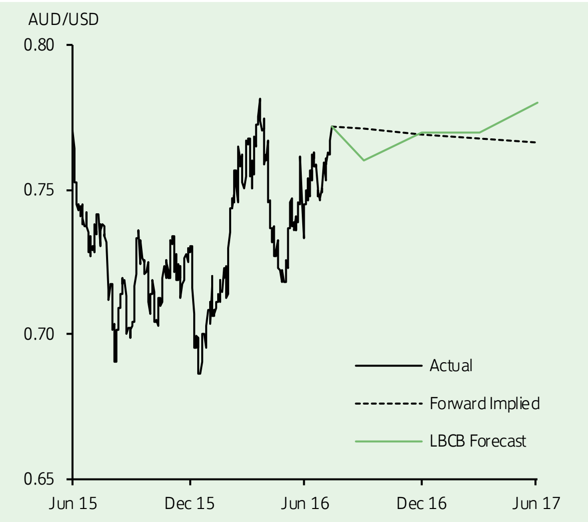
Our estimates suggest that the decline in GBP/EUR since the UK's EU referendum has left GBP approximately 10% undervalued. In part, this divergence reflects the rise in political uncertainty and the associated increase in risk premia since the referendum. While GBP/EUR pulled away from its recent low below 1.16, following Theresa May's appointment as prime minister, the overarching uncertainty over the domestic political outlook leaves sterling susceptible to bouts of volatility. More generally, however, the impact of the referendum on the rest of Europe, given forthcoming elections in the year ahead, suggests that the euro is also vulnerable. While the recently announced policy measures from the Bank of England argue for a weaker sterling, the strong likelihood of an extension to the ECB's QE programme suggests that the ECB's balance sheet will continue to expand at a more rapid pace than that of the Bank of England, which on a relative basis argues for higher GBP/EUR. Overall, we expect GBP/EUR to drift gradually higher towards 1.19 by year end, rising to 1.27 by the end of 2017.

Fundamental Views – G10 FX



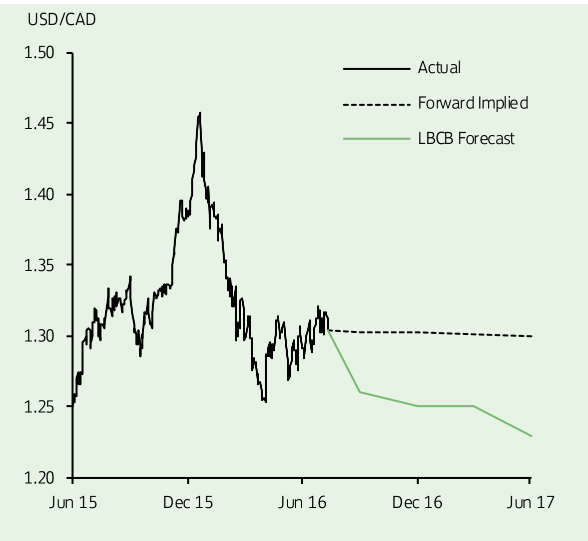
USD/JPY

The JPY has been among the most volatile of currencies after policy makers made notable changes to their fiscal and monetary stances. Most significantly, the Bank of Japan underwhelmed the market after delivering a modest stimulus package at July's meeting. It added just ¥3tn in ETF purchases to existing measures, while leaving both the policy rate and asset purchase target unchanged. USD/JPY collapsed from 105.50 to around 101. On the fiscal front, PM Abe announced a ¥28tn package (including over ¥13tn of "new" spending), designed to boost growth. Recent data supports the need for such action – inflation and inflation expectations are subdued; retail sales fell short of expectations and the manufacturing PMI remains in contractionary territory (below 50). Recent US non-farm payrolls data has also reignited the prospect of the Federal Reserve raising interest rates this year. Indeed, we forecast a 25bp hike in December. Given this, and the historically extreme long JPY positioning, there appears scope for USD/JPY upside in the short term. We forecast the pair to move back towards 105 by end-2016, and 110 by end-2017.



AUD/USD

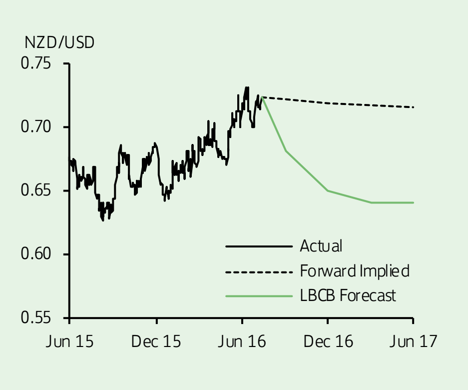
The Australian dollar barely reacted to the latest cut to policy interest rates by the Reserve Bank of Australia, which was triggered by a weak CPI print in July. AUD/USD initially declined to a month low below 0.75, but has subsequently recovered back above 0.76. Demand for AUD remains firm, in part because of country's strong credit rating (AAA), stable political environment and the high yield that Australia offers relative to other developed economies. These three factors are likely to be constructive for the AUD over our forecast period. This, despite the fact that economic data has softened slightly. Retail sales have disappointed, building approvals fell by more than anticipated and Australia's trade deficit has widened. Meanwhile, US data have firmed, with a strong July non-farm payrolls print (255k) solidifying our call for a December Fed hike. As such, we see the AUD/USD trading in a range for a protracted period, with a forecast of 0.77 for year-end and 0.80 for end-2017.



USD/CAD

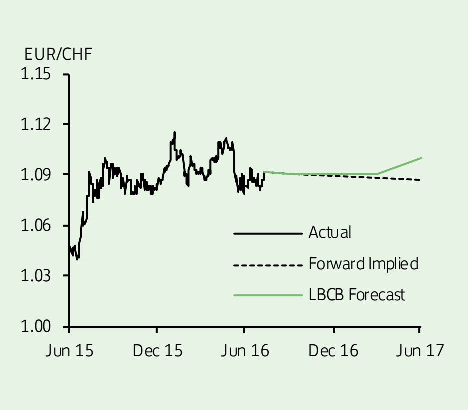
USD/CAD has rallied by around 4% since the UK's decision to leave the EU. In our opinion, this had less to do with risk sentiment, and more to do with shifting US interest rate expectations, lower crude oil prices and relatively weak Canadian economic fundamentals. Consensus expectations are that crude oil prices will move higher by year end. In turn, we expect a partial retracement in recent USD gains. In addition, global risk sentiment has stabilised through July and August. Still, consecutive US non-farm payrolls releases above 250k, highlights the "strength" of the US labour market referenced in the most recent FOMC statement. Concurrently, Canadian employment has underperformed expectations over the last two months, and significantly so in July. Furthermore, recent monthly Canadian GDP also disappointed. This may lead the BoC to consider cutting interest rates, although inflation, retail sales and manufacturing have proved more resilient thus far. As such, we see some room for CAD appreciation, and forecast USD/CAD to decline towards 1.25 by end-2016 and 1.22 by end-2017.

Fundamental Views – Other Developed Market FX



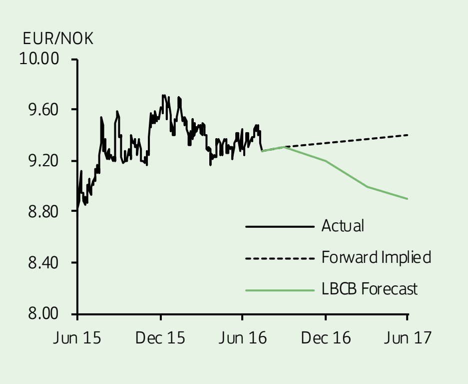
NZD/USD

NZD/USD has spent the recent weeks oscillating between 0.69 and 0.74 in response to shifting policy expectations around the Reserve Bank of New Zealand (RBNZ) and US Federal Reserve. For now, economic data from New Zealand have shown little sign of improvement. Two year inflation expectations are anchored near all-time lows at 1.65%. Meanwhile, earnings growth in Q2 was muted, diary prices (a key export market) remain under pressure and business confidence is subdued. Similarly, the outlook for global demand has weighed on the external outlook. As a result, the RBNZ is likely to retain an easing bias for monetary policy over the coming quarters. At the same time, we expect the US Fed to raise interest rates in December, earlier than the market is predicting. Our view on US interest rates is strengthened by the latest labour market data. Given policy divergence implications, we anticipate NZD/USD declining through the rest of the year, towards 0.65.



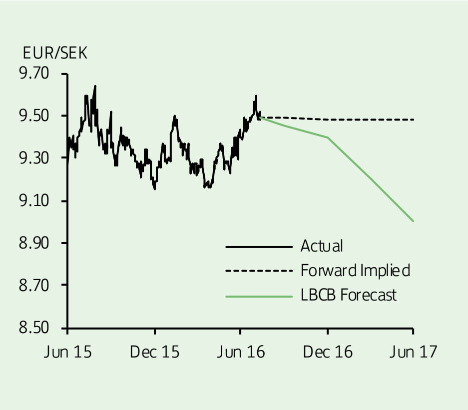
EUR/CHF

Elevated political uncertainty and the ensuing demand for safe-haven destinations has renewed upward pressure on the Swiss franc in recent weeks. This has led the Swiss National Bank (SNB) to intervene heavily in foreign exchange markets, and particularly so in the immediate aftermath of the UK's EU referendum. Since then, the continued rise in SNB's holdings of foreign currency reserves to a record high, suggests the central bank has remained active. With the deposit rate already at -0.75%, we suspect that the SNB will refrain from lowering interest rates further to weaken the exchange rate. Instead, we believe it will favour further currency intervention. This is likely to keep EUR/CHF trading within a fairly narrow range. We forecast the pair at 1.09 at year end before rising gradually to 1.11 by end 2017. However, more marked inflows into the Swiss franc could lead to a more aggressive approach from the SNB, most likely through a reduction in the level of domestic banks' reserves that are currently exempt from negative interest rates.



EUR/NOK

Since hitting a year-to-date high in early June, the steady decline in crude oil prices in recent weeks has been the key driver behind the fall in the Norwegian krone. Against the euro, the krone has weakened from 9.20 to around 9.40, having briefly touched above 9.50 in late July. Nevertheless, the flow of economic data has been encouraging, pointing to stabilisation in Norwegian activity. Although we expect oil prices to recover from the recent slump, these still historically low levels suggest that investment in the oil sector is likely to remain weak. Overall, we suspect this may prompt the Norges Bank to deliver one more rate cut, most likely at its meeting in September. The NOK is already priced to this outlook which is likely to keep EUR/NOK relatively range bound in the near term. Further out, however, fading expectations of further rate cuts, coinciding with a gentle recovery in oil prices supports our view for a decline in EUR/NOK to 9.20 by the end of the year and to 8.90 by mid-2017.



EUR/SEK

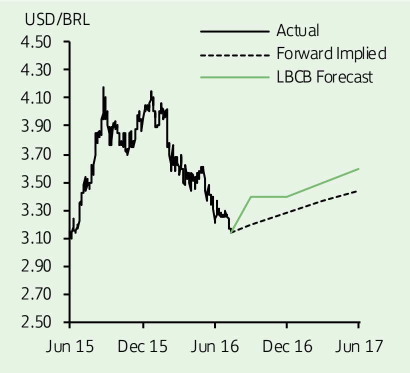
Excluding the pound, the Swedish krona has been the worst performing currency against the euro so far this year. While the move higher in EUR/SEK can partly be explained by the relative shift in interest rates, the weakness of the SEK looks overdone. For now, the fall in the currency and expected boost to inflation, is likely to be welcomed by the Riksbank, which continues to remain particularly sensitive to the outlook for inflation. Various policy officials have reiterated their commitment to deliver more easing. In our view, the bar to further easing remains high. Despite the pace of GDP growth softening in Q2, firmer activity is likely to prevail in the second half of the year. Moreover, long-term inflation expectations remain resilient. In the absence of a marked weakening in the inflation outlook, we believe the Riksbank is likely to refrain from further policy rate cuts. We forecast the EUR/SEK to decline to 9.40 by year end and to below 9.00 by mid-2017.

Developed Markets FX Forecasts

		Current	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
US Dollar	Dollar Index	95.6	96.3	98.1	98.0	98.5	99.4	98.2	97.1	95.3
	£ (£ per $)	0.77	0.78	0.78	0.76	0.75	0.75	0.74	0.74	0.72
	€ (€ per $)	0.89	0.91	0.93	0.93	0.93	0.94	0.93	0.93	0.91
UK Pound	$ ($ per £)	1.31	1.29	1.28	1.32	1.34	1.34	1.35	1.36	1.38
	€ (€ per £)	1.17	1.17	1.19	1.22	1.25	1.26	1.27	1.26	1.25
	Effective	78.0	78.0	78.4	80.9	82.6	83.2	83.9	83.3	83.5
Euro	$ ($ per €)	1.12	1.10	1.08	1.08	1.07	1.06	1.07	1.08	1.10
	£ (£ per €)	0.86	0.85	0.84	0.82	0.80	0.79	0.79	0.79	0.80
Japanese Yen	$ (¥ per $)	101	100	105	108	110	113	110	106	103
	£ (¥ per £)	132	129	134	143	147	151	150	144	142
	€ (¥ per €)	113	110	113	117	118	120	118	114	113
Australian Dollar	$ ($ per A$)	0.77	0.76	0.77	0.77	0.78	0.78	0.80	0.80	0.80
	£ (A$ per £)	1.69	1.70	1.66	1.71	1.72	1.72	1.70	1.70	1.73
	€ (A$ per €)	1.45	1.45	1.40	1.40	1.37	1.36	1.34	1.35	1.38
Canadian Dollar	$ (C$ per $)	1.30	1.26	1.25	1.25	1.23	1.23	1.22	1.22	1.21
	£ (C$ per £)	1.70	1.63	1.60	1.65	1.65	1.65	1.66	1.66	1.67
	€ (C$ per €)	1.46	1.39	1.35	1.35	1.32	1.30	1.31	1.32	1.33
New Zealand Dollar	$ ($ per NZ$)	0.72	0.68	0.65	0.64	0.64	0.63	0.63	0.62	0.61
	£ (NZ$ per £)	1.81	1.90	1.97	2.06	2.09	2.13	2.16	2.19	2.26
	€ (NZ$ per €)	1.55	1.62	1.66	1.69	1.67	1.68	1.70	1.74	1.80
Norwegian Krone	$ (Kr per $)	8.31	8.45	8.52	8.33	8.32	8.30	8.13	7.96	7.73
	£ (Kr per £)	10.85	10.91	10.90	11.00	11.15	11.12	11.06	10.83	10.66
	€ (Kr per €)	9.28	9.30	9.20	9.00	8.90	8.80	8.70	8.60	8.50
Swedish Krona	$ (Kr per $)	8.49	8.59	8.70	8.52	8.41	8.49	8.41	8.15	7.91
	£ (Kr per £)	11.09	11.08	11.14	11.24	11.27	11.38	11.44	11.08	10.91
	€ (Kr per €)	9.49	9.45	9.40	9.20	9.00	9.00	9.00	8.80	8.70
Swiss Franc	$ (F per $)	0.98	0.99	1.01	1.01	1.03	1.04	1.04	1.04	1.02
	£ (F per £)	1.28	1.28	1.29	1.33	1.38	1.39	1.41	1.41	1.41
	€ (F per €)	1.09	1.09	1.09	1.09	1.10	1.10	1.11	1.12	1.12

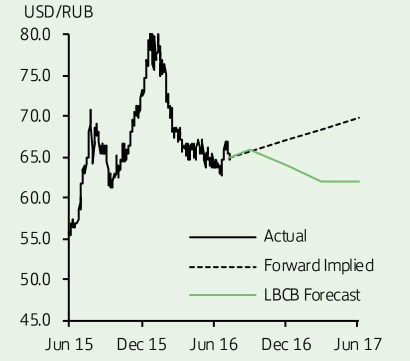
Source: Bloomberg, LBCB

Fundamental Views – BRIC FX



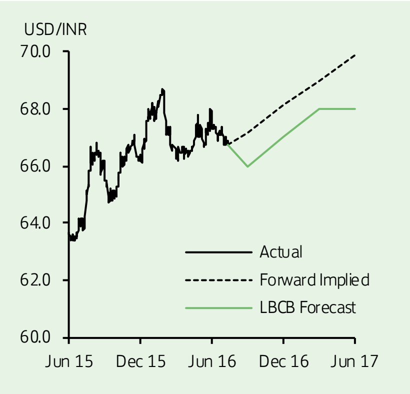
USD/BRL

Year to date the BRL is the best performing EM currency against the USD and may have strengthened further if it were not for central bank intervention. Fuelled by rising confidence that the current interim government can reverse Brazil's economic ails, USD/BRL has recently rallied to a year-to-date low of 3.15 versus a year-to-date high of 4.17 in January. Still, markets could yet be premature in their assessment as congressional approval is needed to address the ongoing fiscal issues. This is unlikely until impeachment proceedings against suspended President Dilma Rousseff are completed on August 29, a week after the conclusion of the Olympics in Rio de Janeiro. If passed, intervention efforts to stem further appreciation are likely to intensify, as the central bank balances the need for attractive yields to combat inflation against concerns that a stronger exchange rate could undermine an economy already in deep recession.



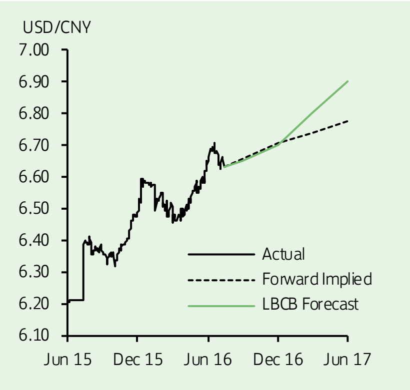
USD/RUB

Russia's short-term interest rates are the second highest amongst the eleven EM countries under our coverage. An attractive yield has helped to shield the ruble from lower crude oil prices over the past month. Yet, there are growing signs that the central bank is ready to slash interest rates. The sharp appreciation in the ruble since January has softened the outlook for inflation, while Russia's economy has been in contraction y/y for five consecutive quarters. Even ignoring the interest rate story, ruble upside appears limited in the future. A strong ruble makes balancing the government's finances more difficult, particularly in a low crude oil price environment. Similarly, the ruble's free float in December 2014 has likely led to a structural shift lower against the USD, given it is more vulnerable to shifts in global risk sentiment.



USD/INR

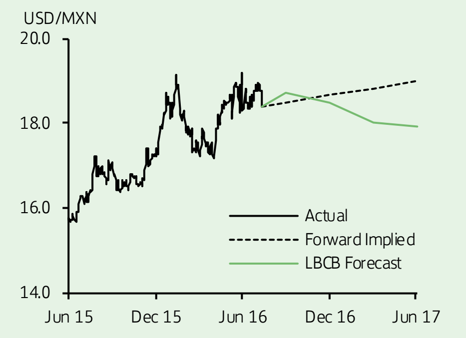
Apparent efforts to boost Indian exports and the imminent appointment of a new RBI governor have led us to revise upward our forecasts for USD/INR. Second only to the Chinese renminbi, the Indian rupee has been the most stable EM currency over the past year. In July, outgoing RBI governor Raghuram Rajan, whose term ends in September, commented that the Indian rupee looked fairly valued. Still, the rupee has strengthened against most Asian currencies enough to raise competiveness concerns from a number of Indian industries. Buckling under political pressure, the new RBI governor is likely to be more receptive to lower policy interest rates and a modestly weaker trade-weighted rupee exchange rate. For us, this translates into a relatively flat outlook for USD/INR. However, Rajan's legacy has been to enshrine an inflation targeting framework, which should limit strong upside pressure on USD/INR.



USD/CNY

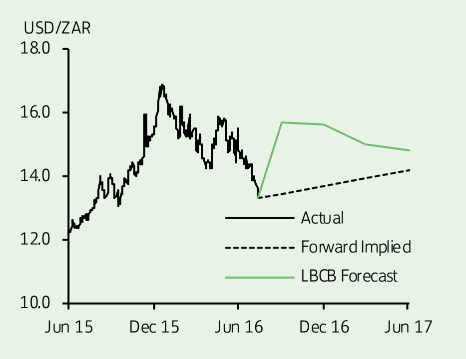
USD/CNY retraced from its multi-year high of 6.70 in July. Broad US dollar weakness over the past month has relieved pressure on the PBoC to devalue the yuan against a trade-weighted basket of currencies. China's foreign exchange reserve data for July suggest that the PBoC worked less hard to support the yuan. Domestic financial market stability, higher property prices and fledgling signs that real economic conditions have improved helped relieve capital outflow pressures. Equally, efforts by the PBoC to curb speculation against the yuan have also contributed to a more benign foreign exchange environment. Nevertheless, we see scope for further modest depreciation in the CNY against the USD. This is largely in order for China to retain external competitiveness, but also helps to accommodate further policy stimulus.

Fundamental Views – Other Emerging Market FX



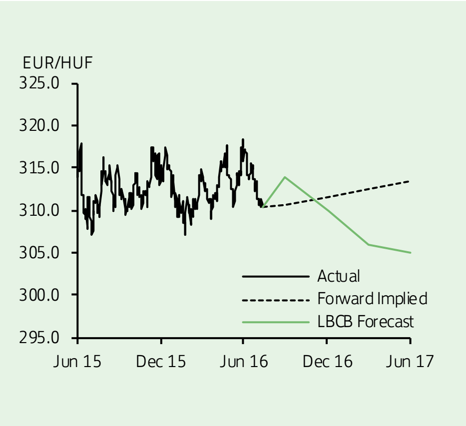
USD/MXN

The initial shock of the UK EU referendum result weighed heavily on the Mexican peso. USD/MXN hit a record high of 19.51 in June. As one of the most actively traded EM currencies, the peso is highly sensitive to shifts in global risk appetite. However, the peso has since found little benefit from the promise of more global stimulus, unlike other EM currencies, This, even after Banxico hiked interest rates by 50 bps in late June. Lower crude oil prices, sluggish industrial production activity in the US (to which Mexico's economy is highly linked) and uncertainty heading into the US presidential election have thus far kept the peso out of favour. If these headwinds fade, it would appear the peso has the opportunity to retrace some of its year-to-date losses.



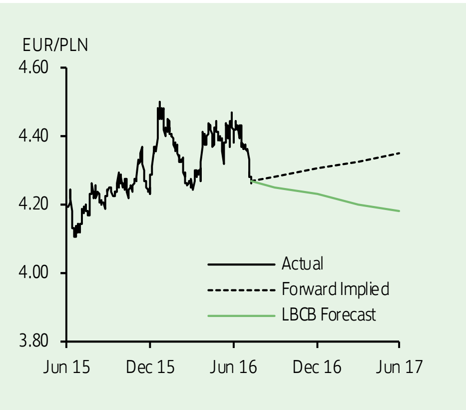
USD/ZAR

USD/ZAR has fallen from a historic high of 17.91 in January to completely retrace its losses since last December. However, for us, this looks more of an overshoot than reflective of a material improvement in the underlying prospects for the rand. The fact that much of the support for the rand has been driven by developments external to South Africa, such as signs of stability in China and higher base metals prices, supports our view of short-term overvaluation. There is, in our opinion, a significant risk that the external environment could again quickly prove highly negative for the rand due to its high external vulnerability. Under such circumstances, recent exchange rate levels would not be justified. There is still a great deal of speculation that South Africa will lose its investment grade credit rating sometime this year, reflecting concerns about the political and economic outlook.



EUR/HUF

After temporarily spiking higher in the aftermath of the UK EU referendum, EUR/HUF is back down towards the bottom of its year-to-date range of 306-322. At current levels, further verbal intervention by the central bank is increasingly likely in order to lift EUR/HUF. The Hungarian central bank has been reticent to cut interest rates, already near the zero bound, and left policy rates unchanged in July. However, the central bank is making greater use of its corridor in order to further bring down market interest rates. Other unconventional policy options are on the table, but any move is likely to be dwarfed by the size of the ECB's QE programme. The poor track record of other non-euro EU member states in managing their currencies lower against the euro suggests any EUR/HUF upside may be modest and short-lived. Even if the central bank further embraces unconventional policy measures, a structural improvement in Hungary's external trade position suggests limited upside to EUR/HUF.



EUR/PLN

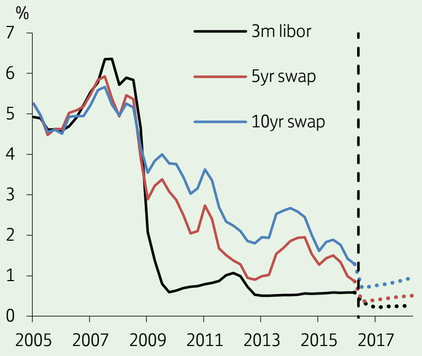
EUR/PLN has broken below 4.30 for the first time since April. The post UK EU referendum shock proved short lived (EUR/PLN spiked to 4.53). Focus, instead, has centered on domestic developments in Poland. Poland's ruling Law & Justice party policies have cast a cloud over the investment climate, but proposals unveiled this month around Swiss loan conversions suggest the government is taking a more pragmatic approach to domestic economic policy. Meanwhile, Poland's central bank seems in no rush to cut interest rates, despite negative inflation, leaving the zloty well supported. More so in terms of the euro, if the ECB upsizes its stimulus program. Still, the risks to our EUR/PLN forecasts remain on the upside. Political risk in Poland remains relatively lower than over the past couple of years and economic data of late have been mixed.

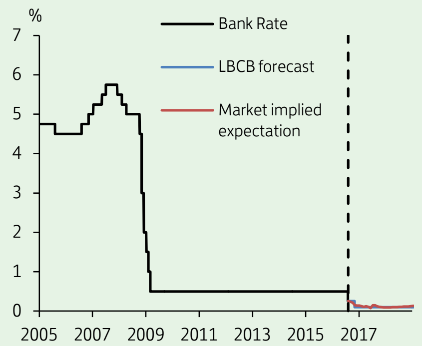
Key EM Currency Forecasts

		Current	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Brazilian Real	$	3.15	3.40	3.40	3.50	3.60	3.60	3.60	3.65	3.65
	£	4.11	4.39	4.35	4.62	4.82	4.82	4.90	4.96	5.04
	€	3.50	3.74	3.67	3.78	3.85	3.82	3.85	3.94	4.02
Russian Rouble	$	64.8	66.0	64.0	62.0	62.0	62.0	62.0	62.0	62.0
	£	84.6	85.1	81.9	81.8	83.1	83.1	84.3	84.3	85.6
	€	72.4	72.6	69.1	67.0	66.3	65.7	66.3	67.0	68.2
Indian Rupee	$	66.7	66.0	67.0	68.0	68.0	67.0	66.0	65.0	65.0
	£	87.1	85.1	85.8	89.8	91.1	89.8	89.8	88.4	89.7
	€	74.5	72.6	72.4	73.4	72.8	71.0	70.6	70.2	71.5
Chinese Renminbi	$	6.63	6.65	6.70	6.80	6.90	7.00	7.10	7.10	7.10
	£	8.66	8.58	8.58	8.98	9.25	9.38	9.66	9.66	9.80
	€	7.41	7.32	7.24	7.34	7.38	7.42	7.60	7.67	7.81
Czech Koruna	$	24.2	24.5	25.0	25.0	25.2	24.5	23.4	23.1	22.7
	£	31.6	31.7	32.0	33.0	33.8	32.9	31.8	31.5	31.4
	€	27.0	27.0	27.0	27.0	27.0	26.0	25.0	25.0	25.0
Hungarian Forint	$	277.7	285.5	287.0	283.3	285.0	278.3	271.0	268.5	263.6
	£	362.6	368.2	367.4	374.0	382.0	372.9	368.6	365.2	363.8
	€	310.3	314.0	310.0	306.0	305.0	295.0	290.0	290.0	290.0
Polish Zloty	$	3.82	3.86	3.92	3.89	3.91	3.92	3.83	3.70	3.64
	£	4.99	4.98	5.01	5.13	5.23	5.26	5.21	5.04	5.02
	€	4.27	4.25	4.23	4.20	4.18	4.16	4.10	4.00	4.00
Mexican Peso	$	18.39	18.70	18.50	18.00	17.90	17.80	17.70	17.60	17.60
	£	24.01	24.12	23.68	23.76	23.99	23.85	24.07	23.94	24.29
	€	20.55	20.57	19.98	19.44	19.15	18.87	18.94	19.01	19.36
South African Rand	$	13.31	15.65	15.60	15.00	14.80	14.50	14.00	14.00	14.00
	£	17.38	20.19	19.97	19.80	19.83	19.43	19.04	19.04	19.32
	€	14.87	17.22	16.85	16.20	15.84	15.37	14.98	15.12	15.40
Turkish Lira	$	2.95	3.00	3.05	3.10	3.20	3.30	3.30	3.40	3.50
	£	3.86	3.87	3.90	4.09	4.29	4.42	4.49	4.62	4.83
	€	3.30	3.30	3.29	3.35	3.42	3.50	3.53	3.67	3.85

Source: Bloomberg, LBCB

Fundamental Views – UK Interest Rates





UK POUND

The EU referendum result saw UK bond yields decouple from other developed market sovereign bond yields. From an eve-of-referendum level of 1.37%, 10-year gilt yields slipped by 44bp over the subsequent two sessions. Further downward impetus came in stages as the Bank of England began to set out the contours of its post-referendum policy response, and the first economic surveys of the post-referendum landscape began to bear out the extent of the UK's changed economic outlook. Having traded less than 20bp through US Treasuries in advance of the referendum, 10-year gilts by 10 August were around 100bp below, at a record low of 0.53%. Although anxiety around possible financial contagion effects of the referendum has so far proved to be a worry too far, US and Eurozone yields have not returned to their pre-vote levels.

The impact of the referendum was also immediately visible in UK short market interest rates. Pre-referendum perceptions of a possible hike in Bank Rate evaporated, and were replaced by expectations of an easing of policy – in short order vindicated by the Bank of England's multi-faceted policy package of 4 August. Having delivered a 25bp cut in Bank Rate – alongside an extension of its quantitative easing programme and a new Term Funding Scheme to help ensure the transmission of policy – Bank Rate is not expected to return to its previous level of 0.50% until around 2022, on prevailing market pricing. Near term, a further cut in Bank Rate is likely, with the Bank of England indicating that a majority on the MPC was in favour of cutting the rate to its 'effective' zero bound at the August meeting. While the BoE has so far carefully avoided specifying the precise level of this lower bound – beyond indicating that it judges it to be "close to, but a little above, zero" – our base scenario sees Bank Rate being eased to 10bp at November's policy meeting, alongside the next update of the Inflation Report projections.

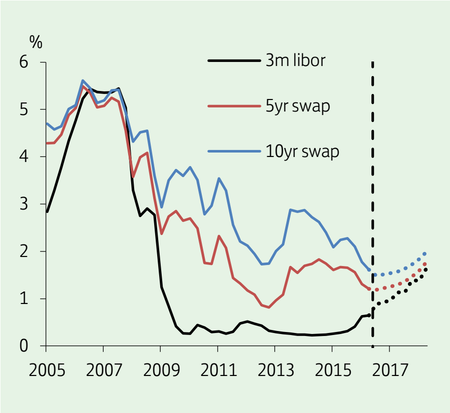
To be sure, the BoE's policy easing is so far based on a forecast of the post-referendum economic outlook made without the benefit of any 'hard' official data that post-dates the vote. The first such data – if past relationships with survey indicators observed since the referendum hold – are likely to see a marked deceleration of growth. As such, the hurdle to further easing is modest, in our view, with risks skewed towards further aggressive action if the economic outlook disappoints the BoE's expectations. That further pressure on UK monetary policy faces implementation challenges, however, with the BoE's QE planned purchases failing to elicit sufficient willing sellers on only the second day. Nevertheless, the expected gradual tightening in US policy is still likely to underpin some normalisation of global yields. This is also likely to impart some upward pressure on gilt yields, although we see the pace of normalisation as slow, reaching only 0.8% by end-2017.

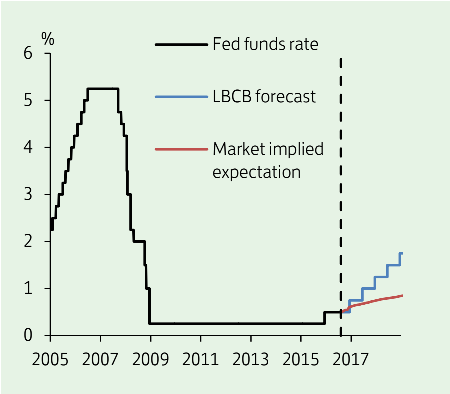
Key Bond and Money Market Forecasts

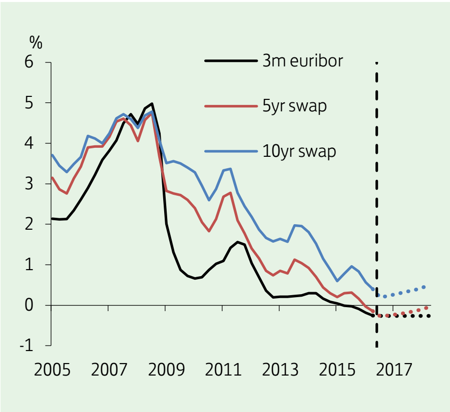
		Current	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
GBP	Key Policy Rate	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
	3-month interbank rate	0.4	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
	2-year bond yield	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2
	10-year bond yield	0.5	0.6	0.6	0.7	0.7	0.7	0.8	0.8	0.9	0.9
	5-year swap rate	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.5	0.5
	10-year swap rate	0.6	0.7	0.7	0.7	0.8	0.8	0.8	0.9	0.9	1.0
USD	Key Policy Rate	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50
	3-month interbank rate	0.8	0.9	0.9	1.0	1.1	1.1	1.4	1.4	1.6	1.6
	2-year bond yield	0.7	0.7	0.8	0.9	0.9	1.0	1.2	1.3	1.5	1.7
	10-year bond yield	1.5	1.6	1.7	1.7	1.8	1.8	1.9	2.0	2.1	2.3
	5-year swap rate	1.2	1.2	1.2	1.3	1.3	1.4	1.5	1.6	1.8	2.0
	10-year swap rate	1.4	1.5	1.5	1.5	1.6	1.6	1.7	1.8	2.0	2.2
EUR	Key Policy Rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	3-month euribor	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
	2-year bond yield	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5
	10-year bond yield	-0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.3
	5-year swap rate	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.1	0.0	0.0
	10-year swap rate	0.1	0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.5	0.6

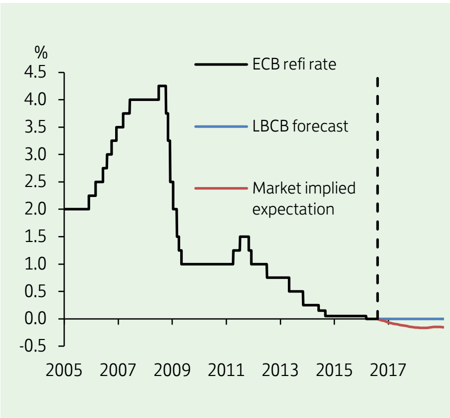
Source: Bloomberg, LBCB

Fundamental Views – Interest Rates









US DOLLAR

The US bond market has been volatile in recent weeks. Ten-year Treasury yields at one point traded as low as 1.32%, before rebounding above 1.60%. In contrast to many other central banks, the expectation remains that the next move in US policy rates will be up. Market-implied expectations of the timing and extent of any interest rate increases, however, continue to fluctuate. After a weaker-than-expected Q2 GDP growth rate the implied probability of a Fed rate hike by the end of 2016 fell to 36%. A stronger than expected July payrolls report, however, saw this pick up towards 50%.

We continue to expect that the Fed will raise interest rates before year end, probably at the December meeting. The July payrolls increase of 255k was the second successive monthly gain in excess of 250k, well above the average monthly increase over the last two years (224k). This suggests that the US labour market remains in good shape and that May's anaemic employment gain of only 24k was an anomaly. Even before the July data some Fed policymakers were arguing that an interest rate rise at the next September FOMC meeting was a possibility. With one more payrolls release due before then it is still possible that another strong report could induce a near-term policy move. Comments from other Fed officials, however, point to a more cautious approach. We believe it is more likely that the FOMC will wait until December. This would be after the presidential election. By that time there would also be clearer indications whether GDP growth has picked up in the second half of the year and whether inflation continues to edge up. We expect one rate rise of 0.25% this year, followed by two hikes in 2017.

This environment of gradual rises in policy rates is also likely to result in a further gradual increase in market interest rates. We expect yields to rise along the curve with 10-year yields rising to 1.7% by end 2016 and 1.9% by end 2017.

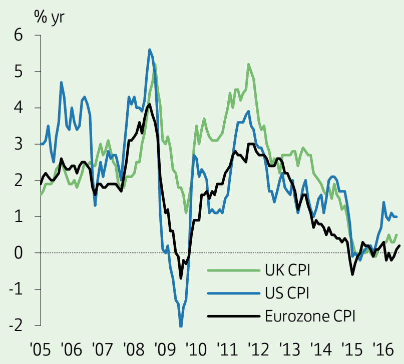
EURO

Following Q1's outsized 0.6% q/q gain, the pace of Euro area GDP growth eased in the second quarter to 0.3% q/q. Yet, the resilience of business surveys since the UK's EU referendum vote suggests that the Euro area has largely shrugged off the immediate impact of the referendum result. While the economic recovery looks set to continue at a moderate pace, the outlook for inflation remains a concern. Headline CPI inflation in July at 0.2% y/y remains well below the ECB's 2% target, while underlying inflation trends look weak, with core CPI (excluding food and energy) below 1.0% for the fourth consecutive month. This suggests that current low inflation in the Euro area cannot solely be attributed to weak energy prices. Indeed, the unemployment rate still remains in double digits at 10.1% and points to continued weak wage pressures, although it has come down from a peak of 12.1% over the past three years.

While Mr Draghi remained coy about the prospect of further easing at the July ECB meeting, updated staff forecasts in September could show downgrades to both GDP growth and inflation projections. The latest June economic projections pre-dated the UK referendum and Mr Draghi has indicated that the impact of the referendum result on Euro area GDP might be between 0.2-0.5% over three years. Moreover, a softer oil price assumption will also cast doubt on the expected pick-up in inflation. On balance, we expect the ECB to formally extend the end date of asset purchases by a further six months to September 2017. Announcements of how it may tweak the rules to increase the universe of German bonds eligible for asset purchases may also be made later in the year – this includes the possible removal of the deposit rate floor or raising individual issue limits. A further cut in the deposit rate is also possible, but our base case is for it to remain at -0.4%. More controversially, the ECB may consider changes to the capital key to reduce the proportion of German bonds that it buys in the future.

Fundamental Views – Inflation

Inflation rates



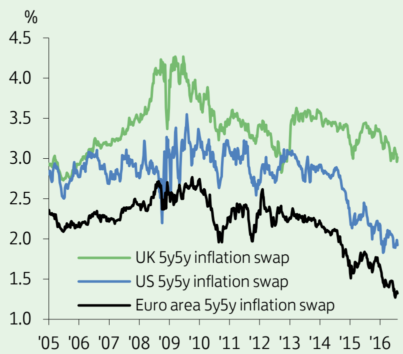
INFLATION TRENDS

The rally in global oil prices – which had provided some upside news for global inflation trends from mid-January to June – recovered its footing from early August, with Brent crude rising above $45, having earlier declined by around 20% from its June peak. For the Eurozone, a weak underlying 'core' inflation dynamic – outside of energy and food prices – remains the key influence as the softer energy price trends remove the impetus towards higher headline inflation. With core inflation unchanged at 0.9% y/y on July's flash estimate, and headline inflation barely ticking up to 0.2% y/y from 0.1% y/y in June, the outlook remains for readings that rise only very gradually from close to zero.

Ebbing momentum in oil prices has also limited the upward push in US headline inflation rates. CPI inflation held at 1.0% y/y in June, still below a recent high of 1.4% y/y in January. However, outside of the influences of food and energy prices, US 'core' inflation remains considerably higher than in the Eurozone, with the 2.3% y/y reading in June returning to 4-year highs. These core outturns notwithstanding, recent readings of market-based inflation expectations have continued to drift lower in both the US and Eurozone. Nevertheless, trends for the Eurozone continue to cause more anxiety as they suggest inflation expectations are near all-time lows – notwithstanding the ECB's recent stimulus efforts, and the possibility of more in September.

For the UK, headline CPI inflation already appeared to be staging a modest recovery even before the impact of the post-referendum depreciation of sterling. June's reading of 0.5% y/y – while reflecting some temporary upward impact from the European football championships on airfares – is likely to push higher over the course of 2016 and 2017 as import costs rise. Indeed, the drop in dollar oil prices over the course of June and July has at least partly been offset by the weakness of sterling, such that forecourt fuel prices have so far seen little downward pressure. Other imported goods, notably food, are likely to see more marked price gains. As such, inflation overall is expected to accelerate more quickly than previously expected, reaching 1.2% by the end of 2016 and through the BoE's 2% target by the middle of 2017. The pressure on other imported goods will also become quickly visible in stronger core inflation readings, at least once the short-term impact of the uptick in airfares unwinds. Nevertheless, further ahead, lower underlying cost pressures are likely to provide an offset owing to a slowing economy and the resulting reduction in labour market tightness, limiting inflation's overshoot relative to target. Overall, relative to the BoE's August projections, our projected overshoot relative to the 2% inflation target comes earlier and is larger in magnitude.

Inflation expectations



INFLATION OUTLOOK

		Avg since '97	Latest	Period	'16 Q3	'16 Q4	'17 Q1	'17 Q2	'17 Q3	'17 Q4	'18 Q1	'18 Q2
GBP	CPI inflation %	2.0	0.5	Jun-16	0.7	1.0	1.6	2.0	2.2	2.5	2.5	2.5
	Core CPI inflation %	1.6	1.4	Jun-16	1.4	1.4	1.7	2.3	2.5	2.7	2.6	2.4
	RPI inflation %	2.8	1.6	Jun-16	1.7	1.9	2.4	2.5	2.6	2.9	2.9	2.8
	RPI index level		263.1	Jun-16	263.8	264.9	266.1	268.7	270.6	272.5	273.8	276.3
	CPI-RPI wedge	0.8	1.1	Jun-16	1.0	0.9	0.8	0.5	0.4	0.4	0.3	0.4
	Sterling EER	93.1	78.0		78.0	78.4	80.9	82.6	83.2	83.9	83.3	83.5
USD	CPI inflation %	2.2	1.0	Jun-16	1.3	1.6	1.8	2.1	2.1	2.1	2.1	2.1
	Core CPI inflation %	2.0	2.3	Jun-16	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1
	PCE deflator %	1.8	0.9	Jun-16	1.0	1.4	1.9	1.9	1.9	1.9	1.9	1.9
	Core PCE deflator %	1.7	1.6	Jun-16	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
EUR	HICP inflation %	1.7	0.2	Jul-16	0.4	0.8	1.4	1.5	1.5	1.6	1.6	1.6
	Core HICP inflation %	1.4	0.9	Jul-16	1.0	1.1	1.2	1.3	1.3	1.4	1.4	1.4

Source: Bloomberg, Haver Analytics, LBCB

Key Economic and Political Calendar

2016

Country	Date	Event
UK	tbc	Autumn Statement

SEPTEMBER

Country	Date	Event
UK	5	House of Commons returns from summer recess
AU	6	RBA interest rate decision
CA	7	BoC interest rate decision
SW	7	Riksbank interest rate decision
EZ	8	ECB rate decision
UK	15	BoE MPC announcement
SZ	15	SNB rate decision
EU	16	EU (ex UK) meets to discuss Brexit
JN	21	BoJ interest rate decision
US	21	FOMC rate decision + press conference
NO	22	Norges Bank rate decision
UK	24	Result of Labour Party leadership contest announc
UK	25-28	Labour Party annual conference
US	26	First Presidential Debate

OCTOBER

Country	Date	Event
EU	1	Michel Barnier starts as EU's chief negotiator on Br
UK	2-5	Conservative Party conference
AU	4	RBA interest rate decision
US	4	Vice President Debate
US	9	Second Presidential Debate
US	19	Third Presidential Debate
CA	19	BoC interest rate decision
EZ	20	ECB rate decision
NO	27	Norges Bank rate decision
SW	27	Riksbank interest 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
SW	21	Riksbank interest rate decision

Source: Bloomberg, LBCB

2017

Country	Date	Event
GE	tbc	Parliamentary elections

MARCH

Country	Date	Event
NE	15	Dutch lower house elections

APRIL

Country	Date	Event
FR	23	First round of France's presidential elections

MAY

Country	Date	Event
UK	4	Local elections
FR	7	Second round of France's presidential elections

Contacts

Research

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

Adam Chester
Head of Economics
Tel: +44 (0) 20 7158 1740
adam.chester@lloydsbanking.com

Carl Paraskevas
Senior Financial 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

Michael Sawicki
Senior Economist
Tel: +44 (0) 20 7158 1746
michael.sawicki@lloydsbanking.com

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

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

Jonathan Thomas
Senior Economist
Tel: +44 (0) 20 7158 1750
jonathan.thomas2@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

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

Global Corporate FX

Anders Nilsson
+44 (0)20 7050 6006
anders.nilsson@lloydsbanking.com

Mid Markets

Lars Olesen
+44 (0)20 7158 6252
lars.olesen@lloydsbanking.com

SME

Thorsten Seeger
+44 (0)20 7158 1670
thorsten.seeger@lloydsbanking.com

Financial Institutions

Adam Barrett
+44 (0) 20 7158 1685
adam.barrett@lloydsbanking.com

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Important Information

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