

Bond Market Analysis

Interest rate and FX outlook

- UK headline inflation rates have started to drift higher and there are likely to be calls in the coming months for quantitative easing to be reversed and official interest rates to be raised sooner rather than later. In our view, that would be a mistake. Nevertheless, the annual rate of CPI rose to 1.9% in November and is likely to rise significantly above the 2% target in the early months of 2010, partly as a result of the rise in VAT to 17.5%, confirmed by the Chancellor in the Pre-Budget Report. Moreover, claimant count unemployment fell in November for the first time since February 2008 and the economy is poised to return to positive growth in the current quarter.
- However, what is relevant from a policy perspective is whether the expected rise in inflation in the next few months is likely to be temporary. If so, policy makers will assess how quickly inflation falls back in the latter part of 2010 and whether it will be below the 2% target in the medium term. The key point is that a significant amount of spare capacity in the economy has opened up, as a result of the deep recession. Even taking into account that some potential output in the economy is lost 'forever', due to factors such as the closure of plants and loss of skills, it will take a long period (perhaps 2-3 years) of very strong growth before any sustained inflationary pressures are likely to materialise. In addition, the economy faces significant headwinds, including weak credit growth and the need to reduce both public and private sector debt levels, meaning that the recovery is likely to be gradual and uneven.
- Therefore, we expect official interest rates to remain at the current historically low level of 0.5% perhaps until 2011, at which point the economic recovery is expected to become more entrenched, leading to the start of policy tightening. The temporary pick-up in inflation in the next few months, however, will add considerable volatility to the financial markets, as expectations for future interest rate policy ebb and flow. For official rates, our central view is for them to rise gradually to 1.5% by end-2011, 2.5% by end-2012 and 4.75% by end-2014.
- The spread between interbank rates and official rates widened massively during the height of the financial market crisis, but has since fallen back to pre-crisis ranges. 3-month libor fell to a low of 0.54% at the end of September and has since moved marginally higher to 0.60%, at the time of writing. We expect 3m libor to move broadly in line with Bank rate over the next five years, rising to 4.5% by end-2014. Swap rates have not fallen as far as interbank rates in the past year, resulting in a significant rise in the cost of carry. Five-year swap rates have recently fluctuated between 3% and 3.5%, but over the five-year horizon we expect 3m libor to average around 2.5%, so on that basis, fixed receivers and floating payers are more likely to benefit. As ever, these are central forecasts, not guarantees, reflecting inherent uncertainties in the economic outlook.
- For us, a key macroeconomic theme in the coming years will be the degree to which the UK economy successfully rebalances away from domestic demand, as both the private and public sectors reduce debt, in favour of net exports. One important ingredient for this to happen is a weaker currency, which will boost the competitiveness of UK exports. Earlier this year, the pound fell nearly 30% on a trade-weighted basis from 2007 peaks, but it has since posted modest gains. As the rebalancing of the economy is only in the early stages, we expect sterling to fall back to a \$1.45-1.50 range over the medium term, helped by a cyclical recovery in the US dollar next year. The overvaluation of the euro means that we expect sterling to move up towards a 1.15-1.20 range over the medium term.

Chart a: The cost of carry is expected to decline over the forecast horizon

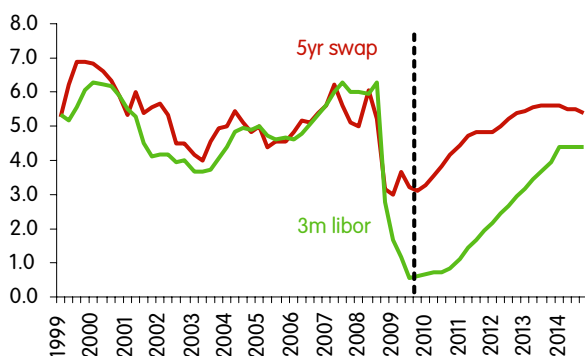
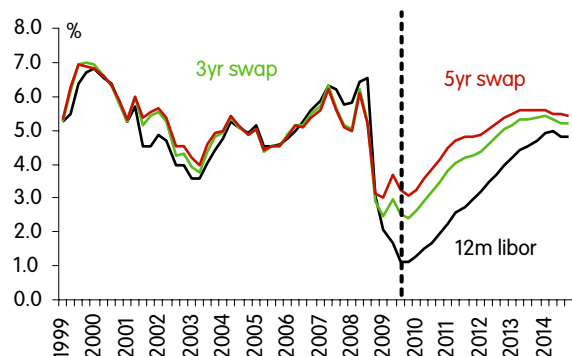


Chart b: The swap curve is expected to flatten



Source: Bloomberg, Lloyds TSB Corporate Markets Economic Research



Table: interest rate forecasts

	latest 17 Dec 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q4 2011	Q4 2012	Q4 2013	10-year avg
US										
US fed funds target	0.25	0.25	0.25	0.50	1.00	1.50	3.75	5.00	4.75	3.20
3m libor	0.25	0.25	0.7	1.2	1.7	2.2	4.4	5.4	4.6	3.60
2y govt yield	0.77	0.8	1.4	1.9	2.4	2.8	4.2	5.3	4.7	3.30
10y govt yield	3.53	3.5	3.7	3.9	4.2	4.5	4.8	5.8	5.4	4.20
3yr swap	1.76	1.8	2.3	2.8	3.2	3.6	4.9	5.9	5.3	3.90
5yr swap	2.66	2.7	3.0	3.4	3.8	4.2	5.1	6.2	5.6	4.30
10yr swap	3.68	3.7	3.9	4.3	4.6	4.9	5.4	6.4	6.0	4.70
UK										
BoE repo rate	0.50	0.50	0.50	0.50	0.50	0.50	1.50	2.50	3.50	4.30
3m libor	0.60	0.6	0.65	0.7	0.75	0.85	1.9	2.9	3.9	4.70
2y govt yield	1.20	1.2	1.6	1.9	2.1	2.4	3.2	4.2	4.6	4.10
10y govt yield	3.86	3.8	4.0	4.3	4.6	4.9	5.3	5.2	5.4	4.50
3yr swap	2.43	2.4	2.6	2.9	3.2	3.5	4.3	5.0	5.4	4.70
5yr swap	3.17	3.1	3.3	3.6	3.8	4.2	4.8	5.4	5.6	4.80
10yr swap	3.93	3.9	4.2	4.5	4.8	5.0	5.5	5.5	5.7	4.80
Eurozone										
ECB refi rate	1.00	1.00	1.00	1.00	1.00	1.00	2.25	4.00	3.75	2.80
3m libor	0.68	0.7	1.1	1.2	1.2	1.4	3.2	4.2	3.7	3.20
2y govt yield	1.15	1.2	1.6	2.0	2.5	2.9	4.1	4.2	3.9	3.00
10y govt yield	3.15	3.3	3.8	4.3	4.8	5.1	5.3	4.7	4.6	3.80
3yr swap	2.06	2.0	2.4	2.8	3.2	3.6	4.7	4.6	4.2	3.40
5yr swap	2.61	2.6	3.2	3.6	4.1	4.4	5.1	4.9	4.6	3.70
10yr swap	3.40	3.5	4.1	4.5	5.0	5.3	5.6	5.0	4.9	4.00

Source: LTSB Corporate Markets Economic Research, Bloomberg

Hann-Ju Ho, Senior Economist, hann-ju.ho@lloydsbanking.com
Tel: +44 (0)207 158 1745

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