



## FX & INTEREST RATE MONTHLY

**European bail-out leaves the FX markets awash with euros.**

European policymakers finally got 'ahead of the curve' with a €750bn rescue package on 9th May, extending support to any euro-zone member facing difficulty financing its debt. However, the associated fiscal consolidation now planned increases deflationary risks for the region, while the new policy also transfers credit risk from peripheral to core euro-zone nations. After the initial sharp rally in the euro, the prospect of weak growth, low interest rates and an erosion of ECB independence look set to continue weighing on the euro.

**The US dollar re-exerts its status as reserve currency.**

With even the Chinese buying US Treasuries again, the Greek crisis has clearly derailed hopes for the euro to replace the dollar as the dominant reserve currency. While the US shares the huge deficit and debt problems of most developed economies, its economy is enjoying a healthy recovery. The dollar is likely to be supported as a safe haven and by our forecast for US interest rates to be raised ahead of other major economies.

**Sterling and the yen look less bad than the euro, although with few reasons to be positive.**

Sterling is set to recover some lost ground versus the euro, with the euro-zone having taken over from the UK as the focus of concerns over deficit and debt levels. However, the new UK government's commitment to fiscal consolidation is likely to bring subdued economic growth and keep interest rates low. By contrast, Japan's ability to repatriate substantial overseas assets gives the yen 'safe haven' attraction in times of uncertainty, but the government's verbal intervention and calls for quantitative easing makes us negative.

**Weak euro-zone demand will hit emerging and commodity currencies, but their government finances are strong.**

Fiscal consolidation across much of the developed world will be a further drag on the global recovery, weighing on the currencies of emerging economies and commodity exporters, which are geared to the strength of global growth. Notably, the Australian dollar has lost 7% against the US dollar so far in May. However, commodity and emerging-market currencies also have other fundamental attractions including strong government finances, positive trade balances and expectations of higher interest rates.

**Interest rate increases postponed again.**

With the two-year German bonds yielding 0.6%, below official ECB rates, it is clear the prospect of a rate hike is more distant than before, whether or not the ECB actually cuts interest rates or moves beyond the current plan of 'sterilised' intervention, swapping European Union funds for troubled member states' debt. Indeed, the euro-zone's crisis has reduced global growth and inflation expectations, pushing out rate-hike forecasts for the rest of the developed world and even emerging economies.

Currencies	Spot 19/05/2010	RBS Forecast (as of 13 May)				Past Performance (in %)					
		Sep-10	Dec-10	Mar-11	Jun-11	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.23	1.21	1.17	1.15	1.14	-2.7	-8.4	-8.7	-17.0	-9.4	-14.0
Yen vs Dollar	91	96	100	102	104	1.9	1.0	0.7	-2.9	5.0	1.9
Sterling vs Dollar	1.44	1.48	1.46	1.44	1.44	-3.3	-6.1	-6.8	-13.6	-7.3	-11.0
Swiss Franc vs Dollar	1.15	1.15	1.18	1.20	1.24	-4.1	-8.3	-6.4	-13.2	-3.6	-11.6
Swiss Franc vs Euro	1.42	1.39	1.38	1.38	1.41	-1.3	0.7	2.8	6.0	6.1	4.1
Australian Dollar vs Dollar	0.84	0.95	0.90	0.88	0.91	-5.9	-8.5	-5.8	-7.9	8.7	-6.4
Euro vs Sterling	0.86	0.82	0.80	0.80	0.79	0.6	-2.5	-2.1	-4.1	-2.3	-3.5
Renminbi vs Dollar	6.83	6.60	6.50	6.40	6.30	0.0	0.0	0.0	0.0	0.0	0.0

	Growth (GDP)			Inflation (CPI)			Interest Rates					Decision
	2009	2010(C)	2011(C)	2009	2010(C)	2011(C)	Current	Sep'10 (F)	Dec'10 (F)	Mar'11 (F)	Jun'11 (F)	Next Date
US	-2.4	3.3	3.1	-0.3	2.0	1.9	0.25	0.75	1.75	2.75	3.75	23-Jun-10
UK	-4.9	1.3	2.3	2.2	2.9	1.8	0.50	0.50	1.00	1.50	2.00	10-Jun-10
Eurozone	-4.0	1.1	1.5	0.3	1.3	1.4	1.00	1.00	1.00	1.00	1.25	10-Jun-10
Japan	-5.2	2.4	1.7	-1.4	-1.0	-0.2	0.10	0.10	0.10	0.10	0.10	21-May-10

(C) Consensus Forecast

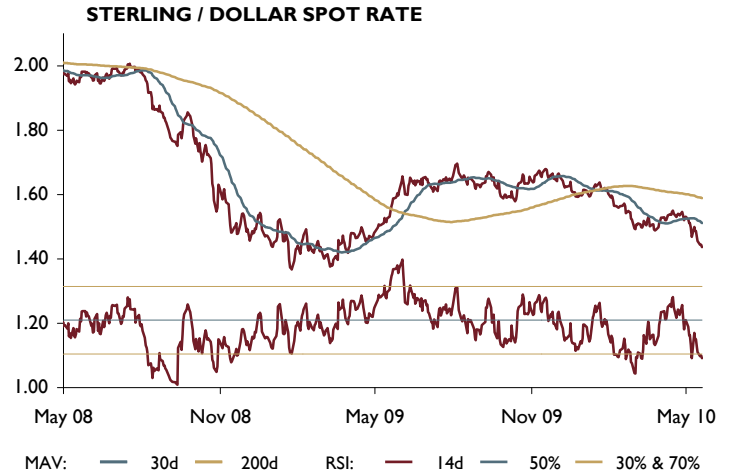
(F) RBS Forecast

# STERLING vs DOLLAR

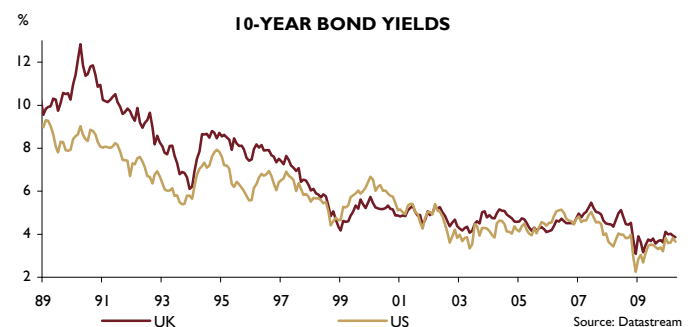
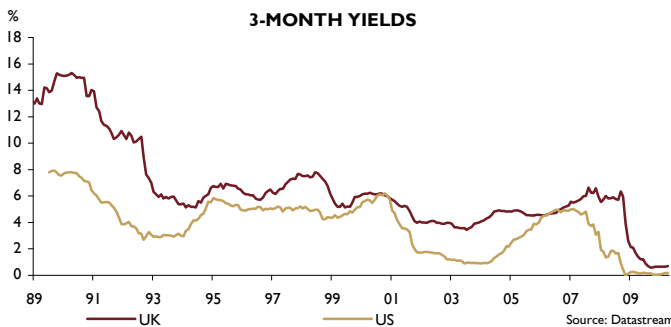
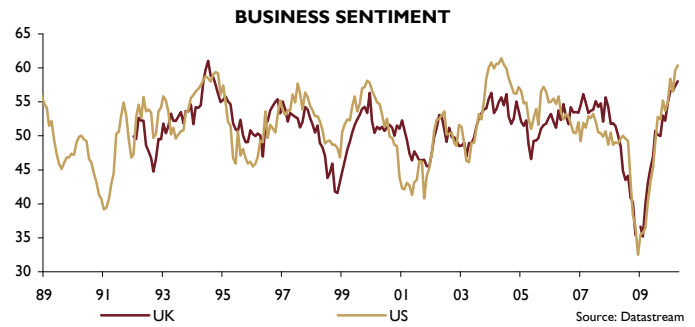
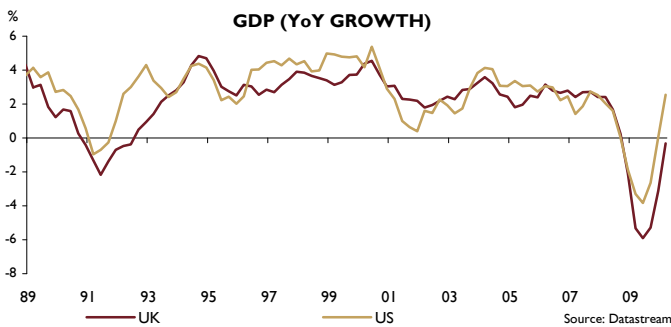
<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>
<b>New</b>	<b>Previous</b>	<b>Conviction</b>
<b>Neutral</b>	<b>Negative</b>	

<b>Performance (as of 19/05)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Sterling vs Dollar (Reuters)	-6.1	-6.8	-13.6	-7.3	-0.1

**Recommendation:** With sterling back at its recent lows against the US dollar, and indeed approaching its lowest point for the past twenty years, we are removing our negative recommendation. However, the new UK government's focus on fiscal consolidation means that economic growth is likely to be subdued, postponing the need for interest-rate increases. Thus we do not expect any rallies against the US dollar to be sustained.



- Valuation:** Sterling is back at the bottom of its 20-year trading range against the US dollar.
- Activity:** The UK has lagged the global upturn, with recovery emerging later, in the final quarter of 2009, and at a slower pace with only 1.2% annualised growth, roughly a fifth of the 5.9% pace for the US in the same quarter. The UK economy is expected to continue to lag with consensus expectations of 1.3% growth for the UK in 2010 compared with 3.3% for the US economy.
- Liquidity:** There is a very large net short speculative trade position in sterling against the dollar, exceeding the level reached last year and the highest for at least ten years. This could drive a rally in sterling if it is unwound. Both currencies effectively have a zero yield, so there is little to choose from on this basis, though we forecast that the US will be first to raise interest rates.
- Risk:** The bias of risk remains against the UK, with the new government under pressure to address the issues of the record deficit and rising national debt.
- Momentum:** While sterling is currently oversold against the US dollar and there is scope for a rebound, the longer-term trend is negative.

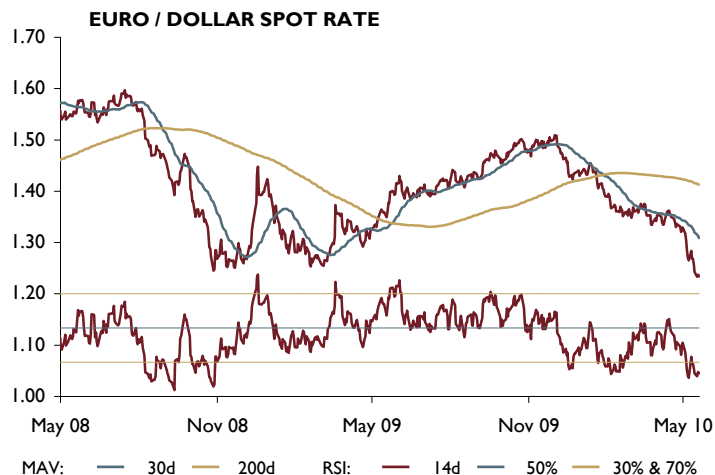


## EURO vs DOLLAR

<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>		
<b>New</b>	<b>Previous</b>	<b>Conviction</b>		
<b>Negative</b>	<b>Negative</b>			

<b>Performance (as of 19/05)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Euro vs Dollar (Reuters)	-8.4	-8.7	-17.0	-9.4	-14.0

**Recommendation:** Despite the fall in the euro we continue to prefer the US dollar. The fall leaves the euro no better than fair value on purchasing parity measures, but stronger US growth means that yield advantage is set to switch to the dollar. Our forecast of further euro decline is based on a soft landing for the euro zone economy and does not reflect the risk of a further crisis presenting a fundamental challenge to the current structure of the euro-zone.



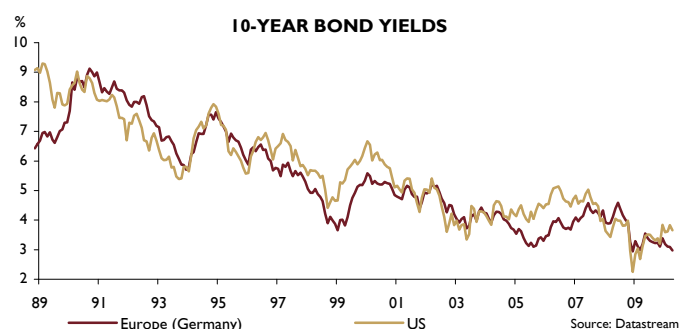
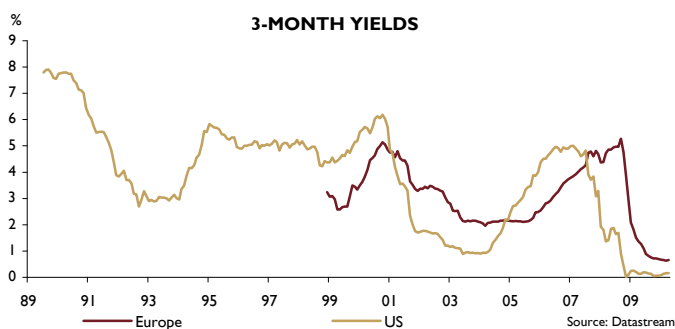
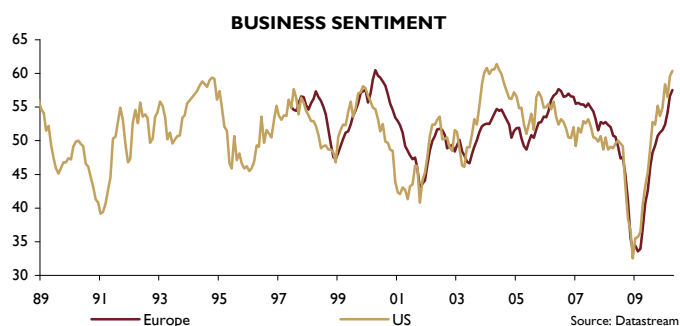
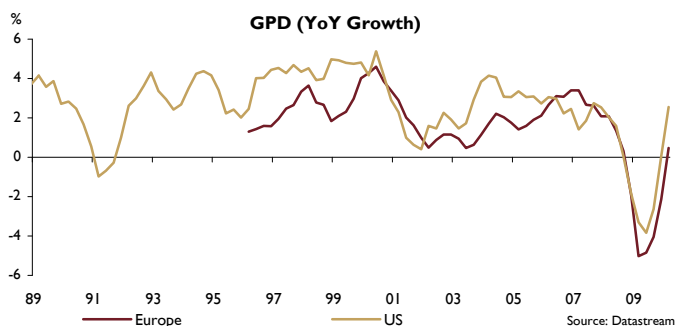
**Valuation:** The euro is approaching fair value on a purchasing parity basis and its ten year average of \$1.20. The range over the ten years of the euro's existence has been huge, from \$0.82 to \$1.58.

**Activity:** While both US and euro-zone economies have emerged from recession, the euro-zone experienced a more severe downturn than the US and the consensus expectation is that its recovery will be substantially slower, at 1.1% compared with 3.3% for the US this year.

**Liquidity:** Investors hold a record net short position in the euro, despite its short-term yield advantage over the dollar. This could drive a rally in the euro if it is unwound.

**Risk:** The €750bn rescue package extends support to any euro-zone member facing difficulties financing its debt in the market. However this transfers credit risk from the periphery 'sinners' to the 'core' larger states, whose budget deficits are already under pressure. The associated fiscal consolidation now planned increases deflationary risks for the region. These issues outweighs concerns over the US budget deficit.

**Momentum:** The euro has a negative long-term trend, although it is obviously oversold following the recent plunge.



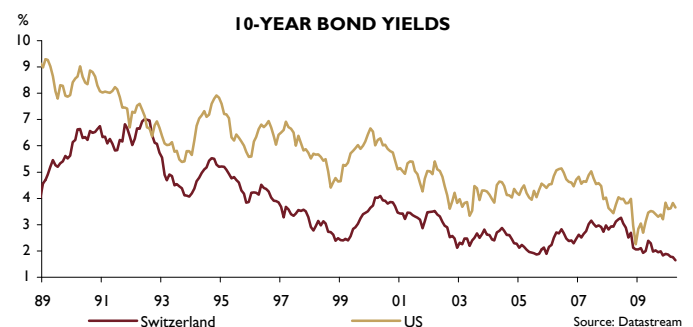
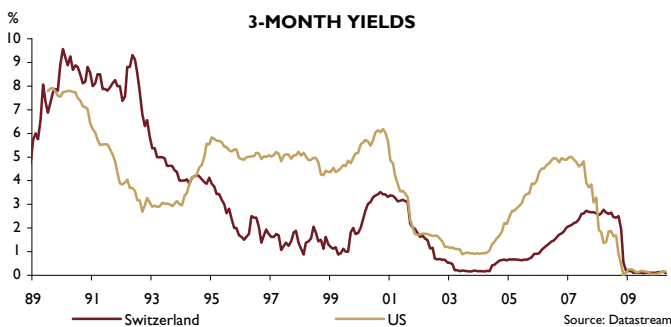
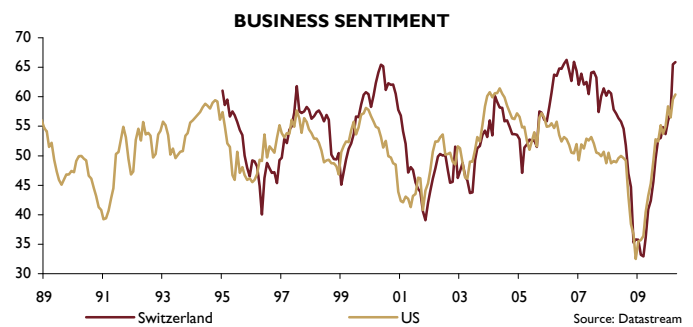
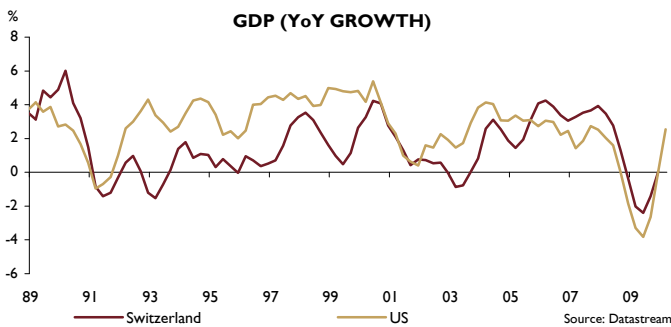
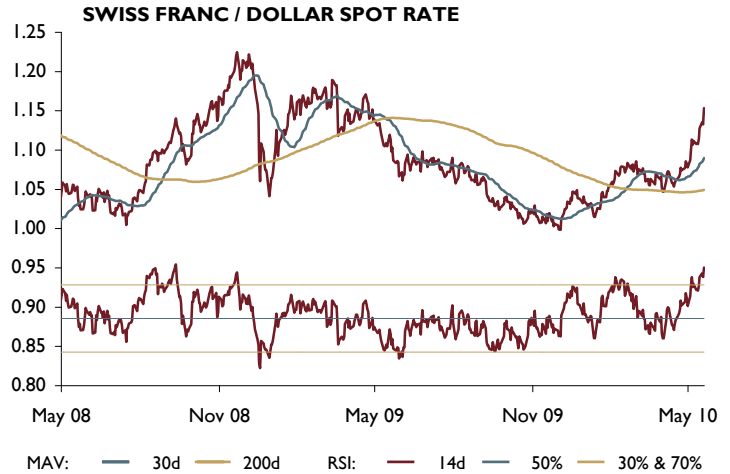
## SWISS FRANC vs DOLLAR

<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>
<b>New</b>	<b>Previous</b>	<b>Conviction</b>
<b>Neutral</b>	<b>Negative</b>	

<b>Performance (as of 19/05)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Swiss Franc vs Dollar (Reuters)	-8.3	-6.4	-13.2	-3.6	-11.6

**Recommendation:** The recent sharp fall of the Swiss franc against the US dollar is likely to relieve some of the pressure on the Swiss economy from a strong franc. This would suggest that the Swiss National Bank may relax its intervention policy, designed to hold down the franc over the past year. We thus have a more neutral outlook for the Swiss franc against the US dollar. We forecast relatively healthy growth for the Swiss economy, though this is still expected to lag the US recovery.

- Valuation:** The Swiss franc still stands towards the top of its long-term historical range versus the dollar.
- Activity:** With the global economy now clearly growing we would expect the US economy to see a stronger recovery, with a consensus forecast of 3.3% growth compared with 1.9% for Switzerland in 2010.
- Liquidity:** Investor positions in the futures market are short of the Swiss franc against the US dollar. This could drive a rally in the Swiss franc if it is unwound. The Swiss National Bank has continued to intervene against strong appreciation by the Swiss franc, with reserves rising by CHF 29bn to CHF 125bn in April.
- Risk:** The Swiss franc is a traditional safe haven for investors at a time of market or economic uncertainty. However, this has been undermined by the repeated interventions by the monetary authorities to prevent unwanted appreciation of the Swiss franc.
- Momentum:** While the Swiss franc is currently oversold against the US dollar and there is scope for a rebound, the longer-term trend is negative.



## YEN vs DOLLAR

<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>
<b>New</b>	<b>Previous</b>	<b>Conviction</b>
<b>Negative</b>	<b>Negative</b>	

<b>Performance (as of 19/05)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Yen vs Dollar (Reuters)	1.0	0.7	-2.9	5.0	1.9

**Recommendation:** The yen has largely kept pace with the US dollar in recent volatile FX markets, reflecting its reputation as a 'safe haven'. Our forecast of yen weakness reflects the US economic recovery and our prediction of US rate rises later this year, reopening the yield gap with the yen. While Japan is also recovering, deflation persists and the government is pressing for additional unconventional monetary measures which could undermine the yen.

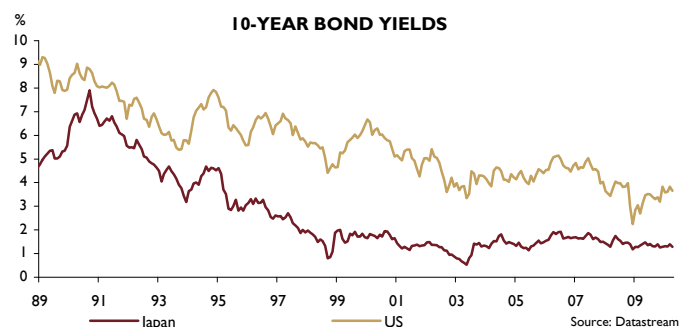
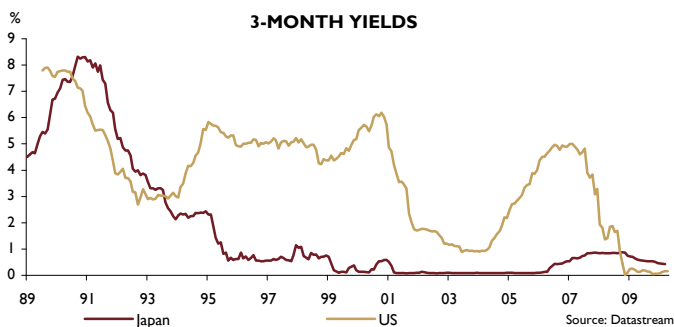
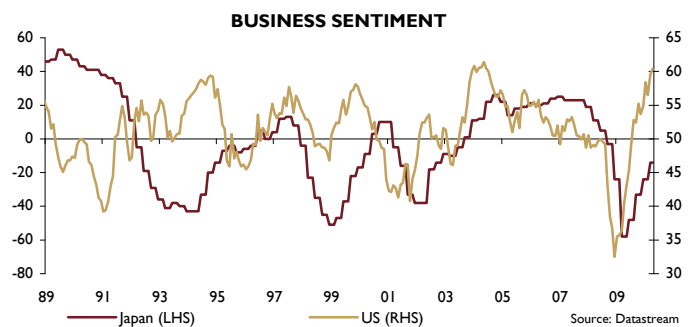
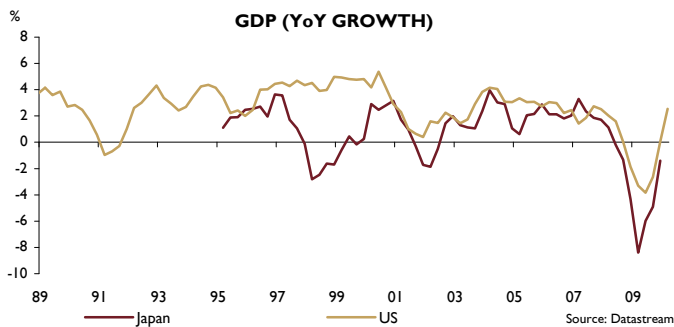
**Valuation:** The last time the yen was below 100 to the US dollar was in 1995. Then, it was overvalued. Now, adjusted for relative inflation, it appears fairly valued.

**Activity:** Consensus forecasts are for Japan to grow by 2.4% in 2010 compared to a 3.3% pace for the US economy.

**Liquidity:** There is a relatively modest net short position in the yen futures market against the US dollar. Current ultra-low US interest rates mean that the yen does not have its historical yield disadvantage, though this is set to change as we forecast US interest-rate increases this year.

**Risk:** The performance of the yen during last year's market turmoil clearly identifies it as a beneficiary of increased risk aversion and de-leveraging. However, the new Japanese Finance Minister has talked of the need for a weaker yen in conjunction with the new budget stimulus and action from the Bank of Japan to support the relatively fragile Japanese economic recovery.

**Momentum:** The recent weakness of the yen has broken the positive technical trend.



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