

## FX & INTEREST RATE MONTHLY

### European bank stress tests give euro a short-term boost.

The euro has rallied in response to the announcement of the European bank stress tests. These tests are a demonstration of increased political and financial commitment to EU institutions by member states. Hence investor fears of an imminent break-up of the euro-zone have been allayed. Our estimates of the potentially punitive costs of leaving the euro-zone, with the loss of up to 10% of the departing country's GDP and an additional 1% for the rest of the euro-zone, suggests that no government is going to opt for the exit while viable alternatives remain. However, our concerns over longer-term structural issues within the euro-zone remain, so we continue to have a negative view on the euro and would recommend using the recent rally to reduce exposure to the currency.

### Fiscal strength will be a key support for currencies, whether recovery continues or not.

While the global economic recovery continues, the fiscally 'good' (Canada, Norway, Sweden and most of Asia and Latin American) will see interest rate hikes to return monetary policy to 'normal' levels. If growth disappoints, these countries have fiscal flexibility to offset the worst of the downturn. By contrast the fiscally 'bad' (US, euro-zone, UK and Japan) are in trouble whether economic recovery continues or not. If it continues, the need for fiscal consolidation means that interest rates need to be held low for longer. Additional quantitative easing will be required to address any slowdown. Consequently, we reiterate our preference for currencies supported by relatively healthy fiscal positions.

### For the main developed economies rates will not just be low for longer - additional measures will be necessary.

We forecast that growth next year will disappoint current expectations. This leaves us not only expecting that interest rates will remain low for longer, but that central banks of all the major developed economic regions will take a second look at unconventional measures to increase the supply of credit in the economy. While the timing of unconventional monetary measures could influence short-term direction and add volatility to the major currency markets, we forecast that the major long-term trend in exchange rates will be the continued appreciation of the currencies of emerging economies. In terms of the major currencies we are most negative on the longer-term structural problems of Japan and the euro-zone. The US should outperform on the back of a better underlying growth trend and its status as a reserve currency. The UK also appears relatively better placed on the basis of a more coherent political and economic policy response to its problems.

Currencies	Spot 21/07/10	RBS Forecast (as of 15 Jul)				Past Performance (in %)					
		Sep-10	Dec-10	Mar-11	Jun-11	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.28	1.18	1.12	1.10	1.09	0.7	3.5	-4.3	-8.8	-9.9	-10.7
Yen vs Dollar	87	90	92	95	98	1.5	4.4	6.5	4.4	6.9	6.4
Sterling vs Dollar	1.52	1.48	1.44	1.43	1.43	-0.4	2.7	-1.2	-6.0	-7.6	-5.8
Swiss Franc vs Dollar	1.05	1.14	1.16	1.18	1.21	0.4	5.2	1.8	-0.4	1.4	-1.7
Swiss Franc vs Euro	1.35	1.34	1.30	1.30	1.32	-0.3	1.9	6.0	8.4	11.2	9.2
Australian Dollar vs Dollar	0.88	0.85	0.88	0.88	0.91	-0.1	0.1	-5.0	-2.6	8.2	-1.9
Euro vs Sterling	0.84	0.80	0.78	0.77	0.76	1.0	0.9	-3.2	-3.1	-2.6	-5.4
Renminbi vs Dollar	6.78	6.75	6.70	6.65	6.60	-0.1	0.3	0.7	0.7	0.8	0.7

	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	3.1	3.0	-0.3	1.7	1.5	0.25	0.25	0.25	1.25	2.25	07-Sep-10
UK	-4.9	1.3	2.1	2.2	3.0	2.3	0.50	0.50	0.50	0.50	0.75	05-Aug-10
Eurozone	-4.1	1.1	1.4	0.3	1.5	1.5	1.00	1.00	1.00	1.25	1.75	05-Sep-10
Japan	-5.3	3.2	1.6	-1.4	-1.0	-0.2	0.10	0.10	0.10	0.10	0.10	07-Sep-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>Negative</b>	<b>Negative</b>	

<b>Performance (as of 21/07)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Sterling vs Dollar (Reuters)	2.7	-1.2	-6.0	-7.6	5.8

**Recommendation:** With sterling back at its recent lows against the US dollar, and indeed approaching its lowest point for the past twenty years, we believe we are close to the bottom. However we would continue to avoid following the recent rebound against the dollar as risks remain in the short-term. The new UK government's focus on fiscal consolidation will depress economic growth at a time when the euro-zone crisis has hit the market for over half of the UK's exports.

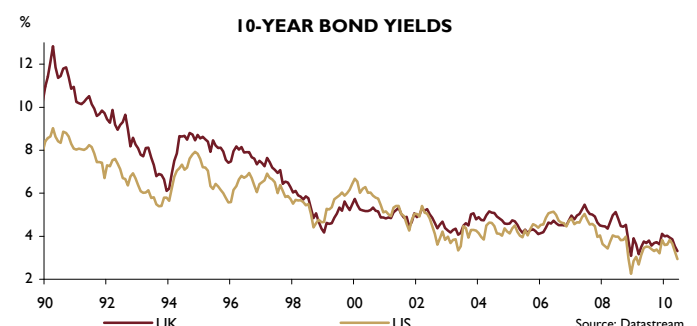
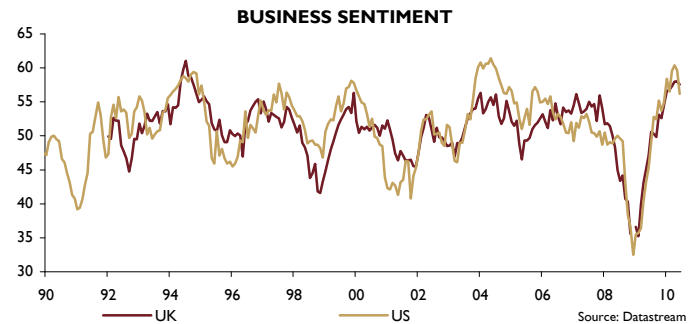
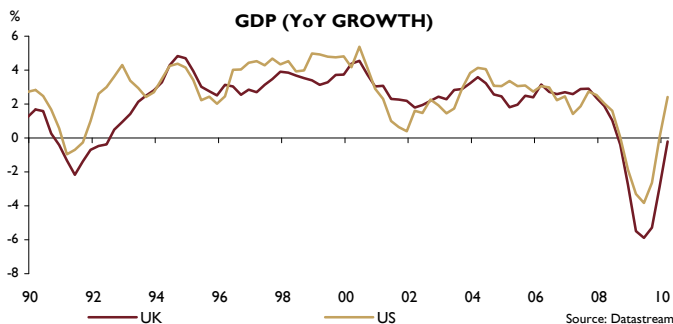
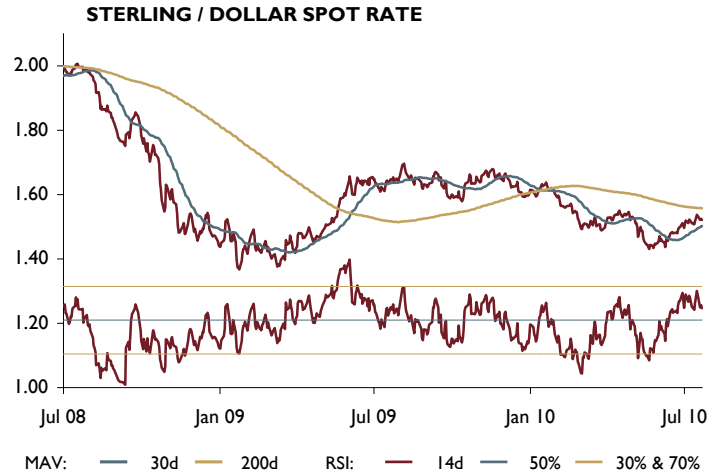
**Valuation:** Sterling is towards the bottom of its 20-year trading range against the US dollar.

**Activity:** The UK economy is expected to continue to lag, with consensus expectations of 1.3% growth in 2010 compared with 3.1% for the US economy.

**Liquidity:** A sharp reduction in investors' short positions in sterling futures, from record levels, has accompanied the bounce in the value of sterling. Investors still hold a net short position in sterling, so there is still potential for further gains 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 currently forecast that the UK will be first to raise interest rates at the end of the year with the US following in early 2011.

**Risk:** With a coordinated political and economic response to the deficit issue, we believe that the outlook for the UK has improved and investors are increasingly focusing on the US deficit ahead of the mid-term elections.

**Momentum:** With sterling appearing overbought in the short-term, after the recent rally, we see no reason to change our view that the longer-term trend is negative.

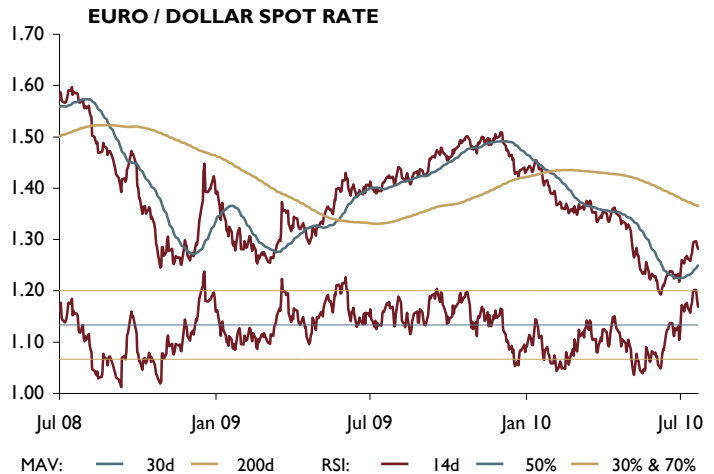


## EURO vs DOLLAR

<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 21/07)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Euro vs Dollar (Reuters)	3.5	-4.3	-8.8	-9.9	-10.7

**Recommendation:** The euro has rallied in response to the announcement of the European bank stress test. These tests are a demonstration of increased political and financial commitment to EU institutions by member states. However our concerns over longer-term structural issues within the eurozone remain, so we continue to have a negative view on the euro and would recommend using the recent rally to reduce exposure to the currency.



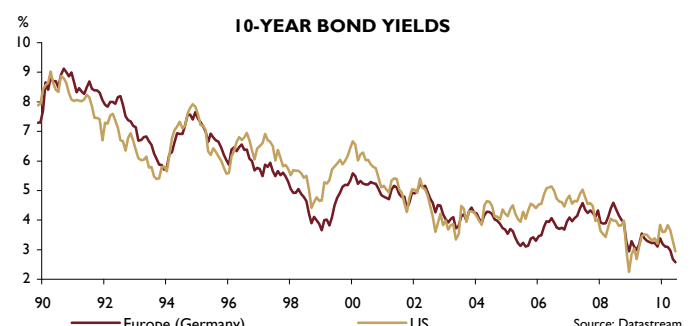
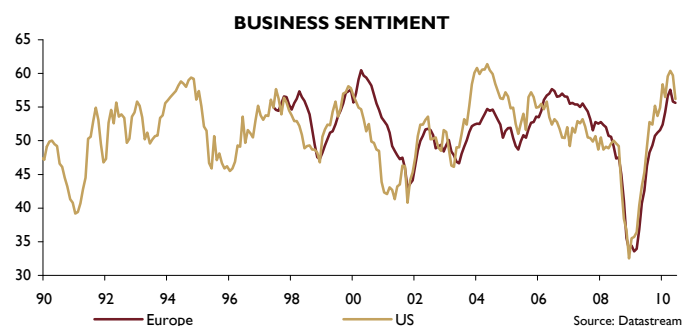
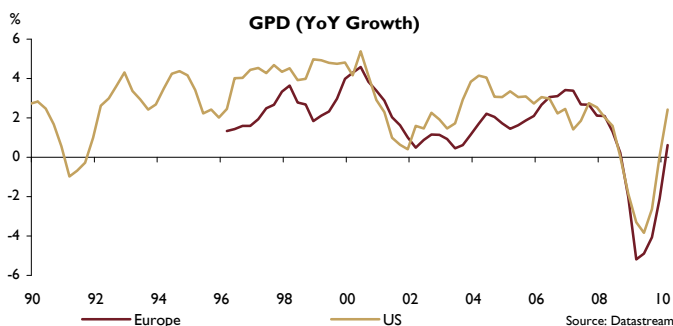
**Valuation:** The euro is close to its fair value on a purchasing parity basis and its ten-year average of \$1.20. The range over the ten years of the euro's existence has been huge, from \$0.82 to \$1.58.

**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 3.1% for the US this year.

**Liquidity:** A sharp reduction in investors' short positions in euro futures, from record levels, has accompanied the bounce in the value of the euro. Investors still hold a net short position in the euro, despite its short-term yield advantage over the dollar, so there is still potential for further gains in the euro if it is unwound.

**Risk:** The European Union bank stress tests and the €750bn backing for the European Financial Stability Facility has shown the commitment of political as well as financial capital to support EU institutions and the euro-zone. However, while this supports our contention that a break-up of the euro zone is very unlikely in the next couple of years, it does not address the diverging levels of competitiveness that create longer-term structural problems for the euro.

**Momentum:** With the euro appearing overbought in the short-term, after the recent strong rally, we see no reason to change our view that the longer-term trend is negative.



## 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>Negative</b>	<b>Negative</b>	

<b>Performance (as of 21/07)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Swiss Franc vs Dollar (Reuters)	5.2	1.8	-0.4	1.4	-1.7

**Recommendation:** The end of foreign exchange intervention by the Swiss authorities allowed the franc to surge against the dollar. A five-fold increase in foreign currency reserves since March 2009 meant that continued intervention was deemed untenable and increased domestic inflation risks. At these levels we see the Swiss franc as overvalued and expect it to retreat against the dollar, though still making further modest gains against the euro.

**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 3.1% growth compared with 2.0% for Switzerland in 2010.

**Liquidity:** Investor positions in the futures market are long of the Swiss franc against the US dollar. This could drive a rally in the dollar if it is unwound. The Swiss National Bank has withdrawn from its previous commitment to fight 'excessive appreciation' of the Swiss franc, after FX reserves ballooned to five times their March 2009 level. We forecast that the SNB will raise interest rates in early 2011, around the same time as the US.

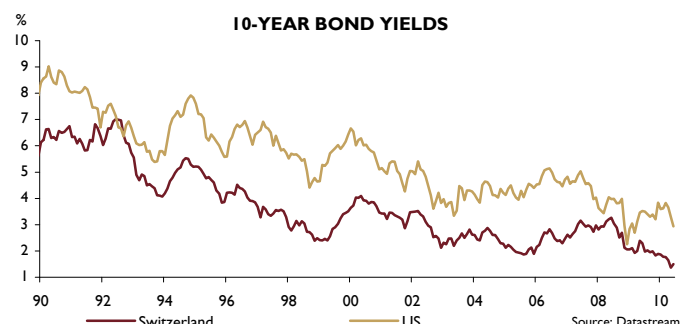
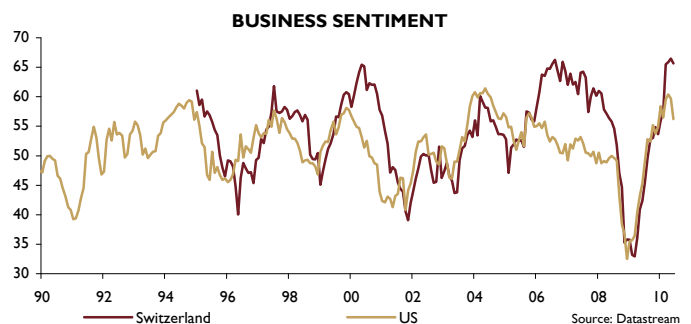
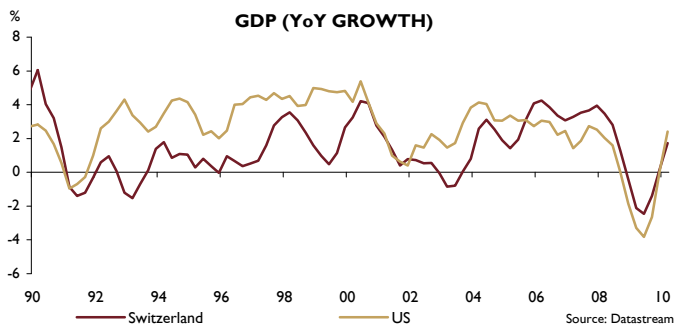
**Risk:** The Swiss franc is a traditional safe haven for investors in times of market or economic uncertainty.

**Momentum:** The Swiss franc has rallied strongly, but is now overbought and the the longer-term trend is still negative.

**SWISS FRANC / DOLLAR SPOT RATE**



MAV: — 30d — 200d RSI: — 14d — 50% — 30% & 70%

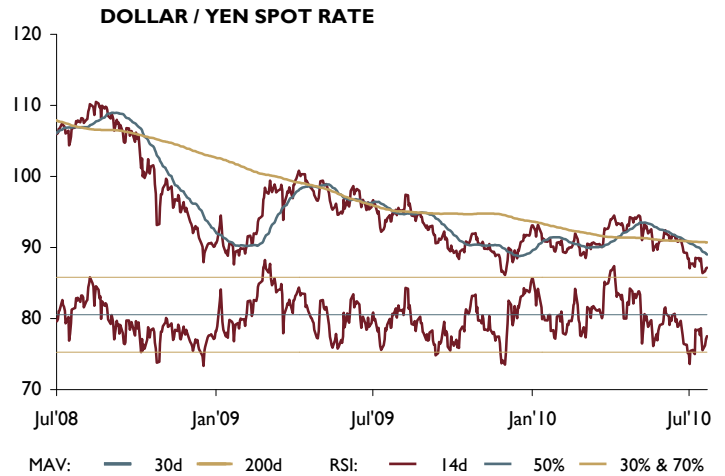


## YEN vs DOLLAR

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

<b>Performance (as of 21/07)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Yen vs Dollar (Reuters)	4.4	6.5	4.4	6.9	6.4

**Recommendation:** Renewed concerns over the outlook for US growth and increased risk aversion amongst investors have driven the yen back to its highs. However, we see the combination of weakening US demand and a strong yen undermining Japan's own recovery. We therefore expect that the yen will weaken to reflect this and other structural economic issues.



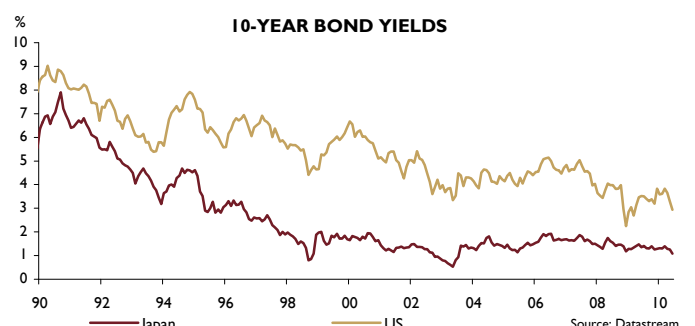
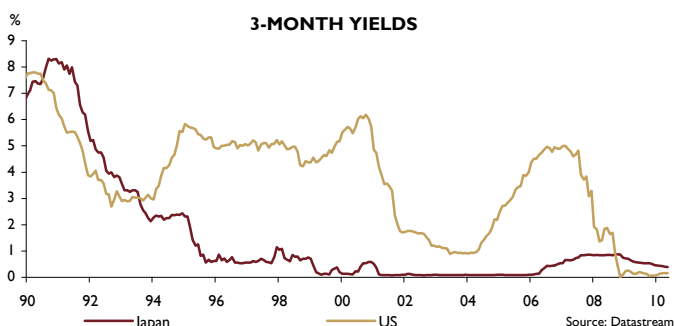
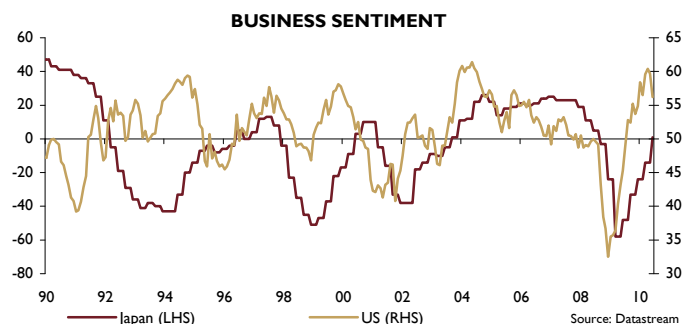
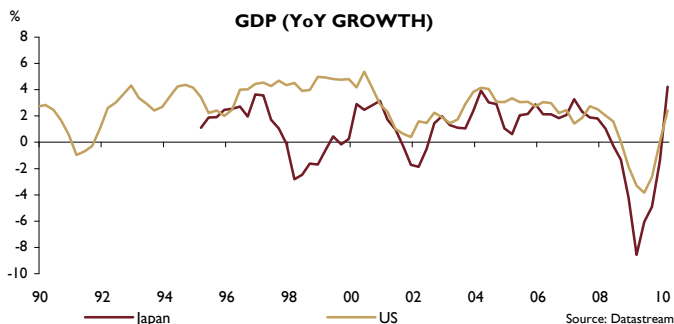
**Valuation:** The last time the yen was below 100 to the US dollar was in 1995. Then, it was overvalued. Now, adjusted for relative inflation, it appears fairly valued.

**Activity:** While consensus forecasts are for Japan to grow by 3.2% in the current year, more than the US, the underlying trend is weaker. Expectations are for a slowdown to 1.6% for Japan in 2011 compared to a sustained 3.0% pace for the US economy.

**Liquidity:** Investors hold long yen positions against the US dollar in the futures market. Current ultra-low US interest rates mean that the dollar does not have its historical yield advantage, though this is set to change as we forecast US interest rate increases next 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 Prime Minister has talked of the need for a weaker yen in conjunction with action from the Bank of Japan to support the relatively fragile Japanese economic recovery.

**Momentum:** The rebound of the yen has provided renewed upward momentum, providing a positive technical background for the yen. However, the yen does appear overbought on its recent rally and so vulnerable to short-term consolidation.



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