



## FX & INTEREST RATE MONTHLY

**We continue to recommend selling the euro...**

**...but the current environment poses risks to all currencies.**

**We prefer the US dollar, the world's unrivalled reserve currency.**

**Commodity currencies and emerging markets are also attractive.**

**We are pushing back our forecasts of interest rate increases in all major markets.**

We see further euro weakness as recent events compound our original concerns on growth and stresses of diverging member economies. Unable to reach political consensus, the eurozone faces significant fiscal austerity that will limit growth and the European Central Bank (ECB) is being forced into quantitative easing as it extends credit and buys member states' distressed debt. News flow remains negative and there is scope for other central banks to scale back euro allocations in their FX reserves, having bought it at higher prices.

We forecast a continued global recovery despite the persistence of aftershocks from the financial crisis. However, austerity measures are likely to push several euro member states back into recession and be a drag on growth, even if the debt crisis remains contained as we expect. It is also a difficult environment for other major developed currencies, which share the problems of over-indebted governments and weak growth. Most won't welcome 'safe-haven' demand pushing their currencies up and harming competitiveness when exports are key for growth, notably Japan.

The dollar looks attractive in this environment. At the most basic, the euro's crisis casts doubt on the major liquid alternative for FX reserves. More positively, we forecast a continued US recovery, even if interest rate increases are now delayed until next year. But the US economy also has its problems, federal debt included, and will not welcome the loss of competitiveness. Still, the dollar remains the liquid, safe haven in an uncertain world.

The backdrop is more positive for commodity-exporting and emerging economies, especially after the recent sell-off. We would look to buy currencies with growing economies and rising rates, including the Australian and Canadian dollars and a number of emerging-economy currencies. However, political considerations are more significant for emerging currencies, with governments reluctant to relinquish economic control in uncertain times.

Outside commodity exporters and emerging markets, which seem set on the recovery path, we have pushed back rate-hike expectations. As noted before, if governments decide (or are forced) to address their record deficits, the resulting squeeze on growth means that rate hikes are likely to be postponed. We still forecast the UK hiking this year, but even this is subject to the new government's special budget, due to be released 22 June. We do not expect the US to raise rates until next year and further quantitative easing by both the ECB and Bank of Japan is likely before they consider rate hikes.

Currencies	Spot 14/06/2010	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	1.15	1.10	1.08	1.06	2.9	-1.2	-10.8	-16.2	-12.3	-14.4
Yen vs Dollar	92	92	95	100	102	-0.1	0.3	-1.1	-3.7	6.6	1.4
Sterling vs Dollar	1.48	1.42	1.39	1.39	1.40	2.0	1.6	-2.6	-9.1	-10.2	-8.4
Swiss Franc vs Dollar	1.14	1.17	1.20	1.22	1.26	2.2	-0.7	-7.2	-10.2	-5.2	-9.9
Swiss Franc vs Euro	1.39	1.34	1.32	1.32	1.34	-0.7	0.5	4.4	7.7	7.7	6.0
Australian Dollar vs Dollar	0.86	0.85	0.88	0.88	0.91	6.1	-2.9	-5.6	-5.4	6.5	-3.8
Euro vs Sterling	0.83	0.81	0.79	0.78	0.76	0.9	-2.8	-9.2	-8.5	-2.4	-7.0
Renminbi vs Dollar	6.83	6.80	6.75	6.70	6.65	0.0	-0.1	-0.1	-0.1	0.0	-0.1

	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	0.25	0.25	1.00	1.50	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	08-Jul-10
Eurozone	-4.0	1.1	1.5	0.3	1.3	1.4	1.00	1.00	1.00	1.00	1.25	08-Jul-10
Japan	-5.2	2.4	1.7	-1.4	-1.0	-0.2	0.10	0.10	0.10	0.10	0.10	15-Jun-10

(C) Consensus Forecast

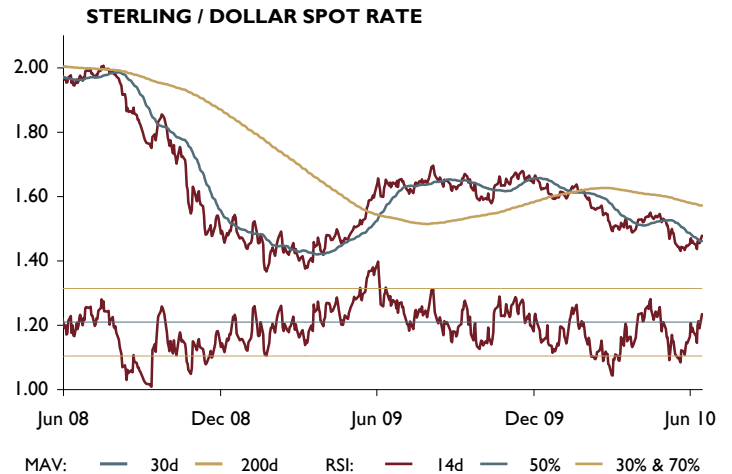
(F) RBS Forecast

## 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>Neutral</b>	

<b>Performance (as of 14/06)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Sterling vs Dollar (Reuters)	1.6	-2.6	-9.1	-10.2	2.8

**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.



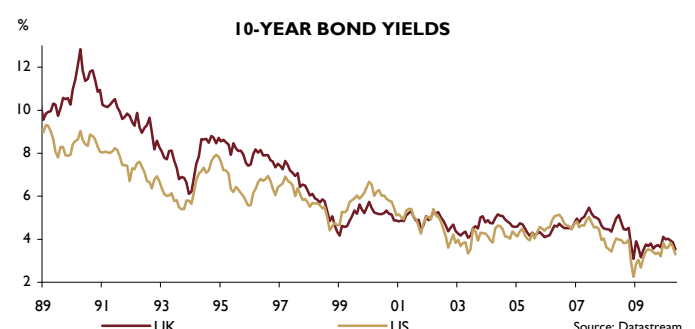
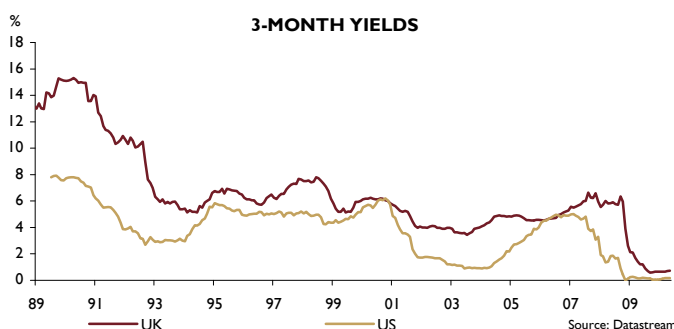
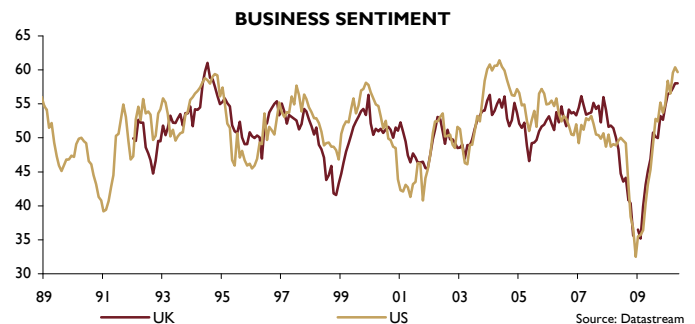
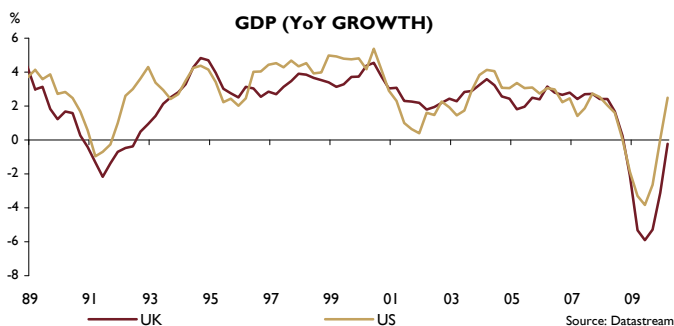
**Valuation:** Sterling is back at the bottom of its 20-year trading range against the US dollar.

**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 in 2010 compared with 3.3% for the US economy.

**Liquidity:** There is a record net short speculative trade position in sterling against the dollar, exceeding the levels reached last year. 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 now 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:** 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 rallying from recent lows, the longer-term trend is negative.

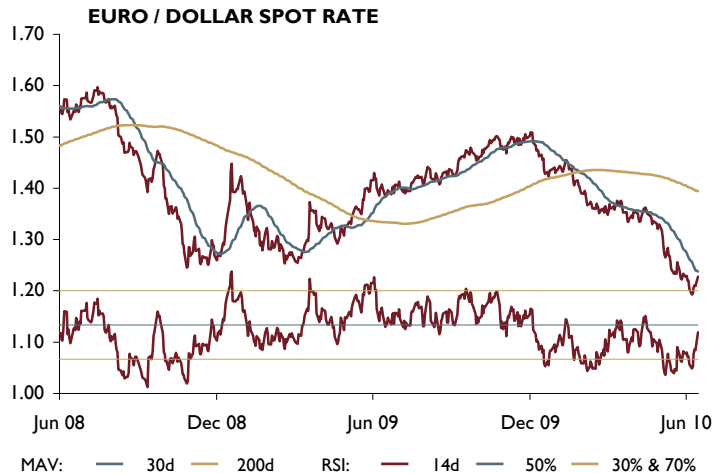


## EURO vs DOLLAR

<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 14/06)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Euro vs Dollar (Reuters)	-1.2	-10.8	-16.2	-12.3	-14.4

**Recommendation:** Despite euro weakness 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 a 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.



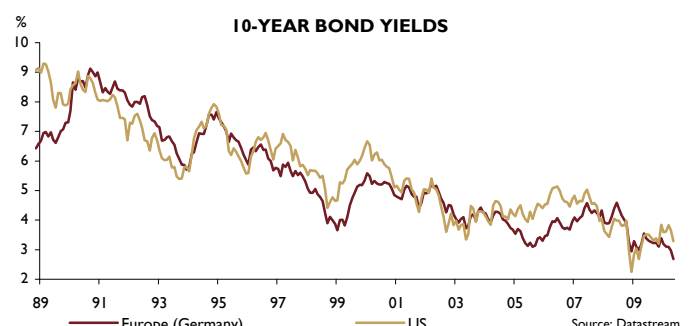
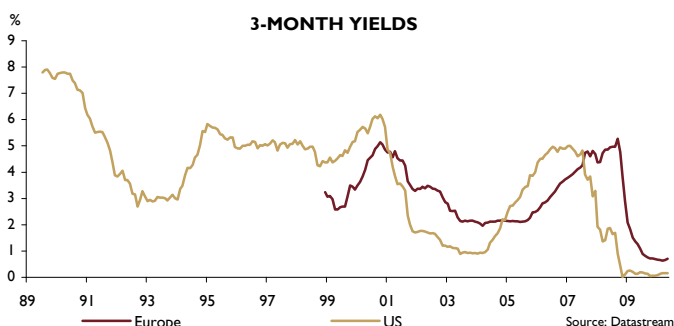
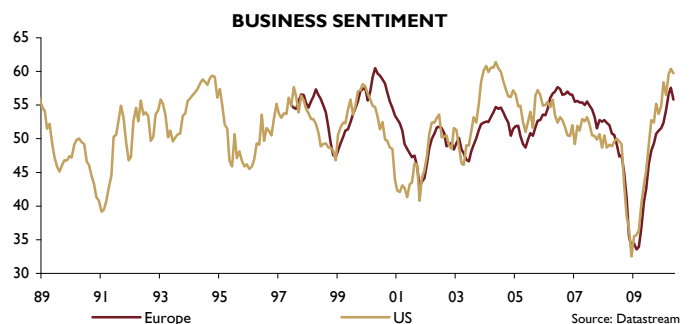
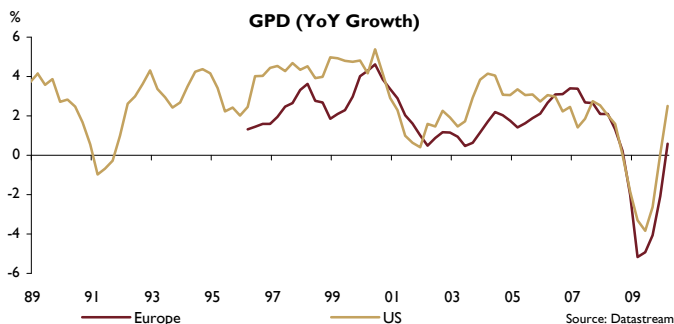
**Valuation:** The euro is approaching fair value on a purchasing parity basis and its ten year average of \$1.20. The range over the ten years of the euro's existence has been huge, from \$0.82 to \$1.58.

**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 record net short positions 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 outweigh concerns over the US budget deficit.

**Momentum:** The euro has a negative long-term trend, although it is currently seeing a modest rebound following the recent plunge.

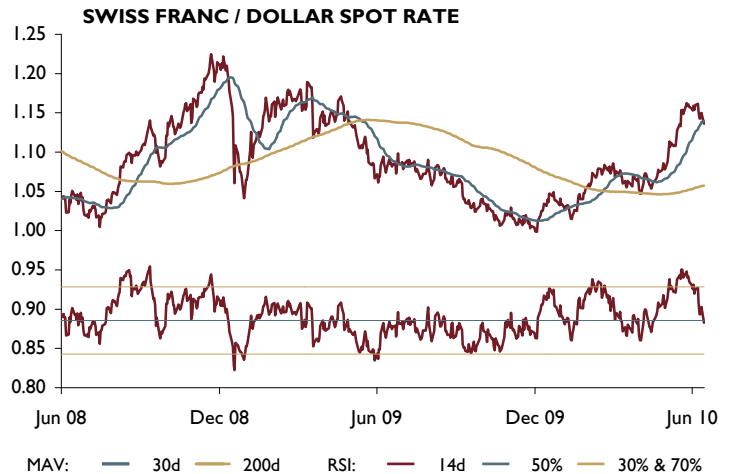


## SWISS FRANC vs DOLLAR

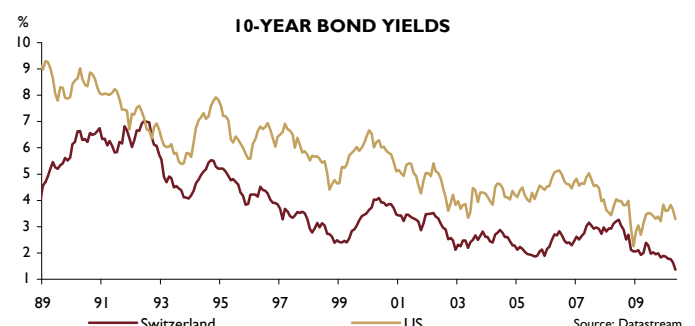
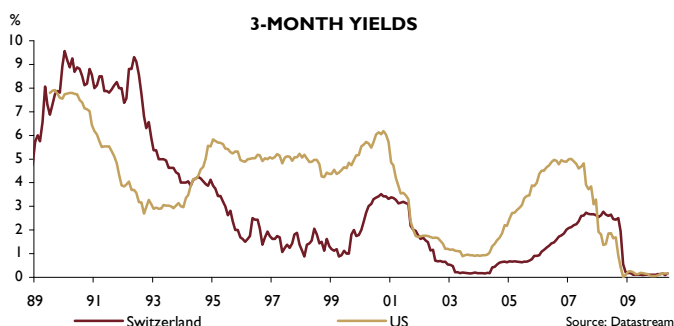
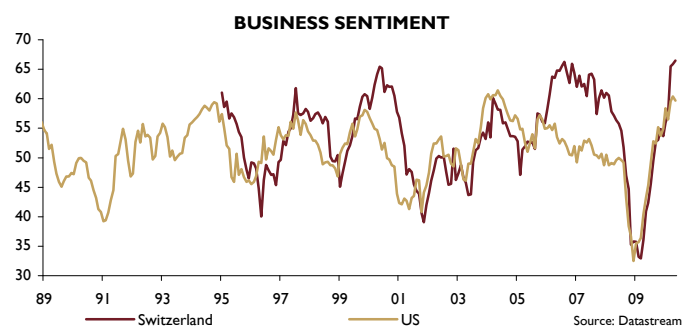
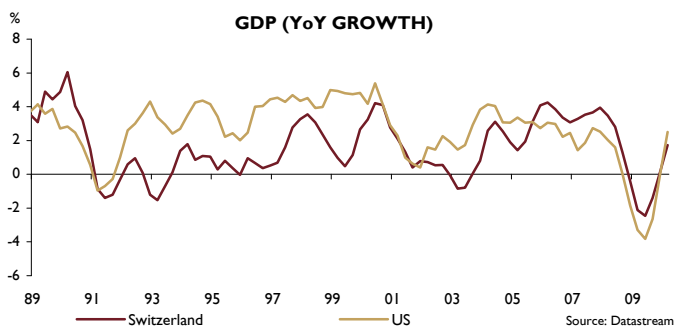
<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>		
<b>New</b>	<b>Previous</b>	<b>Conviction</b>		
<b>Negative</b>	<b>Neutral</b>			

<b>Performance (as of 14/06)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Swiss Franc vs Dollar (Reuters)	-0.7	-7.2	-10.2	-5.2	-9.9

**Recommendation:** We see scope for further Swiss franc weakness against the US dollar. This largely reflects the efforts by the Swiss authorities to avoid a collapse of competitiveness for Swiss exports into the euro-zone, by intervening to hold the franc down against the weakening euro. However rising domestic money supply suggests that the ability of the Swiss National Bank to sustain intervention is limited.



- 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. 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. However, this has been undermined by the repeated interventions by the monetary authorities to prevent unwanted appreciation of the Swiss franc.
- Momentum:** The Swiss franc is currently experiencing a bounce from oversold conditions, but the longer-term trend is negative.

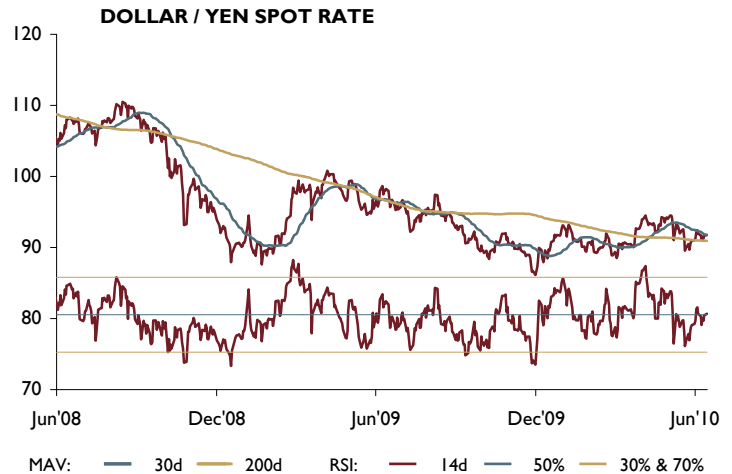


## YEN vs DOLLAR

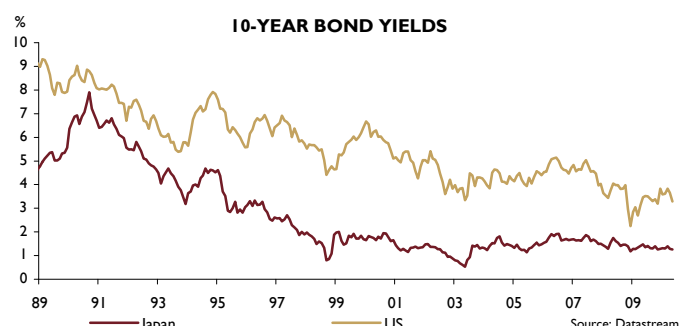
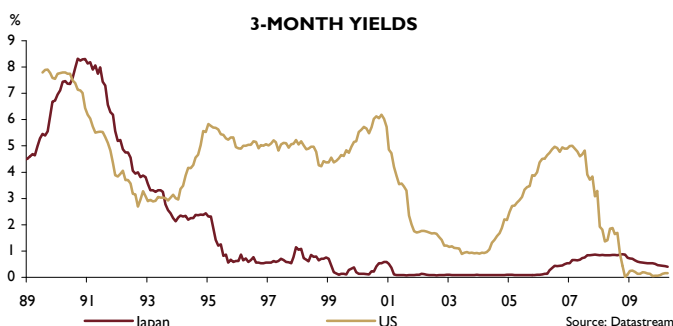
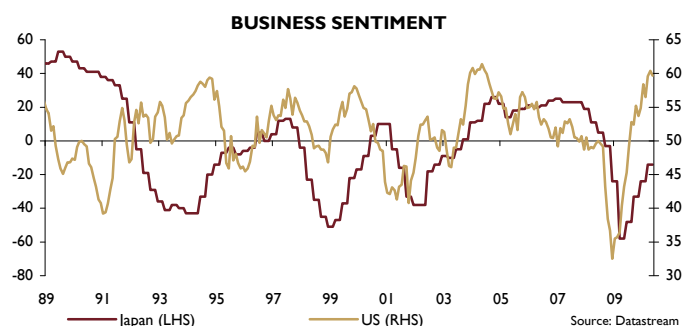
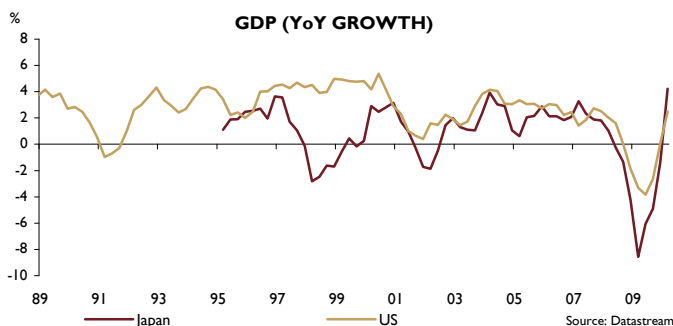
<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>
<b>New</b>	<b>Previous</b>	<b>Conviction</b>
<b>Neutral</b>	<b>Negative</b>	

<b>Performance (as of 14/06)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Yen vs Dollar (Reuters)	0.3	-1.1	-3.7	6.6	1.4

**Recommendation:** The yen has largely kept pace with the dollar in recent volatile markets, reflecting its reputation as a 'safe haven'. With uncertainty persisting and our forecast of US rate hikes pushed into 2011, we see the yen continuing to trade sideways against the dollar over the summer. However, longer term we see a weaker yen resulting from a renewed Japanese focus on measures to reinvigorate their domestic economy.



- 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:** The yen futures market is flat against the US dollar, as the net short yen position has been removed. 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 recent weakness of the yen has broken the positive technical trend, but it's too early to discern the technical indicators of a new long-term direction.



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