FX & INTEREST RATE MONTHLY

Currencies reflect renewed confidence in global economic recovery.

Despite a bitter winter the global economic recovery has continued and relapses, such as Sweden's dip back into recession in the latter part of last year, have not been sufficient to derail it. The dissipation of investor concerns has been reflected in a rally in currencies with a positive gearing to growth and risk appetite at the expense of those regarded as safe havens.

Interest-rate increases are still on the agenda.

Malaysia joined a still-exclusive group of countries that have raised their interest rates over the past year. That list is set to lengthen over the coming year, but will be led and dominated by emerging economies. By contrast we expect the 'big four' of the US Federal Reserve, Bank of England, European Central Bank and Bank of Japan will be slow to increase. The balance of risks is skewed toward undershooting our forecasts as fiscal tightening takes precedence.

Markets are still giving governments the benefit of the doubt on their deficits...

While Greece's debt crisis continues, the risk of contagion appears to have receded. Investors are giving governments with huge, recession-hit deficits the benefit of the doubt, with one apparent exception - the UK. This may be because it combines a huge structural government deficit, excessive consumer debt and an outsized financial industry. But it is just as likely to be that the size of its FX market means that sterling is a large and liquid trade for investors concerned about the world's debt woes. Sterling at least provides a pressure release valve – good for recovery, but bad for holders of the currency.

...but protecting the currency and debt holders brings deflation risks.

By contrast the options for members of the eurozone are constrained. Sharp spending cuts, which bring the risk of deflation, are the option embraced by member countries that are facing a debt crisis. However, it is not an option for larger members or ones with heavy private-sector debt burdens. In the short term it is supportive for the currency, as the example of Japan demonstrates. But it may just be deferring the risks if debt burdens continue rising because growth is lacking and prices are falling.

Liquid commodity currencies provide a proxy for anticipated emerging-currency appreciation.

The growth outlook for emerging economies remains strong, with continued recovery by developed economies removing a potential risk to that growth. A lack of liquidity and the restrictions of managed exchange-rate systems make trading in these currencies expensive and subject to political uncertainty. This leaves 'commodity' currencies such as the Canadian and Australian dollar with clear links to emerging growth as a more liquid proxy for investors seeking participation in these trends.

Currencies	Spot	RBS Forecast (as of 10 March)				Past Performance (in %)					
	15/03/2010	Jun-10	Sep-10	Dec-10	Mar-11	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.37	1.34	1.32	1.28	1.26	0.0	0.4	-6.2	-6.5	5.9	-4.9
Yen vs Dollar	90	92	95	100	102	-0.1	-0.5	-0.8	0.9	7.7	2.8
Sterling vs Dollar	1.50	1.46	1.47	1.47	1.50	-0.2	-3.9	-7.5	-8.5	7.7	-6.9
Swiss Franc vs Dollar	1.06	1.08	1.09	1.13	1.15	0.8	1.4	-2.3	-2.3	10.5	-2.9
Swiss Franc vs Euro	1.45	1.45	1.44	1.45	1.45	0.8	1.0	4.0	4.3	5.2	2.1
Australian Dollar vs Dollar	0.91	0.92	0.90	0.85	0.88	0.0	2.7	0.3	6.1	38.6	1.4
Euro vs Sterling	0.91	0.92	0.90	0.87	0.84	0.2	4.3	1.4	2.1	-1.7	2.1
Renminbi vs Dollar	6.83	6.70	6.60	6.50	6.40	0.0	0.1	0.0	0.0	0.2	0.0

	Growth (GDP)			Inflation (CPI)			Interest Rates					Decision
	2009	2010(C)	2011(C)	2009	2010(C)	2011(C)	Current	Jun' 10 (F)	Sep'10 (F)	Dec'10 (F)	Mar'11 (F)	Next Date
US	-2.4	3.1	3.0	-0.3	2.3	2.0	0.25	1.00	2.00	3.00	3.75	16-Mar-10
UK	-4.8	1.4	2.2	2.2	2.6	1.7	0.50	0.50	0.50	1.00	1.50	08-Apr-10
Eurozone	-3.9	1.3	1.5	0.3	1.2	1.5	1.00	1.00	1.00	1.00	1.25	08-Apr-10
Japan	-5.3	1.5	1.5	-1.4	-1.0	-0.3	0.10	0.10	0.10	0.10	0.10	17-Mar-09

(C) Consensus Forecast

(F) RBS Forecast

Source: All data from Datastream, except where stated otherwise

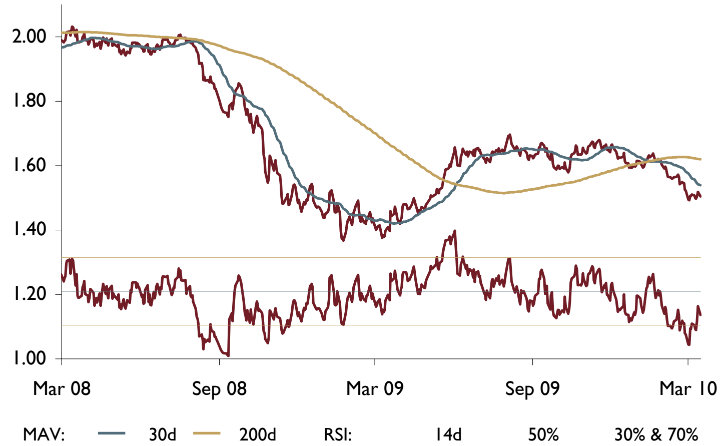
STERLING vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Negative	Negative	

Performance (as of 15/03)	-1M	-3M	-6M	-12M	YTD
Sterling vs Dollar (Reuters)	-3.9	-7.5	-8.5	7.7	4.6

Recommendation: Investor sentiment is negative towards sterling. The UK has a huge structural deficit, excessive consumer debt and an outsized financial industry. But it is just as likely that sterling is a large and liquid trade for investors concerned about the world's debt woes. The US dollar, despite sharing many of the same characteristics, is a beneficiary. The dollar is also supported by a better growth outlook, and we forecast US rates will go up before the UK.

STERLING / DOLLAR SPOT RATE



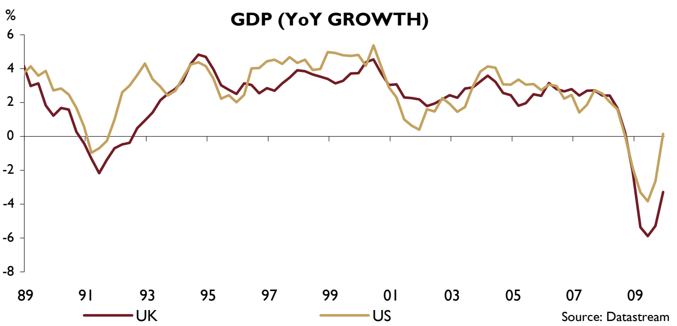
☐ **Valuation:** Sterling is currently close to its 20-year average, though well below more recent levels.

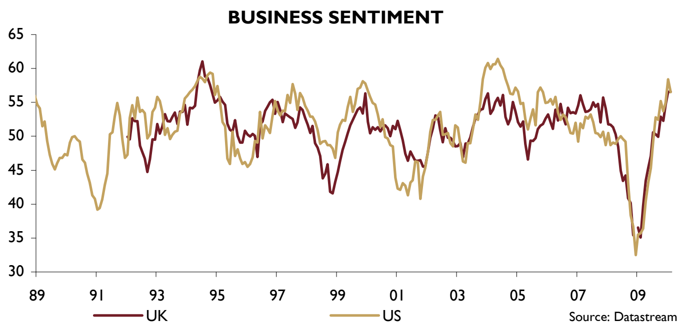
☒ **Activity:** The UK has lagged the global upturn, with recovery emerging later, in the final quarter of 2009, and at a slower pace with only 1.2% annualised growth, roughly a fifth of the 5.9% pace for the US in the same quarter. The UK economy is expected to continue to lag with consensus expectations of 1.4% growth for the UK in 2010 compared with 3.1% for the US economy.

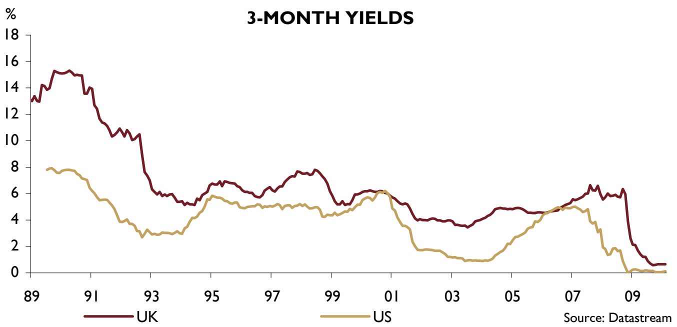
☑ **Liquidity:** There is a net short speculative trade position in sterling against the dollar. Both currencies effectively have a zero yield, so there is little to choose on this basis. Even in terms of quantitative easing, which acts to weaken the currency, both countries' central banks have been active over the past year in boosting the money supply, although the Federal Reserve is leading the way in planning the withdrawal of this support as the domestic economy recovers.

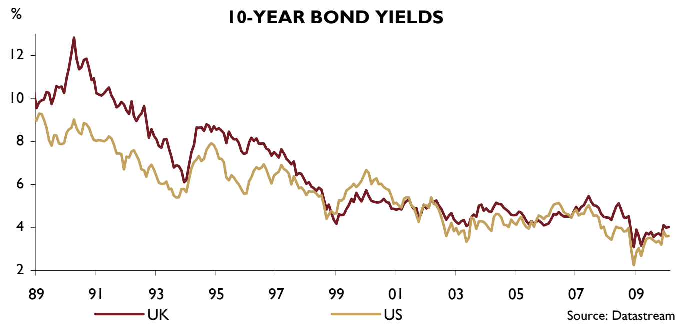
☒ **Risk:** The bias of risk has shifted against the UK, with the government and its budget forecasts appearing unconvincing to financial markets.

☒ **Momentum:** Sterling has fallen below key technical levels. While sterling is currently oversold against the US dollar and there is scope for a rebound, the longer-term trend has turned negative.







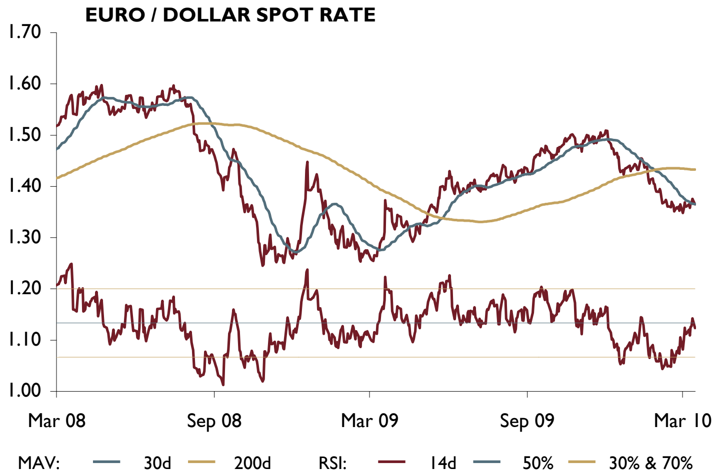


EURO vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Negative	Neutral	

Performance (as of 15/03)	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar (Reuters)	0.4	-6.2	-6.5	5.9	-4.9

Recommendation: Debt and economic crises affecting some member states offset the euro's higher interest rates and lower-inflation environment. Against the risks of deflation affecting growth and future debt affordability, the dollar appears attractive. While the US deficit is huge, continuing economic recovery is likely to lead to higher interest rates by the end of the year increasing the relative attraction of the dollar against the euro.



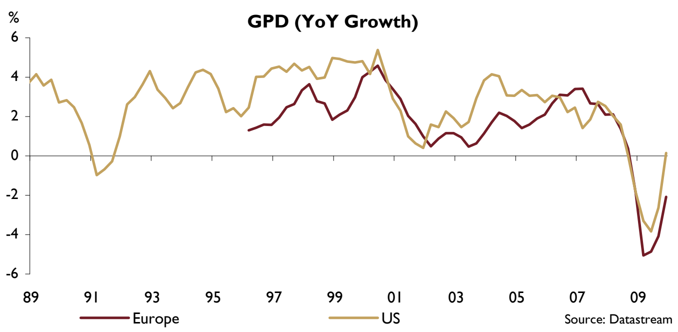
☒ **Valuation:** The euro appears expensive against its average value since its creation in 1999, although the range over the ten years of its existence has been huge, from $0.82 to $1.58.

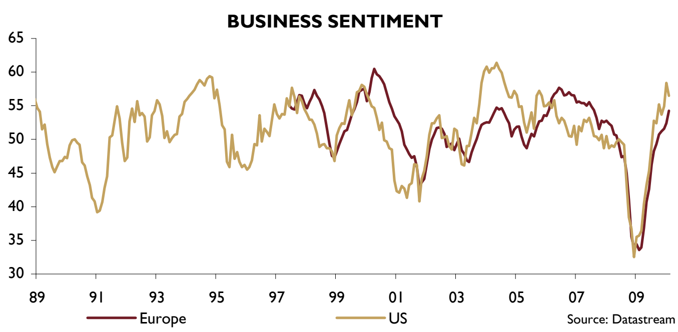
☒ **Activity:** While both economies have emerged from recession, the eurozone experienced a more severe downturn than the US and the consensus expectation is that its recovery will be substantially slower, at 1.1% compared with 3.1% for the US this year.

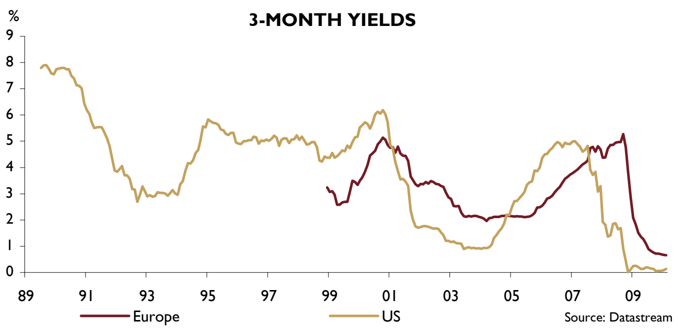
☑ **Liquidity:** Investors hold a net short position in the euro, depsite its short-term yield advantage over the dollar. This could drive a rally in the euro if it is unwound.

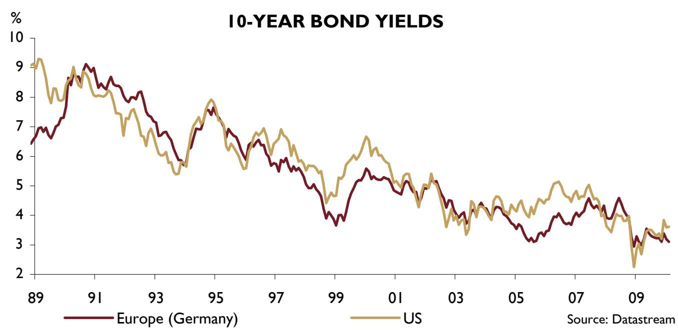
☒ **Risk:** The expectation that the European Union will have to bail out the Greek government and extend greater liquidity support to other troubled member states has triggered weakness in the euro. This outweighs concerns over the US budget deficit.

☒ **Momentum:** The euro has broken key technical levels in its recent fall, suggesting that last year's supportive technical trend is reversing.







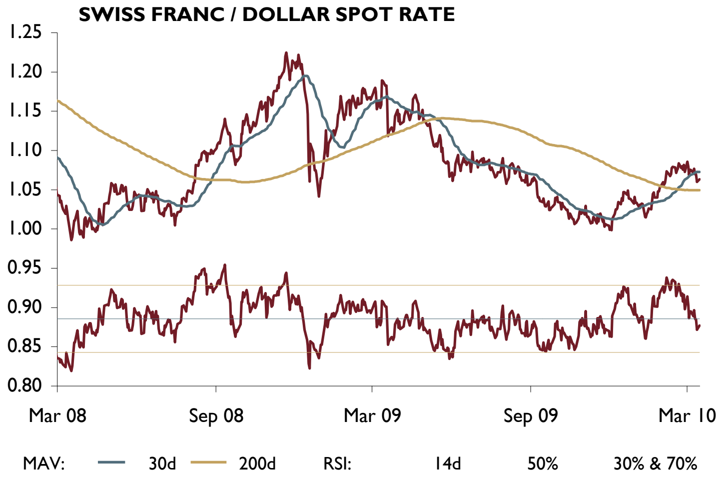


SWISS FRANC vs DOLLAR

Recommendation		Time Horizon:	3 Months
New	Previous		Conviction
Negative	Neutral		

Performance (as of 15/03)	-1M	-3M	-6M	-12M	YTD
Swiss Franc vs Dollar (Reuters)	1.4	-2.3	-2.3	10.5	-2.9

Recommendation: Our forecast of continued recovery in the US economy, with interest-rate increases later in the year, supports a higher US dollar against the Swiss franc. The Swiss National Bank has also been intervening to weaken the franc over the past year. However, the Swiss economy appears healthier than its neighbours in the eurozone, while the franc retains its 'safe haven' status, both factors that could limit the downside.



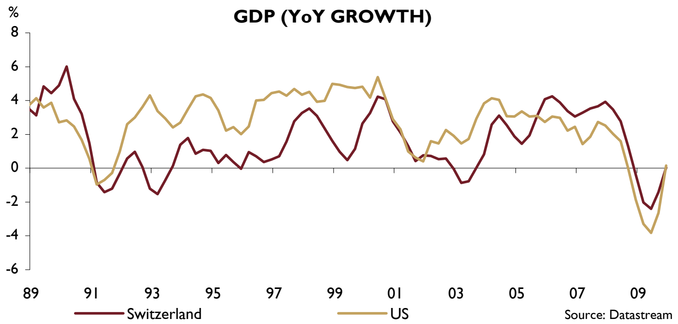
☒ **Valuation:** The Swiss franc still stands towards the top of its long-term historical range versus the dollar.

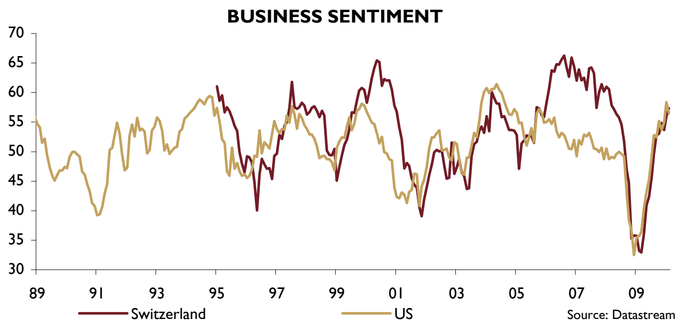
☒ **Activity:** With the global economy now clearly rebounding, we would expect the US economy to see a stronger recovery, with a consensus forecast of 3.1% growth compared with 1.5% for Switzerland in 2010. This performance reflects the close links between the Swiss economy and the European Union, which is also seen lagging the US.

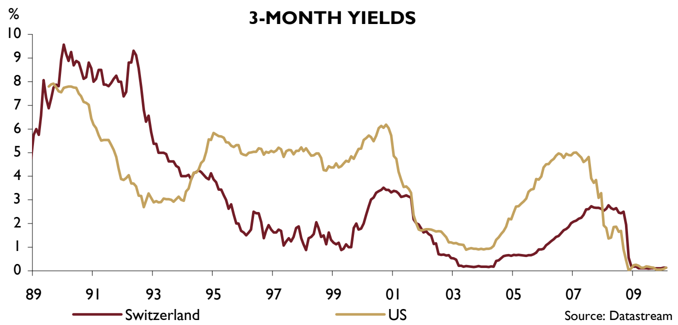
☐ **Liquidity:** Investor positions in the futures market are currently broadly balanced between longs and shorts in the Swiss franc. The US made much more use of quantitative easing to boost the money supply in 2009, which acted to weaken the dollar, but the Federal Reserve is now talking of withdrawing these measures. The Swiss National Bank has also withdrawn some of its quantitative measures, but has continued to intervene against strong appreciation by the Swiss franc, buying up to $45bn in FX markets over the past year.

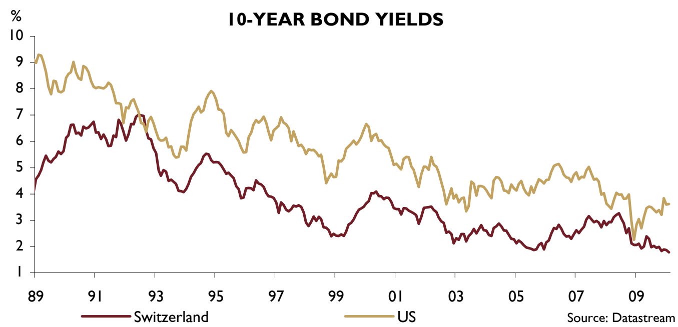
☑ **Risk:** The Swiss franc is a traditional safe haven for investors at a time of market or economic uncertainty. However, this has been undermined by the repeated interventions by the monetary authorities to prevent unwanted appreciation of the Swiss franc.

☒ **Momentum:** The Swiss franc has broken key technical levels in its recent fall. While the Swiss franc is currently off its lows and set to re-test the trend, we see a reversal of the last year's technical uptrend.





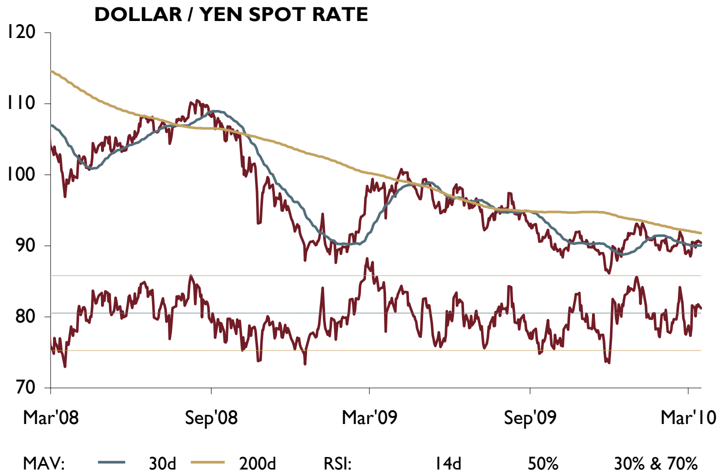




YEN vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Negative	Negative	

Performance (as of 15/03)	-1M	-3M	-6M	-12M	YTD
Yen vs Dollar (Reuters)	-0.5	-0.8	0.9	7.7	2.8



Recommendation: The yen has been supported by its current superior yield over the US dollar. This is the first time that Japanese rates have been higher in more than fifteen years and is likely to be reversed this year as stronger US economic growth leads to interest-rate hikes. The yen is also under pressure from Japan's search for new methods to reinvigorate the economy, which are likely to involve further unconventional monetary measures.

☐ **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 the Japanese economy returned to growth early in 2009 and grew at an annualised rate of 3.8% in the final three months, it is still expected to lag the US economy, which grew at a 5.7% pace in the same quarter. Consensus forecasts are for Japan to grow by only 1.3% in 2010 compared to a 3.1% pace for the US economy.

☒ **Liquidity:** There is a modest net long position in the yen futures market against the US dollar. Current ultra-low US interest rates mean that the yen actually has a miniscule yield advantage, 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 relativaly fragile Japanese economic recovery.

☑ **Momentum:** The strength of the technical trend in favour of the yen has weakened, but remains intact.