



## FX & INTEREST RATE MONTHLY

**Cheap liquidity continues to flood global currency markets...**

**...but the tide is now turning, to the detriment of last year's winners.**

**The overvaluation of the yen and the euro is likely to be increasingly exposed in 2010.**

**The pressure to raise interest rates is already apparent in developing economies that have emerged largely unscathed from the downturn.**

Quantitative easing (QE) has pumped liquidity into the global economy to help drive a recovery from the recession. As the Federal Reserve has issued huge quantities of zero-yielding US dollars, **investors have sought to switch the US currency into higher-yielding or higher risk 'carry trades' - so ensuring that the US dollar sold off in 2009.**

Having achieved the aim of averting a global depression and with growth now recovering, central banks are looking to withdraw some stimulus by reversing QE and raising interest rates. The prospect of this withdrawal - which we do not expect to start until the second half of the year - is already causing nervousness among investors, who have moved swiftly to close net short positions on the US dollar. While this move may be premature, with the 'carry trade' potentially re-emerging in the short term, **we anticipate that the US currency will end the year at significantly stronger levels against other major currencies.**

Among the major developed economies, the US is likely to enjoy the most impressive recovery in the near term. By contrast, **Japan and the eurozone, which maintained more conservative monetary and fiscal policies, should lag, with neither economies expected to raise interest rates this year.** In fact, there is a risk that they may need to take further action to support growth: in the case of the eurozone, because of the emergence of a crisis in one of its member states; and in Japan, the new finance minister has already talked of a weaker yen as an accompaniment to the new budget stimulus and action from the Bank of Japan.

Policy decisions are key to unlocking potential changes in emerging currency markets as these countries face the options of higher inflation, higher interest rates or higher exchange rates. There are likely to be a range of measures from different countries, including temporary stop-gap solutions such as Brazil's capital controls, as they struggle with conflicting risks. However, we expect **the eventual outcome will include a significant appreciation of emerging market currencies against developed country currencies.**

Currencies	Spot 19/01/2010	RBS Forecast (as of 14 January)				Past Performance (in %)					
		Mar-10	Jun-10	Sep-10	Dec-10	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.43	1.48	1.40	1.38	1.35	-1.8	0.0	-4.4	1.2	8.6	-0.5
Yen vs Dollar	91	93	95	98	100	-0.3	-0.5	-0.7	3.1	-0.9	2.0
Sterling vs Dollar	1.64	1.59	1.59	1.61	1.65	1.1	1.8	-0.1	0.3	12.7	1.4
Swiss Franc vs Dollar	1.03	0.99	1.03	1.04	1.07	-1.8	1.3	-2.1	4.1	8.6	0.0
Swiss Franc vs Euro	1.48	1.47	1.44	1.44	1.45	0.0	1.2	2.5	3.0	0.8	0.5
Australian Dollar vs Dollar	0.92	1.00	0.95	0.90	0.87	-0.2	4.2	-0.1	15.3	38.1	2.7
Euro vs Sterling	0.87	0.93	0.88	0.86	0.82	-2.9	-1.8	-4.5	0.9	-3.8	-1.9
Renminbi vs Dollar	6.83	6.80	6.70	6.60	6.50	0.0	0.0	0.0	0.1	0.1	0.0

	Growth (GDP)			Inflation (CPI)			Interest Rates					Decision
	2009	2010(C)	2011(C)	2009	2010(C)	2011(C)	Current	Mar'10 (F)	Jun'10 (F)	Sep'10 (F)	Dec'10 (F)	Next Date
US	-2.5	2.9	3.1	-0.3	2.2	1.9	0.25	0.25	1.00	2.00	3.00	27-Jan-09
UK	-4.7	1.5	2.2	2.1	2.4	1.7	0.50	0.50	0.50	0.50	1.00	04-Feb-10
Eurozone	-3.9	1.3	1.6	0.3	1.2	1.5	1.00	1.00	1.00	1.00	1.00	04-Feb-10
Japan	-5.4	1.3	1.5	-1.3	-1.0	-0.3	0.10	0.10	0.10	0.10	0.10	26-Jan-09

(C) Consensus Forecast

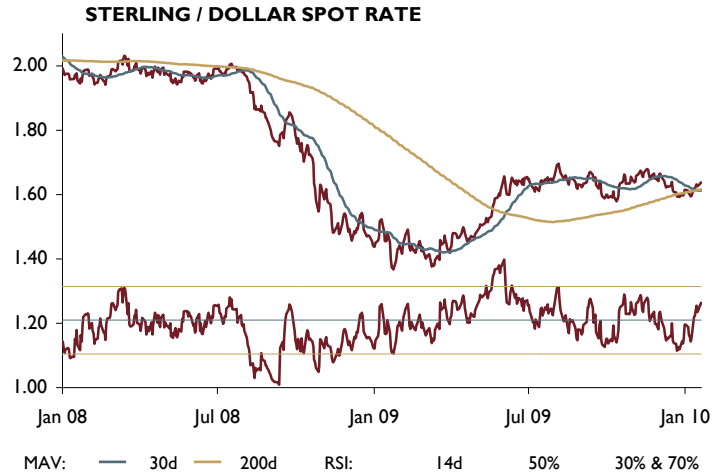
(F) RBS Forecast

# STERLING vs DOLLAR

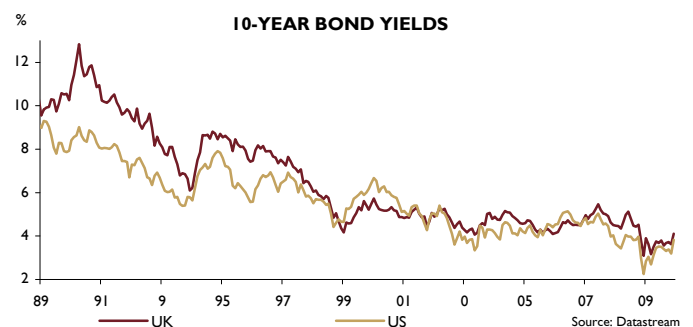
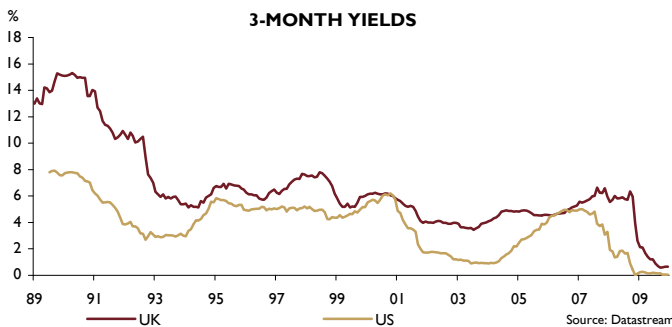
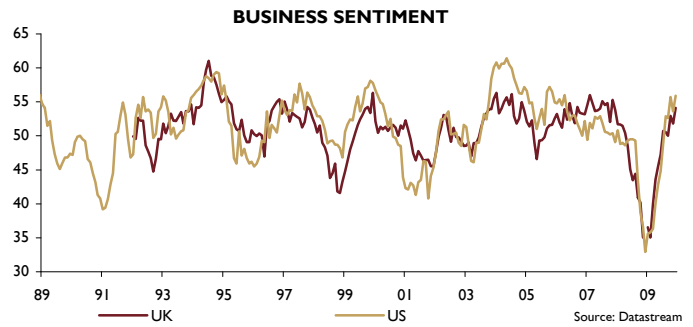
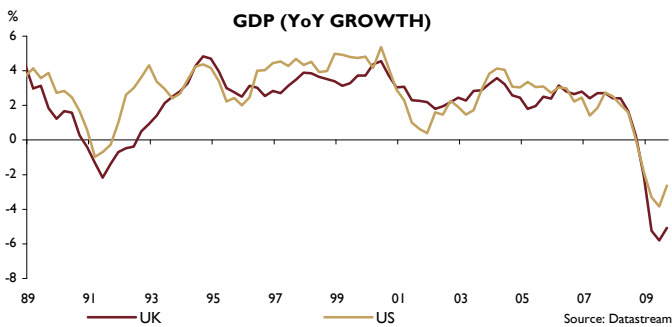
<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>
<b>New</b>	<b>Previous</b>	<b>Conviction</b>
<b>Negative</b>	<b>Neutral</b>	

<b>Performance (as of 19/01)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Sterling vs Dollar (Reuters)	1.8	-0.1	0.3	12.7	1.4

**Recommendation:** While the return of global economic growth alleviates some of the UK's problems, we are still forecasting a sluggish recovery. With no pressure to raise interest rates and the Bank of England currently extending its quantitative easing programme, these factors will continue to be a drag on sterling. While the US dollar shares many of the same issues, we expect that the US recovery will be stronger, leading to rates rises supporting the dollar.



- Valuation:** Sterling is currently close to its 20-year average, though well below more recent levels.
- Activity:** The UK remains one of the few major economies yet to officially exit recession. Its economy is expected to continue to lag in 2010 with consensus expectations of 1.5% growth for the UK compared with 2.9% for the US economy.
- Liquidity:** There is still a net short speculative trade position in sterling. 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 in boosting the money supply, though 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:** Despite recent weakness the technical indicators still support a move higher by sterling.



# EURO 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>Positive</b>	

<b>Performance (as of 19/01)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Euro vs Dollar (Reuters)	0.0	-4.4	1.2	8.6	-0.5

**Recommendation:** There is scope for further short-term US dollar weakness as global recovery encourages investment flows out of low-yielding US assets. However, as recovery progresses we move closer to Fed tightening, which will support the dollar. By contrast, it looks increasingly likely that the ECB will have to extend its liquidity operations to support troubled member states, like Greece. Hence we forecast a dollar rally against the euro later in the year.

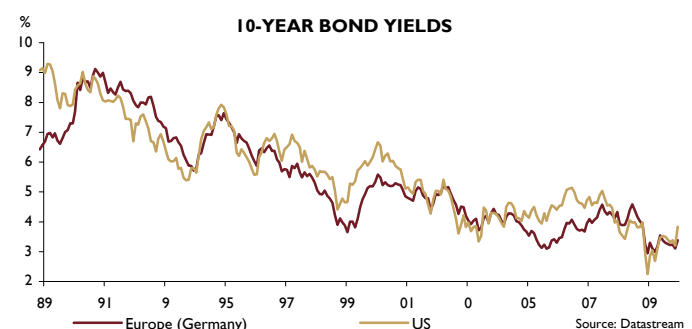
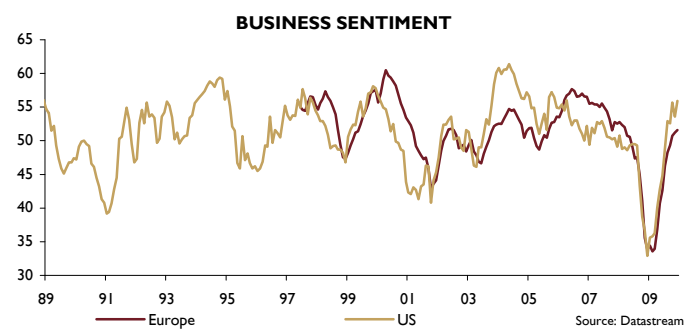
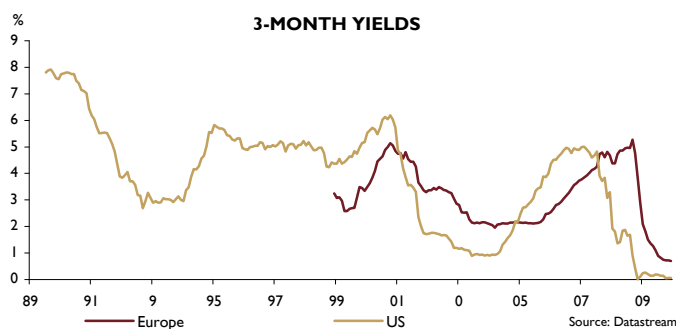
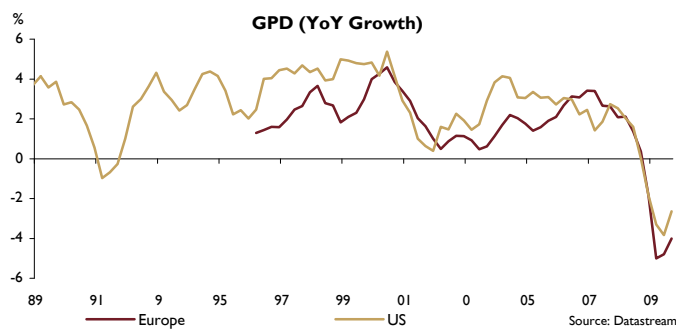
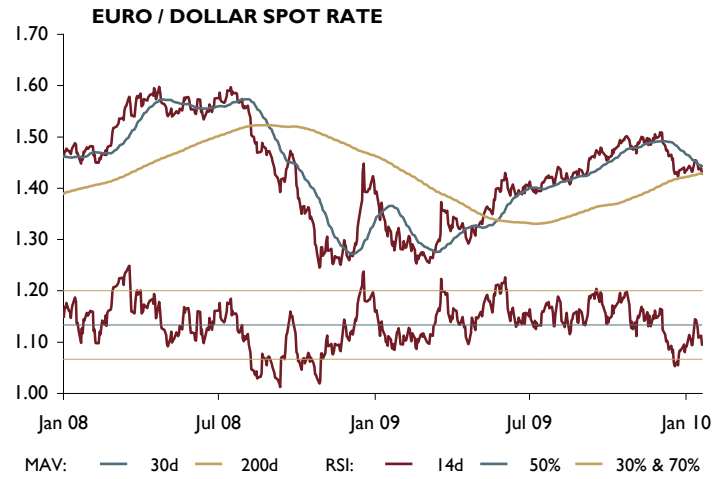
**Valuation:** The euro appears expensive against its average value since its creation in 1999, although the range over the ten years of its existence has been huge, from \$0.82 to \$1.58.

**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 +1.2% compared with +2.9% for the US this year.

**Liquidity:** With the ECB making 1% the floor for interest rates, the euro has a yield advantage. The US has made much more use of quantitative easing to boost the money supply, which has weakened the dollar, though the ECB has also supplied huge quantities of liquidity to the eurozone financial system. These emergency measures will start to be unwound in the first quarter of 2010 and we anticipate that US interest rates will start rising in the second half of the year. Ahead of this the net long speculative position in euros in the futures market has been unwound.

**Risk:** There are considerable additional extraordinary risks to both the dollar and the euro. On the US side, we would cite the huge size of the budget deficit. With the eurozone, it is uncertain how the ECB and the single currency will cope with the continuing pressures on individual member states, such as Greece and Ireland.

**Momentum:** Despite the recent correction, the euro has still not breached its positive technical uptrend against the US dollar.

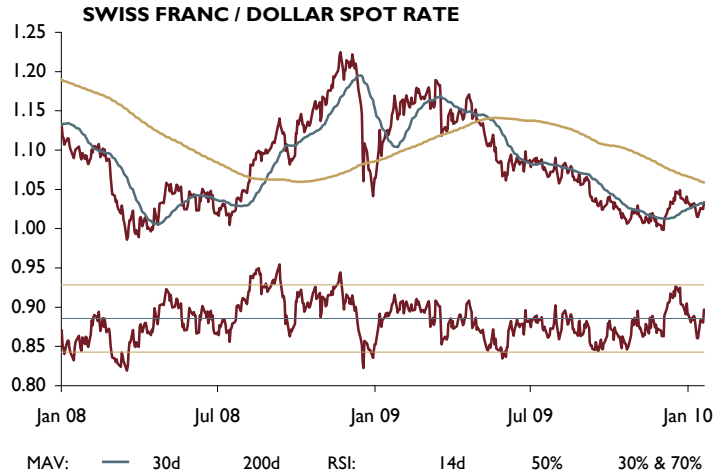


## SWISS FRANC vs DOLLAR

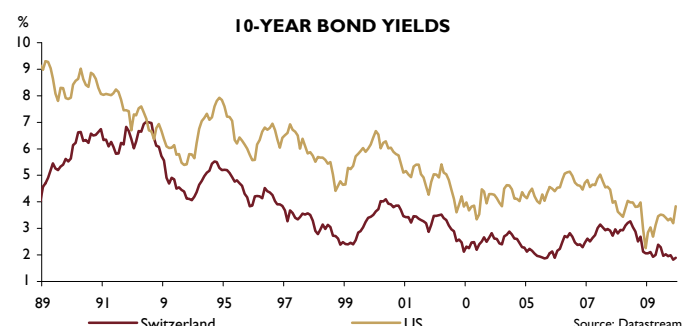
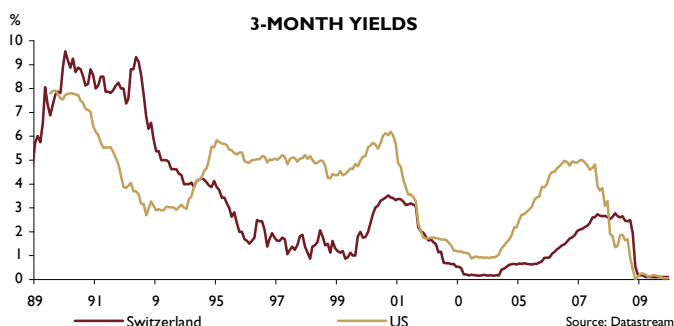
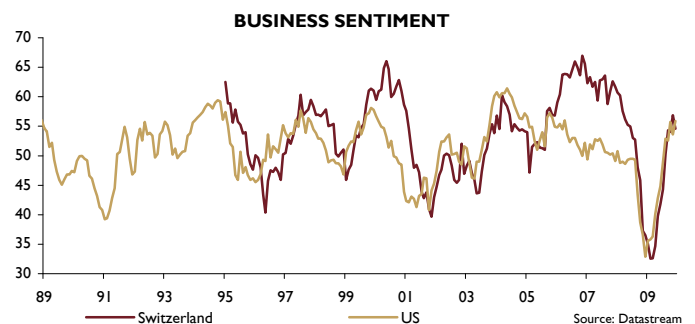
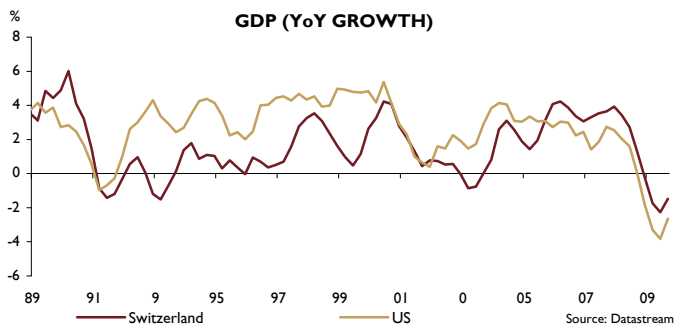
<b>Recommendation</b>	<b>Time Horizon:</b>	<b>3 Months</b>
<b>New</b>	<b>Previous</b>	<b>Conviction</b>
<b>Neutral</b>	<b>Positive</b>	

<b>Performance (as of 19/01)</b>	<b>-1M</b>	<b>-3M</b>	<b>-6M</b>	<b>-12M</b>	<b>YTD</b>
Swiss Franc vs Dollar (Reuters)	1.3	-2.1	4.1	8.6	0.0

**Recommendation:** With investors keen to swap zero-yielding dollars for higher-yielding currencies and risk assets, the US dollar remains under pressure. However, Switzerland shares many of the same issues as the US, such as the weak recovery, little scope to raise interest rates and fears of deflation. Indeed the Swiss authorities have reaffirmed their commitment this year to intervening in currency markets if there should be further unwarranted strength of the Swiss franc.



- 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 in 2010, with the consensus forecast of 2.9% growth compared with only 1.2% for Switzerland.
- Liquidity:** Investor positions in the futures market are currently long the Swiss franc. This is a potential negative when it unwinds. The interest rate differential has effectively disappeared. The US has made much more use of quantitative easing to boost the money supply, which has acted to weaken the dollar, but the Federal Reserve is now talking of moving away from further measures. The Swiss National Bank has also withdrawn some of its quantitative measures, but has retained its threat to intervene against strong appreciation by the Swiss franc, which threatens the domestic economy.
- Risk:** The Swiss franc is a traditional safe haven for investors at a time of market or economic uncertainty. However, this position has been undermined by the losses of the Swiss financial industry, which have required government bail-outs.
- Momentum:** Despite the recent setback, the Swiss franc remains in a technical uptrend against the US dollar.



## 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>Positive</b>	

Performance (as of 19/01)	-1M	-3M	-6M	-12M	YTD
Yen vs Dollar (Reuters)	-0.5	-0.7	3.1	-0.9	2.0

**Recommendation:** With economic recovery set to continue in 2010, we anticipate that the US dollar will outperform. The return of economic growth will allow the Fed to tighten monetary policy, restoring its yield advantage over the yen. By contrast the new Japanese Finance Minister has talked of the need for a weaker yen, in conjunction with the new budget stimulus and action form the Bank of Japan, to support the relatively fragile Japanese economic recovery.

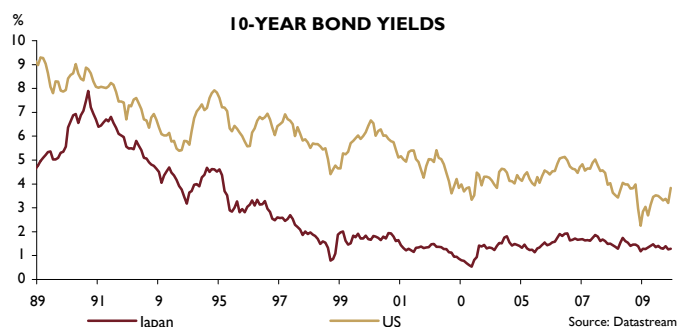
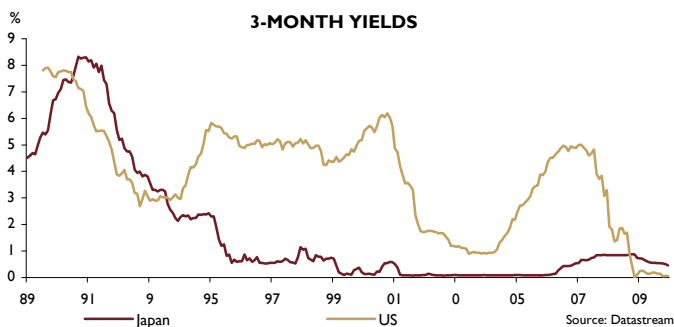
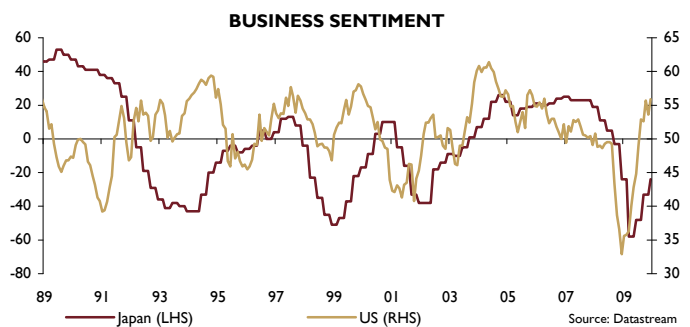
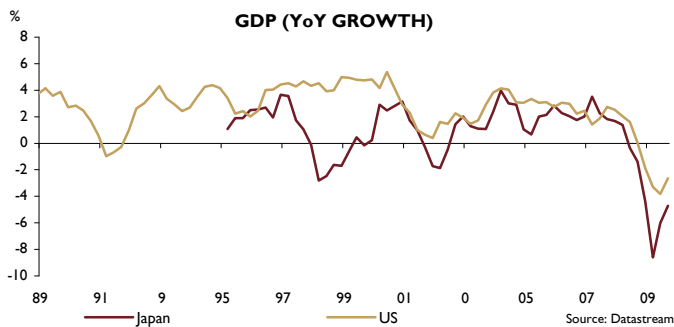
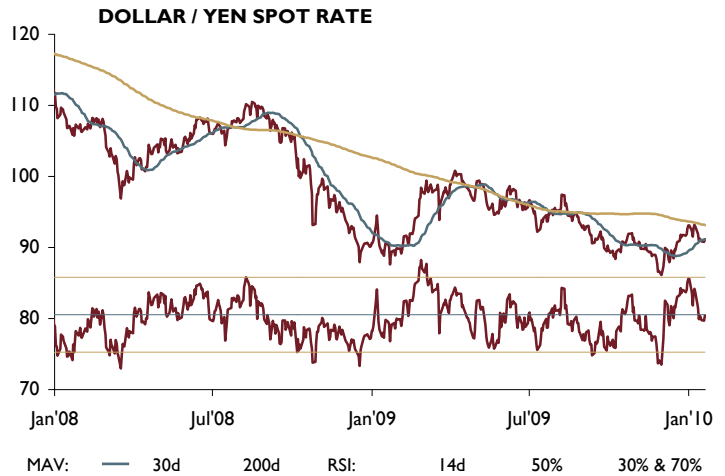
**Valuation:** The last time the yen was below 100 to the US dollar was in 1995. Then, it was overvalued; now, adjusted for relative inflation, it appears fairly valued.

**Activity:** The Japanese economy may have returned to growth earlier in 2009, but its recovery is expected to lag in the current year. Consensus forecasts indicate that Japan will grow by only 1.3% in 2010 compared to a 2.9% increase in economic activity in the US.

**Liquidity:** There is an approximate balance in the yen futures market against the US dollar. Current ultra-low US interest rates mean that there is no material difference with the yen's lack of yield, though this is set to change as we forecast US interest rate increases in the second half of the 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. The new Japanese Finance Minister has talked of the need for a weaker yen in conjunction with the new budget stimulus and action form the Bank of Japan to support the relatively fragile Japanese economic recovery.

**Momentum:** The strength of the technical trend in favour of the yen has weakened substantially in recent months.



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