16 February 10

FX & INTEREST RATE MONTHLY

The major themes of risk and recovery have dominated FX and other markets over the past year.

The scale of the market collapse in 2008 and recovery in 2009 were sufficient to overwhelm all other factors. A binary trading environment has prevailed, with the US dollar and the yen on one side and practically everything else on the other side. It mirrored the same division between the safe haven of government bonds on one hand and risk assets, especially equities and commodities, on the other. **As some stability returns to both the global markets and global economy, there is scope for other, currency-specific factors to regain greater influence over currency moves.**

The reversal of the 'carry trade' has supported the US dollar.

The current sell-off in risk assets has again coincided with a period of US dollar strength. **A direct connection is the 'carry trade' where dollars, whether borrowed or part of investment portfolios, are invested in foreign-currency-denominated risk assets.** A correction in risk assets, prompting an unwinding of these positions, means that as investors return to the 'safe haven' of US Treasuries they will move back into dollars.

Greece's debt crisis has produced independent euro weakness.

While the break-up of the eurozone remains a distant possibility, **the direct and indirect costs of bailing out the Greek government will continue to weigh on the euro**. A bail-out would represent an additional injection of euros into the market, while the tighter fiscal policy required of the Greek and other national governments further postpones any potential tightening of monetary policy. We do not forecast an interest-rate hike by the European Central Bank within the next twelve months.

Government policy remains a key driver of currency markets.

Policy decisions are likely to be the key driver of emerging currency markets. With a swift recovery, having avoided many of the worst affects of the financial crisis, many emerging countries now face the options of higher inflation, higher interest rates or higher exchange rates. **We expect the eventual outcome will include a significant appreciation of emerging market currencies against developed country currencies.** By contrast the policy of the Swiss and Japanese authorities has been directed to preventing currency appreciation, as investors seeking 'safe havens' threaten to bid up their currencies to levels that endanger export competitiveness and therefore economic recovery in these countries.

Currencies	Spot	RBS Forecast (as of 11 February)				Past Performance (in %)					
	15/02/2010	Mar-10	Jun-10	Sep-10	Dec-10	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.36	1.38	1.35	1.32	1.28	-0.8	-5.4	-8.7	-4.5	5.3	-5.2
Yen vs Dollar	90	91	93	97	100	-0.8	1.0	-0.4	4.8	2.2	3.3
Sterling vs Dollar	1.57	1.52	1.53	1.54	1.56	0.1	-3.7	-6.1	-5.3	8.5	-3.1
Swiss Franc vs Dollar	1.08	1.07	1.07	1.09	1.13	-0.8	-5.1	-6.3	-0.6	6.9	-4.3
Swiss Franc vs Euro	1.47	1.47	1.45	1.44	1.45	-0.1	0.6	2.9	3.9	2.0	1.2
Australian Dollar vs Dollar	0.89	0.85	0.90	0.88	0.83	2.0	-3.9	-4.7	6.2	33.9	-1.3
Euro vs Sterling	0.87	0.91	0.88	0.86	0.82	-0.9	-1.8	-2.8	0.8	-3.0	-2.3
Renminbi vs Dollar	6.83	6.80	6.70	6.60	6.50	-0.1	-0.1	-0.1	0.0	0.1	-0.1

	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	16-Mar-10
UK	-4.7	1.5	2.2	2.1	2.4	1.7	0.50	0.50	0.50	0.50	1.00	04-Mar-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-Mar-10
Japan	-5.4	1.3	1.5	-1.3	-1.0	-0.3	0.10	0.10	0.10	0.10	0.10	18-Feb-09

(C) Consensus Forecast

(F) RBS Forecast

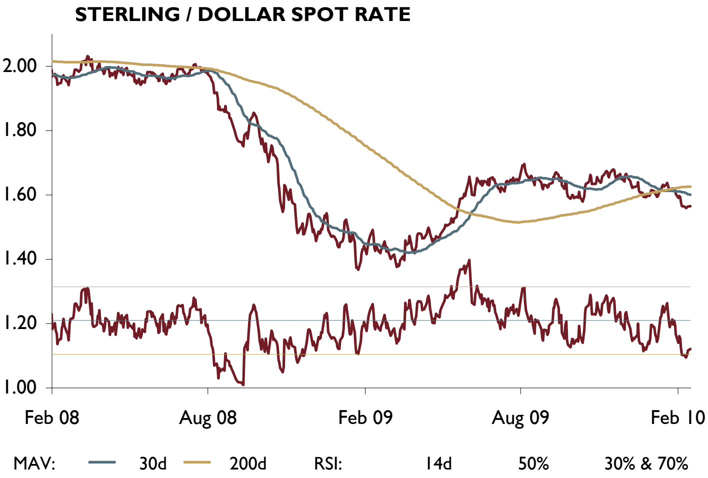
Source: All data from Datastream, except where stated otherwise

STERLING vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Negative	Negative	

Performance (as of 15/02)	-1M	-3M	-6M	-12M	YTD
Sterling vs Dollar (Reuters)	-3.7	-6.1	-5.3	8.5	8.9

Recommendation: The UK's recovery has lagged the global recovery, emerging later and at a slower pace. With the government's fiscal deficit causing concern in the markets, there is pressure for action on this front, which could dampen growth and further postpone the need for interest rate increases. While the US dollar shares many of the same issues, we expect that the US recovery will be stronger, leading to rate rises supporting the dollar.



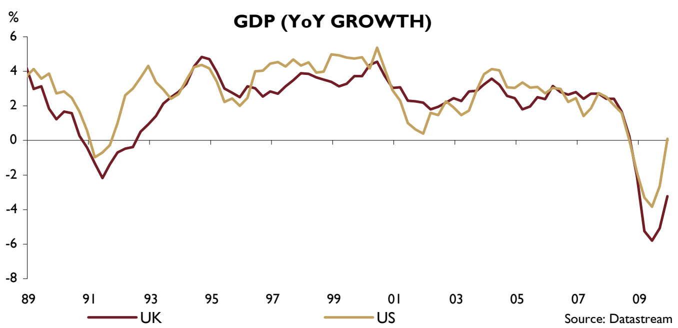
☐ **Valuation:** Sterling is currently close to its 20-year average, though well below more recent levels.

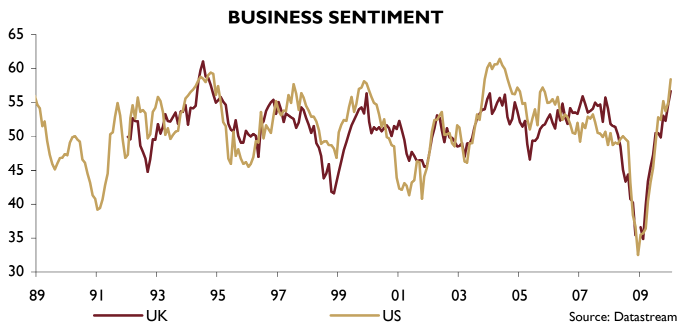
☒ **Activity:** The UK has lagged the global upturn, with recovery emering later, in the final quarter of 2009, and at a slower pace with only 0.1% growth compared with a 5.7% pace for the US. The UK economy is expected to continue to lag in 2010 with consensus expectations of 1.5% growth for the UK compared with 2.9% for the US economy.

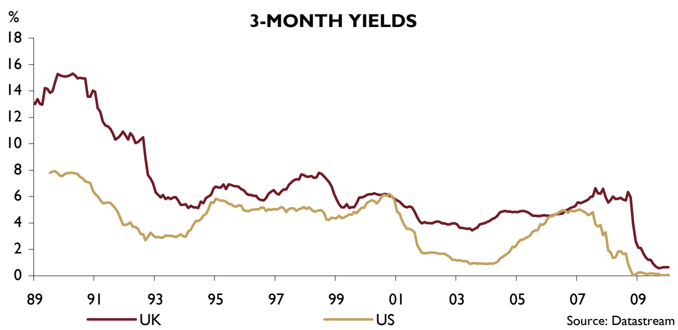
☑ **Liquidity:** There is a still a net short speculative position in sterling against the dollar. Both currencies effectively have a zero yield, so there is little to choose on this basis. Even in terms of quantitative easing, which acts to weaken the currency, both countries' central banks have been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

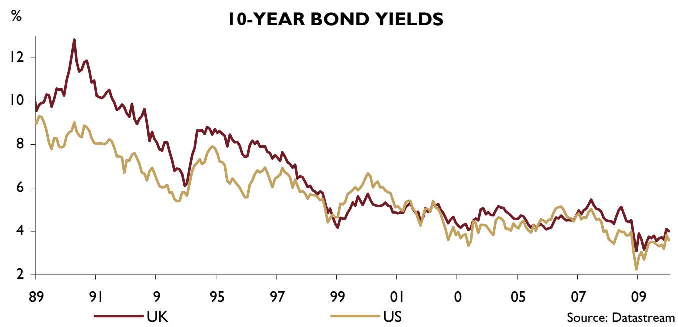
☒ **Risk:** The bias of risk has shifted against the UK, with the government and its budget forecasts appearing unconvincing to financial markets.

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





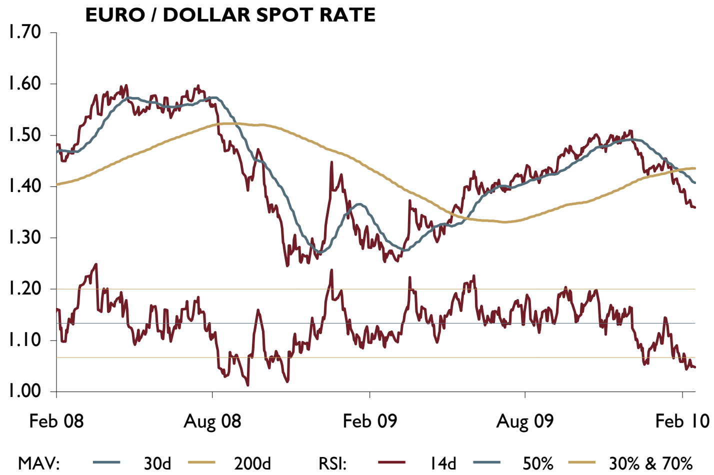




EURO vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Neutral	Neutral	

Performance (as of 15/02)	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar (Reuters)	-5.4	-8.7	-4.5	5.3	-5.2



Recommendation: The expectation that the core eurozone countries will have to bail-out the Greek government and extend greater liquidity support to other troubled member states has triggered weakness in the euro. While the short-term political outcome is unpredictable and the euro could rally, our longer-term expectation is that the euro will weaken given underlying economic weakness. We forecast that a stronger US recovery will lead to rate rises supporting the dollar.

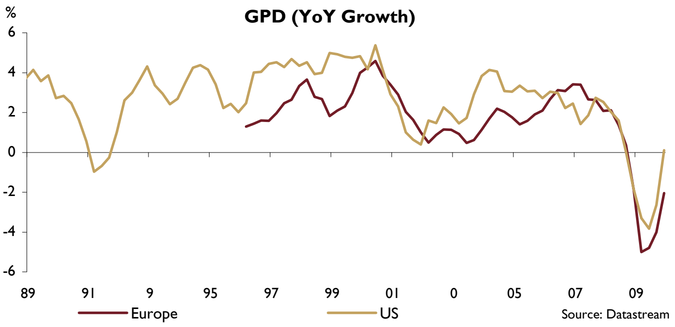
☒ **Valuation:** The euro appears expensive against its average value since its creation in 1999, although the range over the ten years of its existence has been huge, from $0.82 to $1.58.

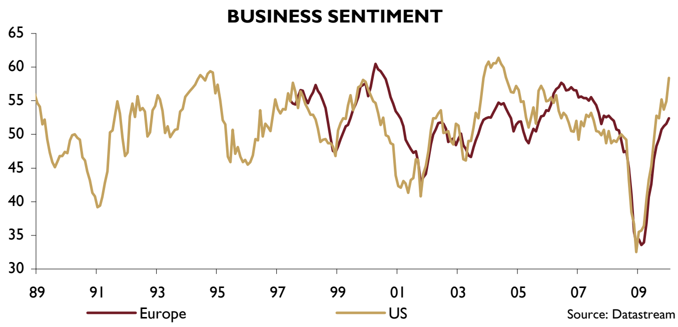
☒ **Activity:** While both economies have emerged from recession, the eurozone experienced a more severe downturn than the US and the consensus expectation is that its recovery will be substantially slower, at +1.3% compared with +2.9% for the US this year.

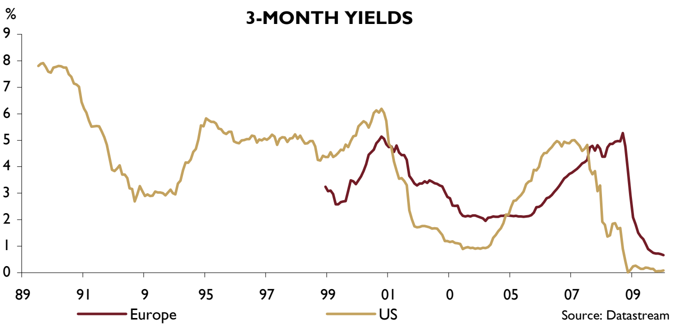
☑ **Liquidity:** Investors hold a net short position in the euro, though it has a short-term yield advantage over the US dollar. This could drive a rally in the euro if short positions are unwound.

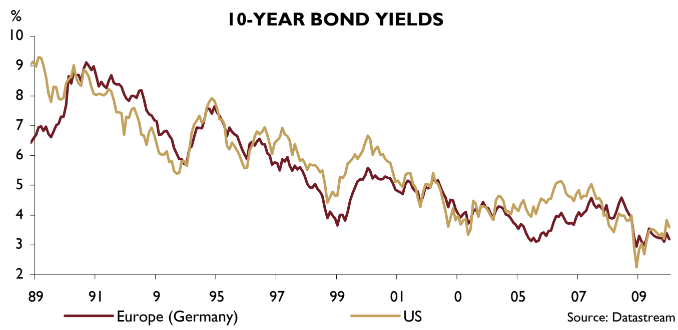
☒ **Risk:** The expectation that the European Union will have to bail-out the Greek government and extend greater liquidity support to other troubled member states has triggered weakness in the euro. This outweighs concerns over the US's own budget deficits.

☐ **Momentum:** The euro has broken key technical levels in its recent fall. While the euro is currently oversold against the dollar and could rally, the longer-term positive trend has been broken.







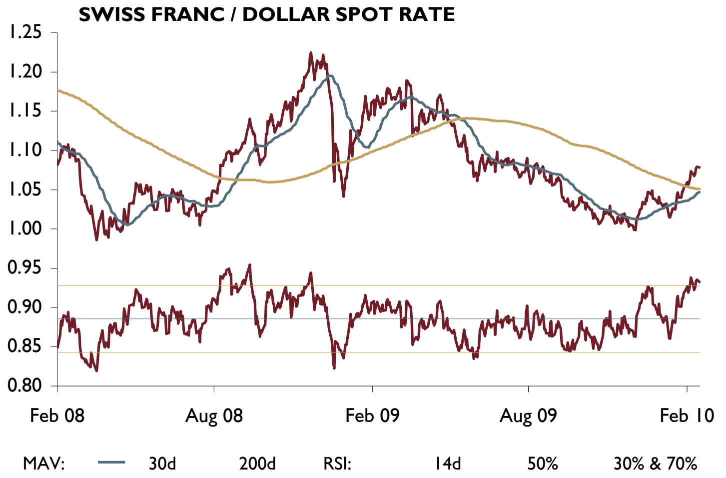


SWISS FRANC vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Neutral	Neutral	

Performance (as of 15/02)	-1M	-3M	-6M	-12M	YTD
Swiss Franc vs Dollar (Reuters)	-5.1	-6.3	-0.6	6.9	-4.3

Recommendation: The fragility of the Swiss economic recovery underscores the determination of the Swiss authorities to avert unwanted appreciation of the franc that would threaten export competitiveness. This links the Swiss franc to the weakened euro, so we expect it, at best, to hold level with the US dollar. The US dollar will benefit from a more robust recovery, leading to higher interest rates.



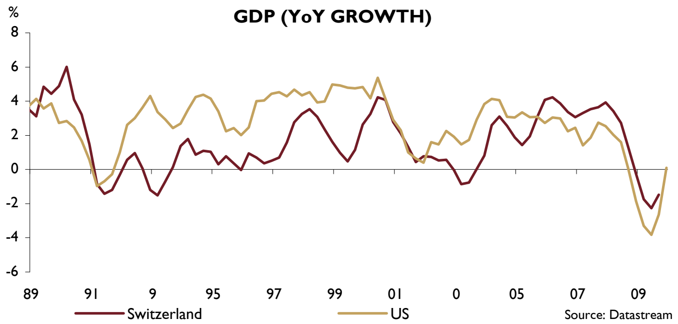
☒ **Valuation:** The Swiss franc still stands towards the top of its long-term historical range versus the dollar.

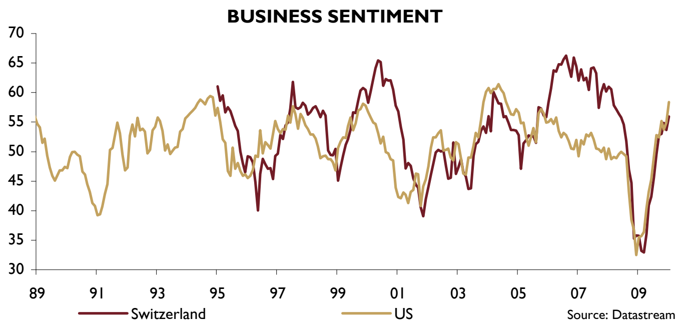
☒ **Activity:** With the global economy now clearly rebounding, we would expect the US economy to see a stronger recovery, with the consensus forecast of 2.9% growth compared with only 1.2% for Switzerland in 2010. This performance reflects the close links between the Swiss economy and the European Union.

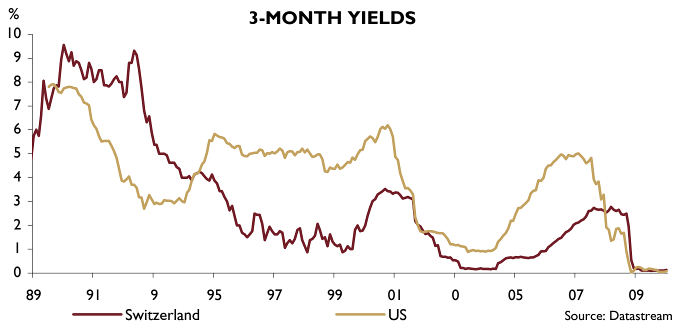
☐ **Liquidity:** Investor positions in the futures market are currently broadly balanced in the Swiss franc. The US made much more use of quantitative easing to boost the money supply in 2009, which acted to weaken the dollar, but the Federal Reserve is now talking of withdrawing these measures. The 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 the FX markets over the past year.

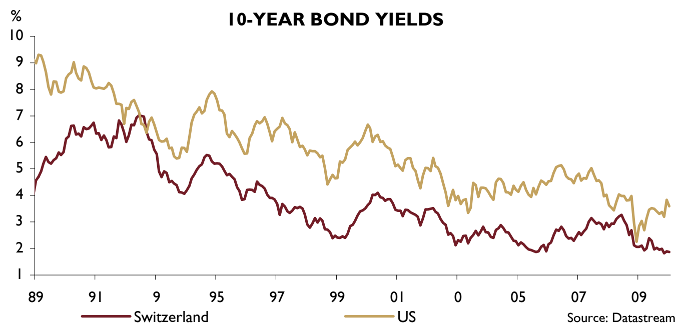
☑ **Risk:** The Swiss franc is a traditional safe haven for investors at a time of market or economic uncertainty. However, this has been undermined by the repeated interventions by the monetary authorities to prevent unwanted appreciation of the Swiss franc.

☐ **Momentum:** The Swiss franc has broken key technical levels in its recent fall. While the Swiss franc is currently oversold against the dollar and could rally, the longer-term positive trend has been broken.







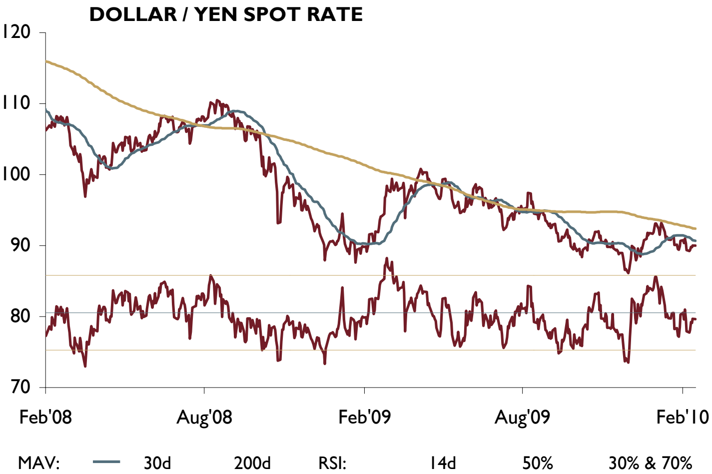


YEN vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Negative	Negative	

Performance (as of 15/02)	-1M	-3M	-6M	-12M	YTD
Yen vs Dollar (Reuters)	1.0	-0.4	4.8	2.2	3.3

Recommendation: Despite surging at the end of 2009, the outlook for the Japanese economy is weak and government finances are overshadowed by the scale of the national debt. The new government is thus likely to continue to press for more quantitative easing by the Bank of Japan and a weaker yen to support the economy. The US has similar problems, but we forecast its recovery will outpace other major developed economies, leading to interest rate increases by the end of the year.



☐ **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 4.6% in the final quarter, it is still expected to lag the US economy, which also outpaced Japan in the final quarter with a 5.7% surge. 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 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 new government stimulus and action form 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.