



FX & INTEREST RATE MONTHLY

The new year is forecast to start as 2009 ended - with a weak US dollar...

...but we expect the currency to stage a rally later in 2010.

Next year also presents the potential for a more fundamental change in exchange rates.

In developed economies, currencies will remain under pressure to depreciate...

...while emerging markets struggle over a policy dilemma...

...but may ultimately opt for a significant currency appreciation.

Zero-yielding US dollars continue to flood the US economy in order to support the recovery. As a consequence, **the US currency remains under pressure as investors switch into higher-yielding or higher-risk currencies** as part of the 'carry trade'.

However, November's stronger-than-expected US employment figures provided a timely reminder to the market that an economic recovery - however lacklustre - is underway. With the budgetary issues of the UK, Japan and some smaller EU countries highlighting the problems across the developed world, **the US dollar versus other developed currencies seems - at least in relative terms - to be increasingly oversold.**

In fact, **the aftermath of the global crisis appears to have set the scene for a fundamental change in exchange rate regimes in 2010.** This is in response to the long-term trend of emerging market development, but the catalyst may well prove to be the policy decisions now being made in response to the after-effects of the turmoil.

The headwinds to growth in developed economies mean that these countries may have to keep interest rates low for longer. These economies would also welcome a weaker currency as a means to encourage external demand and aid capital inflows to help finance existing debts. The depth of the recession and the need to repair banking systems limits the inflationary risks, whether from loose monetary policy or imported goods. In addition, some investors have fundamental concerns about the valuation of these countries' fiat currencies. As a result of these factors, we forecast that **developed economy currencies in general will depreciate against emerging market currencies.**

Cheap money from developed economies is being diverted to invest in the faster-growing emerging economies. But the pegged exchange rates mean that these countries are effectively importing loose monetary policy from their developed counterparts. **As emerging economies only suffered a short, sharp recession, the return of growth suggests inflationary pressures are building.** As a consequence, these countries face the options of higher inflation, higher interest rates or higher exchange rates.

Policy decisions are key to unlocking the potential change in currency markets. We expect a range of answers from different countries, including temporary stop-gap solutions such as Brazil's capital controls, but we believe the eventual outcome will include a significant appreciation of emerging market currencies against developed country currencies.

Currencies	Spot 11/12/09	RBS Forecast (as of 10 December)				Past Performance (in %)					
		Mar-10	Jun-10	Sep-10	Dec-10	-1W	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar	1.46	1.55	1.48	1.40	1.38	-1.8	-2.4	0.1	3.9	10.5	5.2
Yen vs Dollar	90	85	90	93	96	0.4	0.3	1.1	8.5	2.4	1.2
Sterling vs Dollar	1.62	1.62	1.57	1.47	1.57	-1.8	-2.1	-2.8	-1.7	8.6	12.9
Swiss Franc vs Dollar	1.03	0.97	0.99	1.03	1.05	-2.1	-2.6	0.1	3.7	13.1	2.8
Swiss Franc vs Euro	1.51	1.51	1.47	1.44	1.45	-0.3	-0.1	0.1	-0.1	4.0	-2.2
Australian Dollar vs Dollar	0.91	1.00	0.95	0.90	0.87	-0.4	-1.9	5.2	11.6	35.5	30.7
Euro vs Sterling	0.90	0.96	0.94	0.95	0.88	0.0	-0.4	2.9	5.4	1.7	-7.3
Renminbi vs Dollar	6.83	6.80	6.70	6.60	6.50	0.0	0.0	0.0	0.1	0.4	-0.1

	Growth (GDP)			Inflation (CPI)			Interest Rates					Decision
	2008	2009(C)	2010(C)	2008	2009(C)	2010(C)	Current	Mar'10 (F)	Jun'10 (F)	Sep'10 (F)	Dec'10 (F)	Next Date
US	0.4	-2.6	2.3	3.8	-0.5	1.8	0.25	0.25	0.50	1.50	2.00	16-Dec-09
UK	0.7	-4.3	0.9	3.6	1.8	1.7	0.50	0.50	0.50	0.50	1.00	07-Jan-10
Eurozone	0.6	-4.3	0.6	3.3	0.3	1.2	1.00	1.00	1.00	1.00	1.00	07-Jan-10
Japan	-0.7	-6.1	1.3	1.4	-1.2	-0.6	0.10	0.10	0.10	0.10	0.10	18-Dec-09

(C) Consensus Forecast

(F) RBS Forecast

STERLING vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Neutral	Negative	

Performance (as of 11/12)	-1M	-3M	-6M	-12M	YTD
Sterling vs Dollar (Reuters)	-2.1	-2.8	-1.7	8.6	12.9

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. With the US dollar similarly depressed, we see little to choose between the two currencies at present, but the US economy is showing more vigour in its recovery.

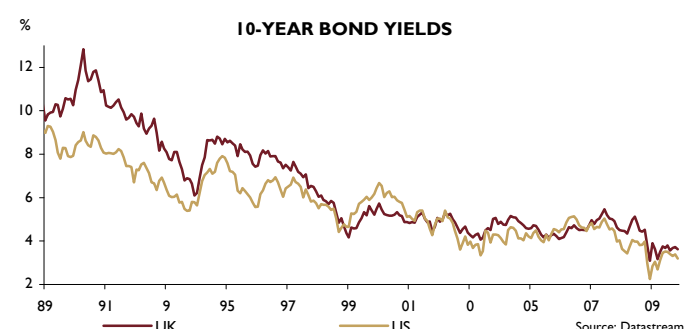
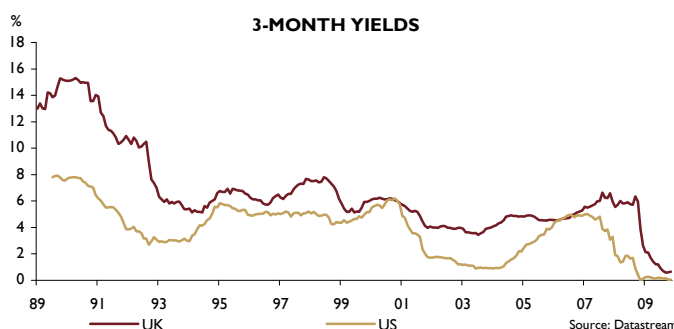
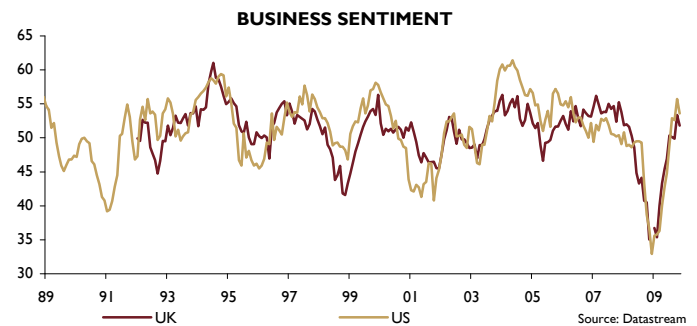
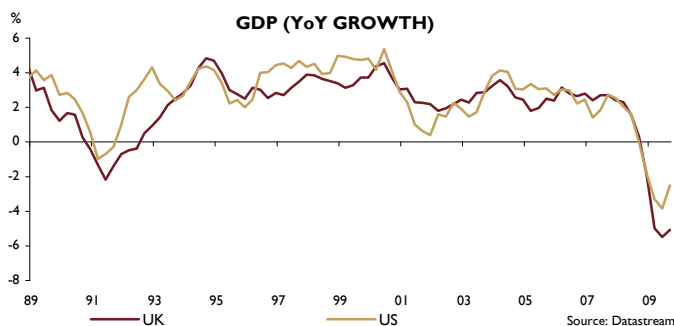
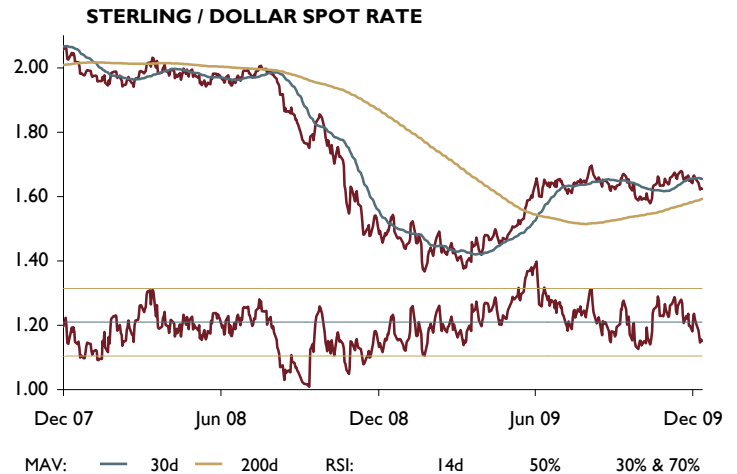
Valuation: Sterling is currently close to its 20-year average, though well below more recent levels.

Activity: The UK remains one of the few major economies yet to officially exit recession. Its economy appears to have fared worse than the US in 2009, with a consensus expectation of -4.5%, versus 'only' -2.5% for the US economy.

Liquidity: There is still a net short speculative trade position in sterling. However, the US dollar also has an overall short position. 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: An upward move by sterling is suggested by the technical indicators.

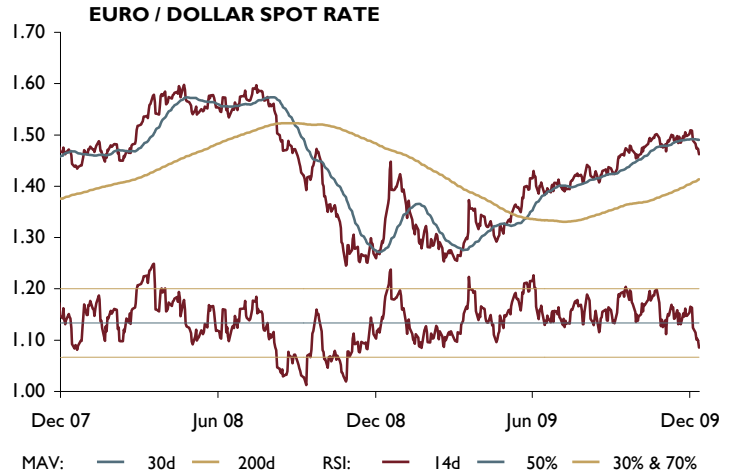


EURO vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Positive	Positive	

Performance (as of 11/12)	-1M	-3M	-6M	-12M	YTD
Euro vs Dollar (Reuters)	-2.4	0.1	3.9	10.5	5.2

Recommendation: We see further weakness for the US dollar as the global recovery encourages investment flows out of low-yielding US dollar assets. By comparison, euro assets are more attractive, given higher interest rates and a more economically-sensitive equity market. As a consequence, we expect further dollar weakness until US interest rates increase or there is a setback in the market for risk assets.



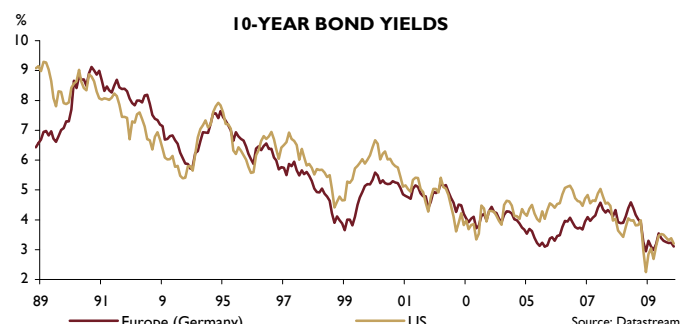
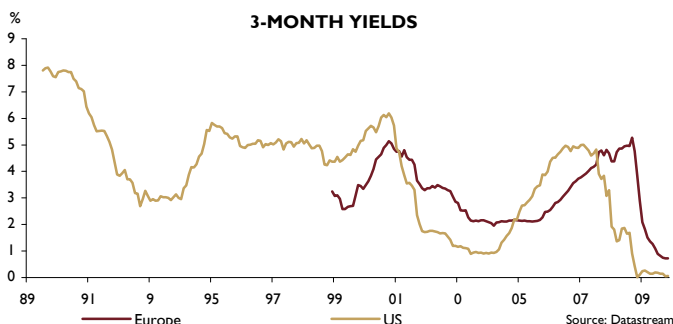
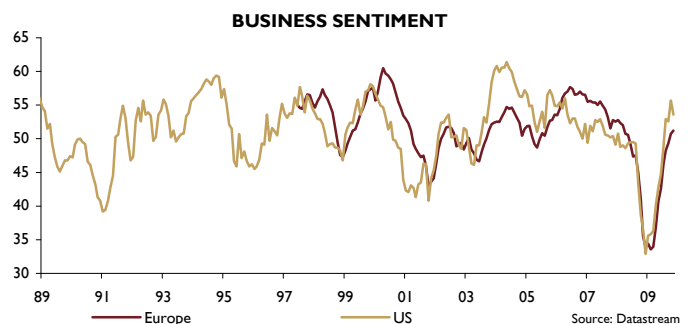
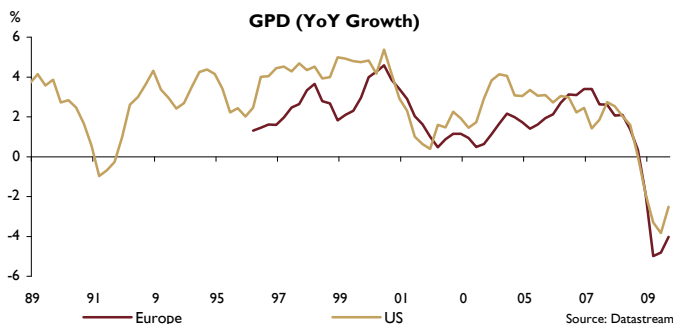
Valuation: The euro appears expensive against its average value since its creation in 1999, although the range over the ten years of its existence has been huge, from \$0.82 to \$1.58.

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 +2.7% for the US in 2010.

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. There is a net long speculative position in the futures market which would be negative for the euro if it was 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 remains in a positive uptrend against the US dollar.

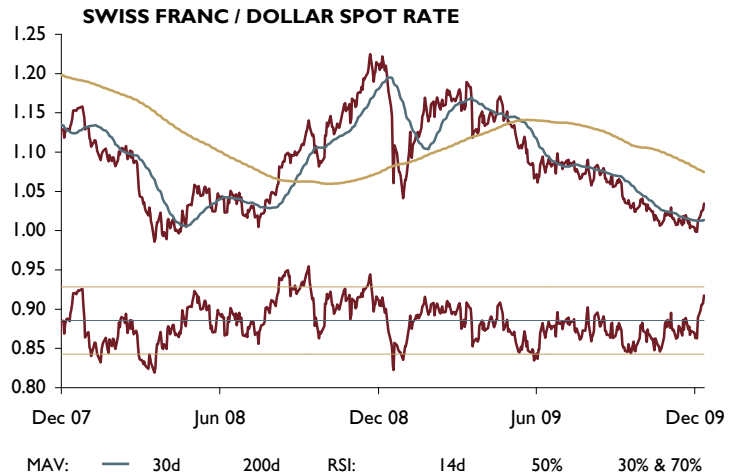


SWISS FRANC vs DOLLAR

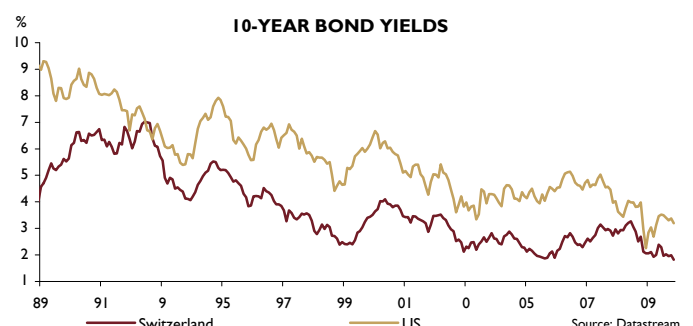
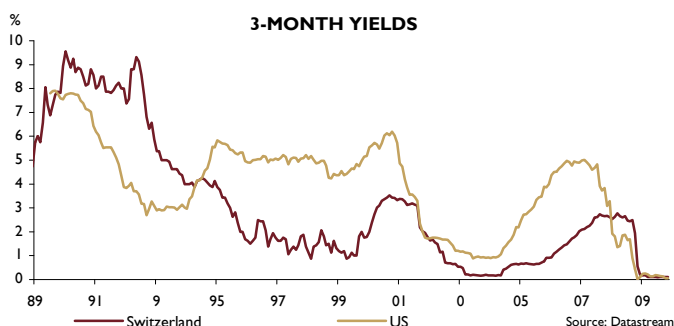
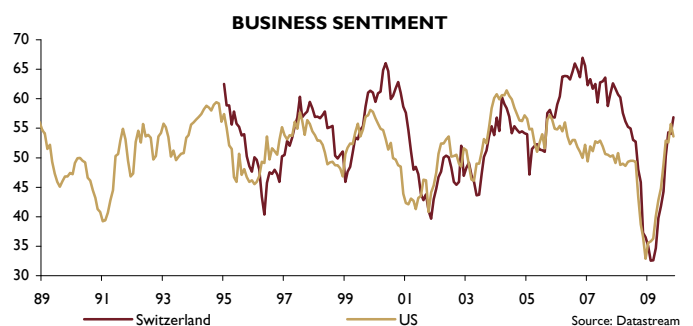
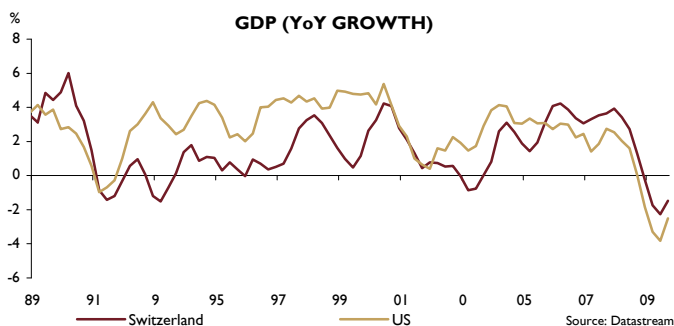
Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Positive	Positive	

Performance (as of 11/12)	-1M	-3M	-6M	-12M	YTD
Swiss Franc vs Dollar (Reuters)	-2.6	0.1	3.7	13.1	2.8

Recommendation: With investors keen to swap zero-yielding dollars for higher-yielding currencies and risk assets, the US dollar is under pressure. While 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, we see the Swiss franc as being a beneficiary of the current trend of dollar weakness.



- 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 2.7% growth compared with only 1.3% for Switzerland. US and Swiss interest rates have converged at close to zero.
- 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.

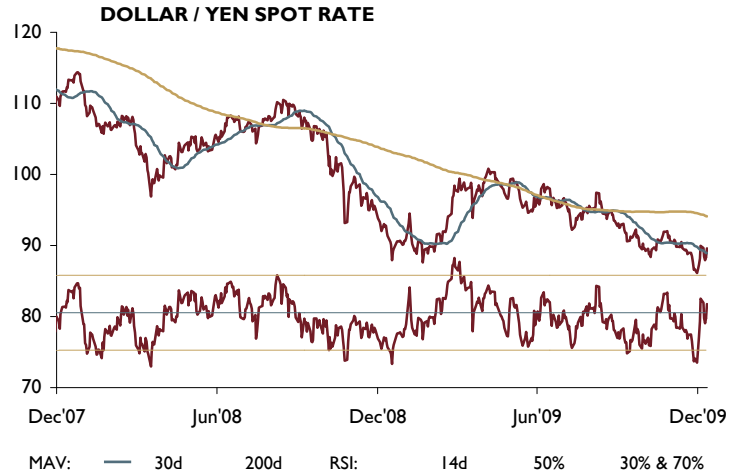


YEN vs DOLLAR

Recommendation	Time Horizon:	3 Months
New	Previous	Conviction
Positive	Neutral	

Performance (as of 11/12)	-1M	-3M	-6M	-12M	YTD
Yen vs Dollar (Reuters)	0.3	1.1	8.5	2.4	1.2

Recommendation: The yen has appreciated against the dollar, reflecting its perceived defensive qualities during the global financial crisis, which has had a limited impact on Japan. This comes at a time when the dollar remains under pressure from investment flows because of its zero yield. After the recent setback, we expect this trend to continue into 2010.



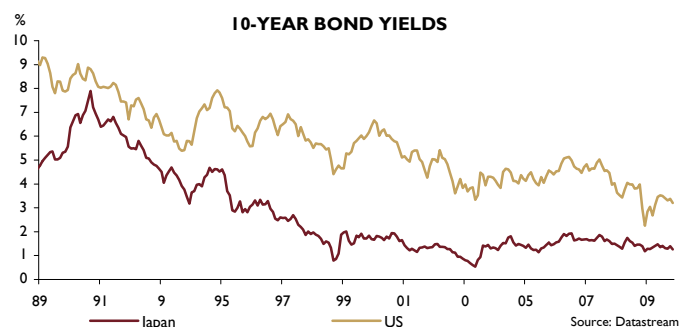
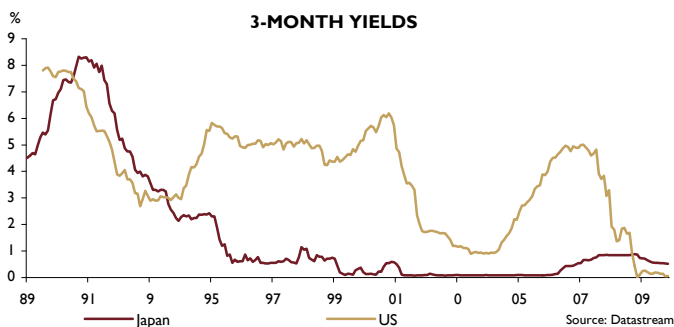
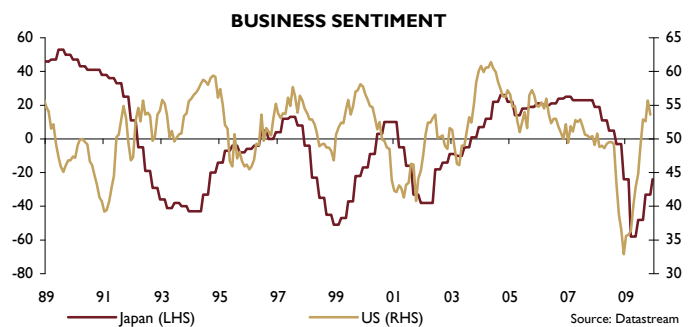
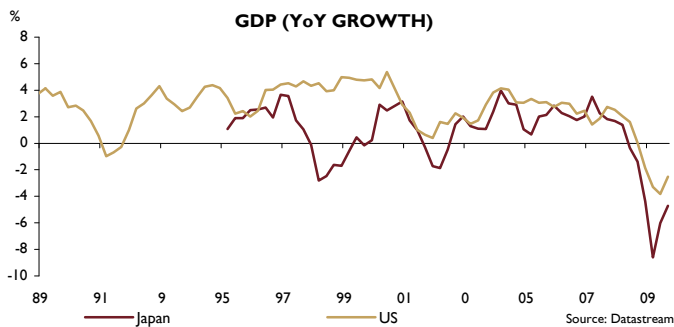
Valuation: The last time the yen was below 100 to the US dollar was in 1995. Then, it was overvalued; now, adjusted for relative inflation, it still appears fairly valued.

Activity: Notwithstanding the growth rebound reported in the second quarter, the Japanese economy's reliance on exports means that it will experience a much sharper decline in activity (-5.3%) than the US (-2.5%) in 2009.

Liquidity: There is a net long position in the yen futures market against the US dollar, which is a potential negative if it was to be unwound. By contrast, there is a very significant net short position in US dollar futures, representing the carry trade. Given low US interest rates, the yen's traditional yield discount is no longer a material influence.

Risk: The performance of the yen during the recent market turmoil clearly identifies it as a beneficiary of increased risk aversion and de-leveraging. Japan has a huge stock of savings, and the yen was supported by repatriating investment flows during the liquidity crisis.

Momentum: The yen's latest move against the dollar confirms that it remains in a positive technical trend, having consistently bounced off the 200-day moving average. However, the strength of the trend has weakened substantially in recent months.



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