

6th November 2009

Interest Rates

UNITED KINGDOM: The UK's Monetary Policy Committee (MPC) opted to extend the asset purchase scheme by £25bn to £200bn at its November meeting. The additional £25bn will be spent over the next three months and the scale of the scheme will be kept under review. This decision won't have been straightforward. Near term inflation prospects argued against an extension. Inflation has been stickier than policymakers expected, and the Bank of England's projections for near-term inflation will probably have been revised *up*, given the continuing weakness of the pound (which pushes up import prices) and higher energy prices on international markets.

But the lack of convincing evidence that the UK is firmly on the road to recovery will have trumped these concerns. There is no plan B to quantitative easing, and as a result, policymakers view the risks of doing too little as greater than doing too much. Despite the upbeat tone of business surveys in recent months, the UK's economic performance was much worse than expected in Q3. Activity contracted by 0.4% q/q, confounding hopes that the recession was over. This recession is now the longest since the Second World War, and as deep as the 1980s.

Despite the upward pressure on prices in the near-term, inflation is likely to undershoot the MPC's 2% target further out. The gap between what the economy is producing and could produce will put downward pressure on prices in the medium term. Our interest rate forecast is unchanged - we expect rates to remain at 0.5% for an extended period, with the first hike unlikely until late 2010/early 2011.

UNITED STATES: The US economy returned to growth in the third quarter, clocking up an impressive 3.5% quarter-on-quarter (annualised) expansion. Although this marks the end of the recession in technical terms, the strength of the rebound is in part due to the incentive plans to encourage

spending. 'Cash for clunkers' gave a huge boost to durable goods purchases, and the tax rebate for first time buyers helped shore up the housing market. As these programmes unwind there is a risk that growth will falter without additional stimulus measures.

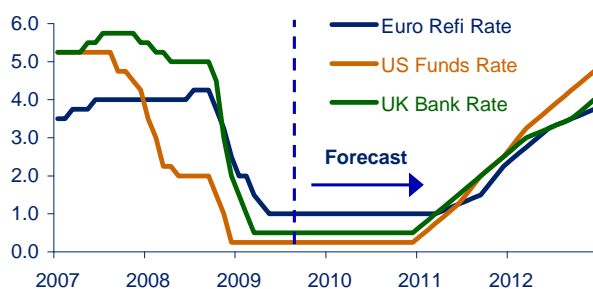
The statement following the Federal Reserve's November meeting continued themes evident in September's communiqué: the Fed is still very much on hold with rates at 0.25%. The FOMC again stated that it would keep interest rates "exceptionally low" for an "extended period", but went on to describe specific economic conditions that justify this position. The three factors cited were 1) low rates of resource utilization, 2) subdued inflation trends, and 3) stable inflation expectations. The economy will have slack for years, and inflation is normally a lagging indicator, so these two factors could imply low rates for a very long time indeed. However, the one factor that may eventually force the Fed's hand is a pick-up in inflation expectations. On balance, we continue to expect interest rates will be on hold for the whole of 2010, before gradually rising in 2011.

EURO AREA: Improvements in businesses indicators and measures of industrial output suggest the region as a whole probably returned to growth in Q3. Industrial production rose in July and August, and business surveys - key leading indicators - moved further into expansionary territory in September and October. A moderation in the rate of job losses also points to an easing of economic conditions, though labour market dynamics continue to diverge at the country level.

We expect a gradual recovery for the euro area in 2010, ensuring inflationary pressures remain subdued and inflation expectations stay well-anchored. The ECB kept interest rates on hold at their November meeting and we continue to expect the first movement will be in early 2011.

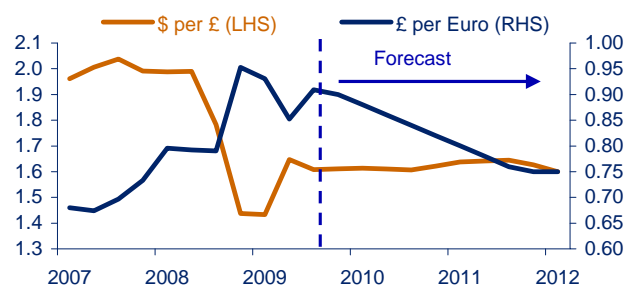
Interest Rate Forecast in %

Source: Thomson Datastream, RBS Group Economics



Exchange Rate Outlook

Source: Thomson Datastream, RBS Group Economics



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Exchange Rates

To the casual observer, exchange rate movements frequently appear to defy logic - last month proved to be no exception. In a month that saw the US return to growth and the UK announce that the recession continued and that additional stimulus would be required by expanding QE, sterling strengthened against both the dollar and the euro.

Sterling had been languishing in the 0.90's against the euro for the last two months but moved back into the high 0.80's in early November. But against the dollar the appreciation was even more pronounced: at the time of writing a pound could buy six more US cents than at the beginning of October (1.66 \$/£ compared to 1.59).

In the short term, exchange rates are likely to be volatile as the economic outlook remains uncertain and policy makers weigh up how much stimulus is needed to keep their economies growing. Investors searching for yield will

continue to look for the first signs of monetary tightening as a guide to where to put their cash.

In the medium term, we expect the pound to strengthen a little further against the euro and hold fairly steady against the dollar. We don't expect the Eurozone economy to outperform over the medium term, which will dampen investor appetite for Eurozone assets relative to UK and US equivalents, especially once investor fears about the potential negative impact of QE measures subside. Although a competitive exchange rate is going to be part of the necessary re-balancing of the UK economy, sterling has probably weakened too far against the euro, as it looks to be well below its long run fair value (the pound looks closer to fair value against the dollar).

RBS Group Economics Interest and Exchange Rate Forecasts							
	EXCHANGE RATES (end of period)				INTEREST RATES (% end of period)		
	\$ per £	\$ per €	£ per €	¥ per \$	Euro Refi Rate	US Funds Rate	UK Bank Rate
2009 Q1	1.44	1.32	0.92	99	1.50	0.25	0.50
Q2	1.65	1.41	0.86	97	1.00	0.25	0.50
Q3	1.59	1.46	0.92	90	1.00	0.25	0.50
Q4	1.61	1.45	0.90	92	1.00	0.25	0.50
2010 Q1	1.61	1.42	0.88	93	1.00	0.25	0.50
Q2	1.61	1.39	0.86	94	1.00	0.25	0.50
Q3	1.61	1.35	0.84	95	1.00	0.25	0.50
Q4	1.62	1.33	0.82	95	1.00	0.25	0.50
2011 Q1	1.64	1.31	0.80	95	1.00	0.75	1.00
Q2	1.64	1.28	0.78	95	1.25	1.25	1.50
Q3	1.64	1.25	0.76	95	1.50	2.00	2.00
Q4	1.63	1.22	0.75	95	2.25	2.50	2.50

Key Central Bank Monetary Policy Meetings in 2009/2010	
Bank of England	10 Dec, 7 Jan, 4 Feb, 4 Mar
US Federal Reserve	15 Dec, 27 Jan, 16 Mar
European Central Bank	3 Dec, 14 Jan, 4 Feb, 4-Mar

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