

Interest and Exchange Rate Forecast

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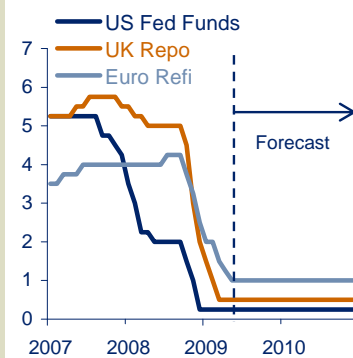
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



Interest Rates

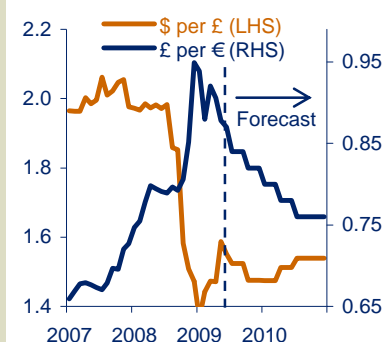
The UK's Monetary Policy Committee (MPC) increased the size of the kitty earmarked for asset purchases by another £50bn. This came in addition to the £75bn announced back in March. The key reason for upping its firepower is the Committee's ongoing pessimism over the outlook for the wider economy. The Bank of England's latest forecasts were significantly weaker than its March projections, showing a contraction of -3.9% this year and tepid growth of 1.1% next year. With these numbers, central bankers are acknowledging that the shift away from debt-financed consumption will be a drag on the UK for some time. Another cause for concern is that 'quantitative easing' is not proving as successful in holding down market interest rates as initially hoped. The yield on 10-year government bonds crept above 3.7% this month, their highest level since February. Against this backdrop, it was not surprising to hear the Governor of the Bank of England noting that the risks for the economy remained skewed towards, "a relatively slow and protracted recovery". But central bankers are likely to wait for another couple of months before announcing additional measures to give asset purchases some time to gain traction.

Minutes of its April meeting suggest that the Federal Open Market Committee believes that the worst of the financial crisis is over. In particular, members pointed to short-term money markets, where the spread between three-month interbank lending rates and the Fed Funds rate has halved since the beginning of the year. The results of the much-discussed banking sector stress tests were also something of a (welcome) anti-climax. The conclusions that losses at the 19 largest US banks could total \$600 billion over two years, and that ten US banks needed to raise a total of \$75 billion extra capital, were not as bad as feared. The start of the public-private investment plan to remove toxic assets from bank balance sheets should further strengthen the financial sector, reducing uncertainty. However, problems in the wider economy remained severe – unemployment continued its relentless ascent, hitting 8.9% in April, the highest level since 1983. We have little doubt that the Fed will remain on its toes to ensure that recent signs of stabilisation in financial markets feed through to the rest of the economy.

The European Central Bank (ECB) cut interest rates by another 25bps to 1% at its May meeting, and outlined its first unorthodox policy measures. The ECB plans to spend up to €60bn on covered bonds issued by financial institutions in the euro area. Covered bonds are popular - they are basically very low credit risk bonds backed by mortgages or loans to the public sector. In the view of the ECB, the market for covered bonds has been amongst the hardest hit, and supporting this market would be an effective way of supporting credit flows into the wider economy. There is little doubt that the economy needs all the help it can get to drag itself out of recession. The euro area contracted by a record 2.5% q/q in the first three months this year, led by export-dependant Germany which experienced a quarterly decline of 3.8%. France, with its large public sector and more strictly regulated economy, suffered relatively less, shrinking 'only' 1.2% q/q. We believe that the ECB will now focus on asset purchases to prop up the economy, and leave official rates at 1% for a prolonged period.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

The past four weeks saw the pound rally across the board. Sterling gained 8% against the dollar, and 3% vis-à-vis the euro. However, it is difficult to reconcile these moves with the most recent data that continued to point to a sombre outlook for the UK. Most noteworthy, Standard & Poor's, a leading rating agency, downgraded the medium term outlook for UK government debt from 'stable' to 'negative'. All else equal, this should have put downward pressure on the pound. Similar downbeat news also came from the labour market, where unemployment leapt to 7.1% (up from 5.3% before the financial crisis) and from the corporate sector, with insolvencies reaching their highest level since the 1990s.

That the pound overcame these challenges suggests two things. First, it seems to be the market's view that the level of the pound already reflects very downbeat expectations for the UK economy. Data confirming a negative UK view are therefore not as potent in moving the exchange rate as before. Second, investor sentiment towards riskier assets has improved markedly since the first quarter. Bar a renewed spike in risk aversion, sterling is likely to continue its upward journey against the euro, albeit at a more gradual pace.

The flipside of higher risk tolerance was a falling dollar. The greenback appreciated significantly between September 2008 and March this year as international investors stampeded for the exit on anything but the safest investments, seeking refuge in the liquidity of dollar markets. Some of that money is now leaving the US again, in part due to a search for higher yields. The aggressive actions by the Federal Reserve have also left some investors fretting over the long-term value of their dollar assets. We think that these concerns are exaggerated, and that the dollar will make up some of the lost ground as the pace of the US recession eases and the economy gradually returns to growth early next year ahead of the other major industrialised economies.

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
2008 Q1	1.98	1.56	0.79	102	4.00	2.25	5.00
Q2	1.99	1.58	0.79	106	4.00	2.00	5.00
Q3	1.77	1.40	0.79	106	4.25	2.00	4.50
Q4	1.44	1.39	0.95	91	2.50	0.25	2.00
2009 Q1	1.44	1.32	0.92	99	1.50	0.25	0.50
Q2	1.55	1.35	0.87	90	1.00	0.25	0.50
Q3	1.52	1.28	0.84	90	1.00	0.25	0.50
Q4	1.48	1.21	0.82	90	1.00	0.25	0.50
2010 Q1	1.48	1.18	0.80	92	1.00	0.25	0.50
Q2	1.51	1.18	0.78	95	1.00	0.25	0.50
Q3	1.54	1.17	0.76	95	1.00	0.25	0.50
Q4	1.54	1.17	0.76	95	1.00	0.25	0.50

Key Central Bank Monetary Policy Meetings in 2009

Bank of England	4 Jun, 9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	24 Jun, 11 Aug, 22 Sep, 4 Nov, 15 Dec
European Central Bank	4 Jun, 2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec

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