

Interest and Exchange Rate Forecast

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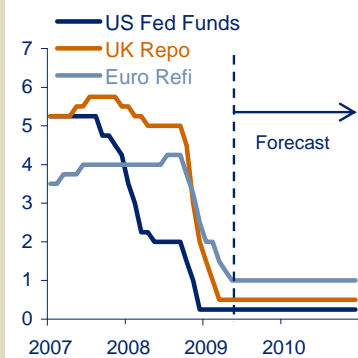
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The Bank of England pressed ahead with asset purchases, and has now spent c75% of the £125bn pot allocated for this programme. There were no changes in the Bank Rate, and we expect it to stay at 0.5% until the beginning of 2011. That is because the wider economy still looks fragile, in spite of some more signs of stabilisation. The latest data on industrial output (for April) managed a rebound of sorts, rising 0.3% m/m, but it remains 12% below the level of last year. Unemployment continued its steady trek upwards, rising 230k in the three months to April. More worryingly still, the number of workers employed suffered its sharpest fall on record, as 270k were put out of a job between February and April. Wage growth also continued to be depressed. The effects of a weaker labour market have started to feed through to retail spending, which declined in May. The volume of sales on the high street is now 1.7% lower than a year ago. This will have knock on effects on profitability and rents across the high street. And yet inflation stubbornly stayed above the Bank's 2.0% target. Looking forward, inflation is likely to moderate in the face of subdued wage growth and little retail pricing power.

This month's statement by the Federal Reserve was very similar to the one in April.

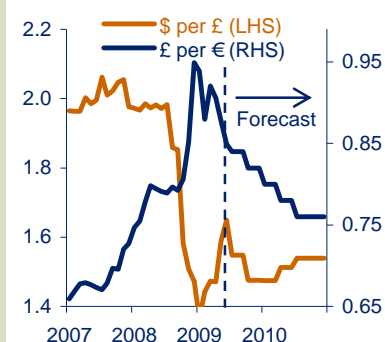
The Fed is not planning further stimuli. Interest rates are likely to stay at their exceptionally low levels "for an extended period". The reference in the statement accompanying the meeting that "inflation will remain subdued for some time" was further meant to quell rumours of a not-too-distant rate hike. At the same time, the Fed seemed a little more relaxed on the dangers of deflation as well. In terms of economic data over the past month, there were further modest improvements, although most indicators are still consistent with a shrinking economy. For example, the ISM manufacturing index rose to 42.8 (from 40.1), but is still a long way below the crucial 50-mark that separates contraction from growth. Most encouraging was the improvement in the new orders component, which suggested that order books were starting to grow again. Headline inflation fell again, to -1.3%, in May, reflecting the sharp fall in oil prices since peaking in July a year ago. Excluding oil and other volatile components, 'core' inflation fell only slightly to 1.8%.

The European Central Bank (ECB) kept rates on hold at 1.0% in May and released further details of its asset purchase programme.

The ECB plans to buy €60bn of covered bonds, but it is still unclear how purchases will be distributed across member countries and what maturities will be targeted. Meanwhile, the Bank lent almost €0.5trn at 1% to financial institutions in the euro area for one year – the most favourable terms in the Bank's history of lending operations. It is clear that the benefits could not come soon enough. Industrial production continued to contract in April, leaving production 22% below the same month last year. The regional unemployment rate went up to 9.2%. In Spain, it is almost twice this. Current figures suggest the recession in the euro area has accelerated in Q2. The OECD estimates the economy will shrink 3.1% q/q, even faster than the -2.5% outturn in Q1. At the last meeting of the Governing Council, President Trichet described the current 1% rate as "appropriate" for the economic environment. But with the official policy rate already at historically low levels, and asset purchases underway, it begs the question of what tools are left in the ECB armoury.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Investors stepped up their sterling purchases again in June. The pound gained another 3% against the euro and the dollar. Taking a slightly longer-term perspective, sterling has increased more than 10% against a basket of currencies of the UK's most important trading partners since the start of the year. In parts, this rebound is due to the view that the recession in the UK might not turn out to be as deep and long as initially feared. The best leading indicator for activity, for example, signaled that the wider economy would stop contracting in the second half of this year.

We expect the pound to strengthen further against the euro in the medium term, but short-term risks remain. The UK is likely to be one of the main beneficiaries of a recovering global economy – UK goods and services remain relatively cheap compared to exports from the euro area and the US. This could give a significant boost to the UK's trade balance later this year and next, potentially providing a significant support for sterling. On the risk side, a large chunk of the UK's public deficit needs to be financed by overseas investors, exposing the pound to fickle investor sentiment.

The dollar is caught between a rock and a hard place. There is growing sense that the US may well be the first of the industrialised economies to come out of the financial crisis. However, the aggressive policy response that backstopped the economy is as much a blessing as a curse for the dollar. Alarm bells from overseas are ringing louder, questioning the dollar's viability as the world's leading reserve currency. Foreign capital inflows already reflect some of these worries, having seen a significant shift from longer term Treasuries that are vulnerable to inflation into short-term T-Bills that are less so. On balance, we think that in the likely case where the US economy outperforms other recession-hit countries, investors will flock back into all of the major US asset classes, bolstering the greenback.

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	1.60	1.41	0.85	96	1.00	0.25	0.50
Q3	1.55	1.30	0.84	95	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	9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	11 Aug, 22 Sep, 4 Nov, 15 Dec
European Central Bank	2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec

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