



# Exchange Rate Outlook

- Interest rate differentials continue to support the dollar
- Sterling still vulnerable as markets debate interest rate outlook
- Yen continues to disappoint

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## Summary of Forecasts

Forecast Range Over The Period					
	Current	Q1 - 2006	Q2 - 2006	Q3-2006	Q4-2006
<b>Euro Versus</b>					
USD	1.1967	1.18-1.23	1.20-1.25	1.22-1.27	1.23-1.28
GBP	0.6880	0.67-0.69	0.67-0.69	0.67-0.69	0.67-0.69
JPY	141.89	139-144	138-143	137-142	135-140
PLN	3.81	3.80	3.80	3.90	3.95
HUF	251	250	252	255	255
NOK	8.01	8.05	8.00	7.90	7.90
SEK	9.26	9.35	9.30	9.00	9.00
<b>Dollar Versus</b>					
JPY	118.56	115-120	112-117	110-115	108-113
GBP	1.737	1.73-1.78	1.75-1.80	1.80-1.85	1.80-1.85
CHF	1.298	1.29	1.28	1.25	1.25
CAD	1.15	1.16	1.17	1.15	1.15
AUD	0.739	0.74	0.75	0.76	0.76
NZD	0.676	0.69	0.71	0.71	0.71
CNY	8.05	8.05	8.03	8.02	8.01
<b>Sterling Versus</b>					
YEN	206	206	205	205	201
CAD	2.00	2.04	2.08	2.10	2.10
AUD	2.35	2.37	2.36	2.40	2.40
NZD	2.57	2.54	2.54	2.57	2.57

# Interest Rate Outlook

## **US Rates to Rise Further**

As expected, the Fed raised US interest rates by another 0.25% at its policy meeting in January, bringing the Fed funds rate to 4.5%. A new Fed Chairman, Ben Bernanke, was appointed on 1 February to replace Alan Greenspan.

The FOMC statement accompanying the January rate hike indicated that the Fed judges that some further policy firming may be required. Thus, the market expects that the Fed will hike rates again in March and possibly again in Q2, before policy goes on hold in the second half of the year.

Recent strong labour market data, including a decline in the unemployment rate to 4.7%, point to further rate hikes in the US. Economic activity is also expected to be robust in the early part of 2006. However, a slowdown in the housing market is expected later in the year, bringing an end to the prolonged period of Fed tightening.

## **Further ECB Rate Hikes in Store**

The ECB hiked rates by 0.25% to 2.25% in December, the first increase since 2000. With growth in the eurozone picking up pace, the ECB deemed it appropriate to withdraw some of its policy accommodation to dampen upside risks to inflation. Rates were left on hold in January and February.

Leading indicators point to continued economic recovery in the months ahead. Thus, another 0.25% rate hike is expected in March, with the market also looking for a further rate hike in Q2. Policy may then be put on hold, with inflation forecast to fall to under 2% in H2 2006.

There is a risk, though, that rates may be hiked again to 3.0% towards year end. However, this could be dependent on external developments, like the performance of the US economy and the value of the euro, as much as on a continuation of the uptrend in the eurozone economy.

## **BoE to Stay on Hold**

The Bank of England cut UK interest rates by 0.25% in August 2005, bringing the repo rate down to 4.50% but has kept rates on hold since then.

Expectations for another rate cut have been dented by recent signs of a pick up in housing activity and consumer spending. The BoE could remain on hold for all of 2006 as growth picks up towards trend and with inflation expected to remain around 2.0%, though the possibility of a rate cut remains.

### **US Interest Rates**

	Fed Funds	3 Mth	1 year	2 Year*	5 Year*
Current	4.50	4.68	4.98	4.99	5.01
Mar '06	4.75	4.85	5.10	5.10	5.05
June '06	5.00	5.05	5.15	5.15	5.10
Sept '06	5.00	5.00	5.00	5.00	4.90

\* Swap Forecasts Beyond 1 Year

### **Eurozone Interest Rates**

	Refi Rate	3 Mth	1 year	2 Year*	5 Year*
Current	2.25	2.53	2.87	3.12	3.39
Mar '06	2.50	2.65	3.00	3.20	3.50
June '06	2.75	2.85	3.10	3.25	3.50
Sept '06	2.75	2.85	3.10	3.25	3.50

\* Swap Forecasts Beyond 1 Year

### **UK Interest Rates**

	Repo Rate	3 Mth	1 year	2 Year*	5 Year*
Current	4.50	4.51	4.55	4.63	4.64
Mar '06	4.50	4.52	4.56	4.65	4.65
June '06	4.50	4.53	4.58	4.68	4.68
Sept '06	4.50	4.55	4.60	4.70	4.70

\* Swap Forecasts Beyond 1 Year

# US Dollar

The key issue for the dollar continues to be the outlook for US monetary policy and how long the Fed will remain on its tightening path. The dollar showed signs of weakness in early 2006 but, as we anticipated, has adopted a firmer tone of late as the markets' view on US interest rates moves more into line with our own.

Futures markets are now discounting a Fed funds rate of 4.75-5.0% by mid year, the most aggressive position adopted so far in this cycle. Thus, after a period of uncertainty in the run up to the January FOMC meeting, expectations of higher US interest rates are once again lending support. Thus, we expect the dollar to fluctuate around current levels against European currencies and the yen over coming weeks, particularly if US data underpin rate hike expectations.

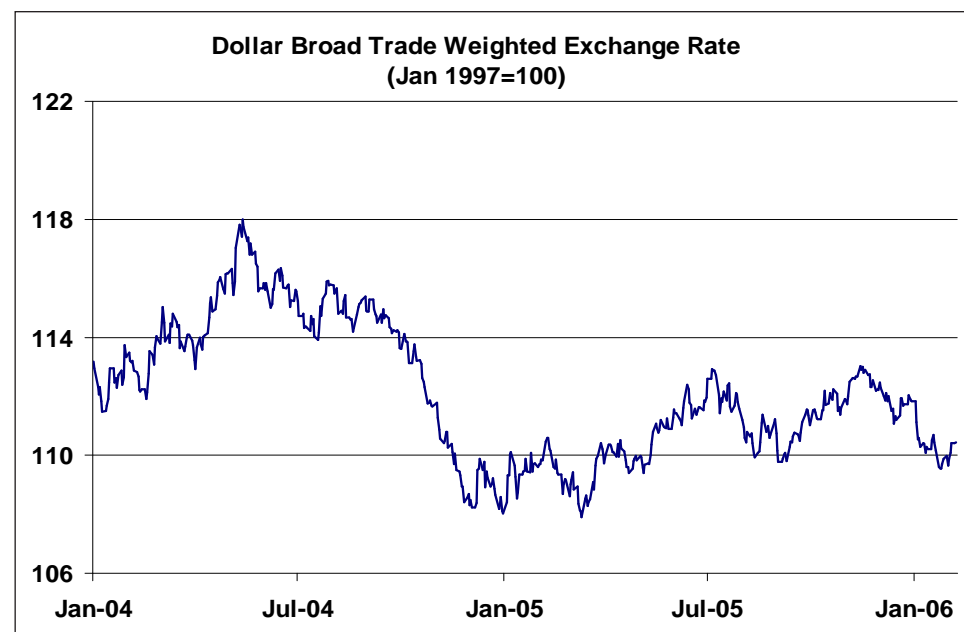
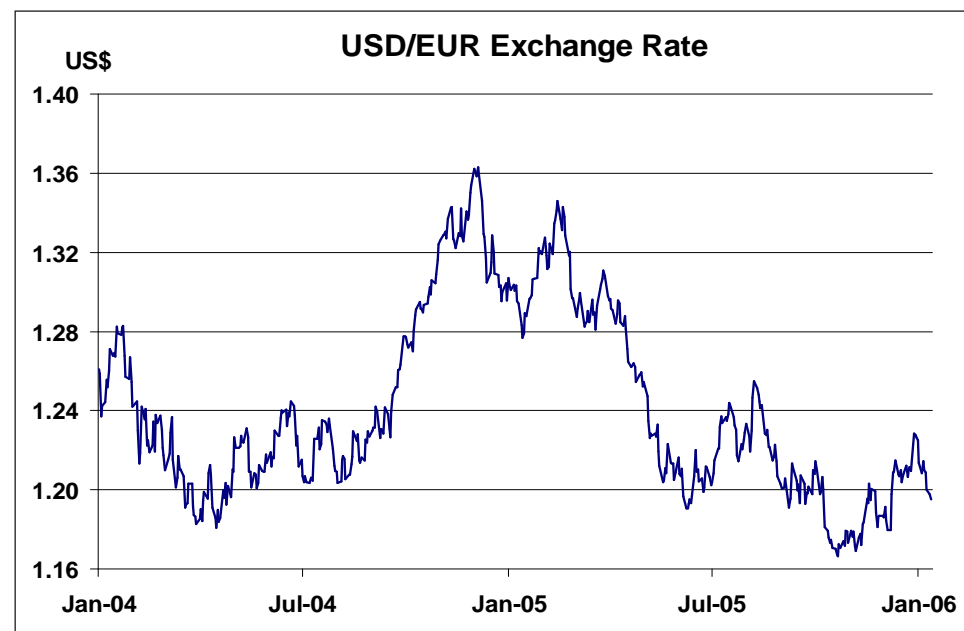
With the Fed indicating that it is now on "data-watch", the dollar should be highly sensitive to US economic numbers. Of particular importance are labour market, housing and inflation data and these releases warrant close attention over the coming weeks in terms of setting direction.

Technicals are also providing support to the dollar at the moment. By late January, speculators had increased their net short dollar position to its highest level since March 2005. However, since then there has been a change in sentiment, reflecting the more hawkish outlook for US monetary policy. There is also evidence to suggest that demand for carry trades has resumed as markets price in a higher Fed funds rate.

The US current account deficit remains a long-term negative for the dollar but is not a key focus for financial market right now. The deficit pulled back from record high levels in November and showed further improvement in December. Furthermore, US net capital inflows (as per the TICs report) remain at elevated levels.

## Key Forecasts

	Current	Q1-2006	Q2-2006	Q3-2006	Q4-2006
US\$/EUR	1.1967	1.18-1.23	1.20-1.25	1.22-1.27	1.23-1.28
USD/GBP	1.737	1.73-1.78	1.75-1.80	1.80-1.85	1.80-1.85
YEN/USD	118.56	115-120	112-117	110-115	108-113
CHF/USD	1.298	1.29	1.28	1.25	1.25



After a reasonably strong start to the year, the euro has lost momentum in recent weeks, failing to break through key resistance above \$1.2325. This comes despite near confirmation from ECB President Trichet that eurozone interest rates will be increased to 2.50% at the March meeting.

The fall back in the euro has been driven mainly by a shift in US interest rate expectations but also by the fact that markets believe that the tightening cycle in the eurozone will be modest. Thus, we expect the euro to remain in the lower half of a \$1.18-1.23 trading range for the time being.

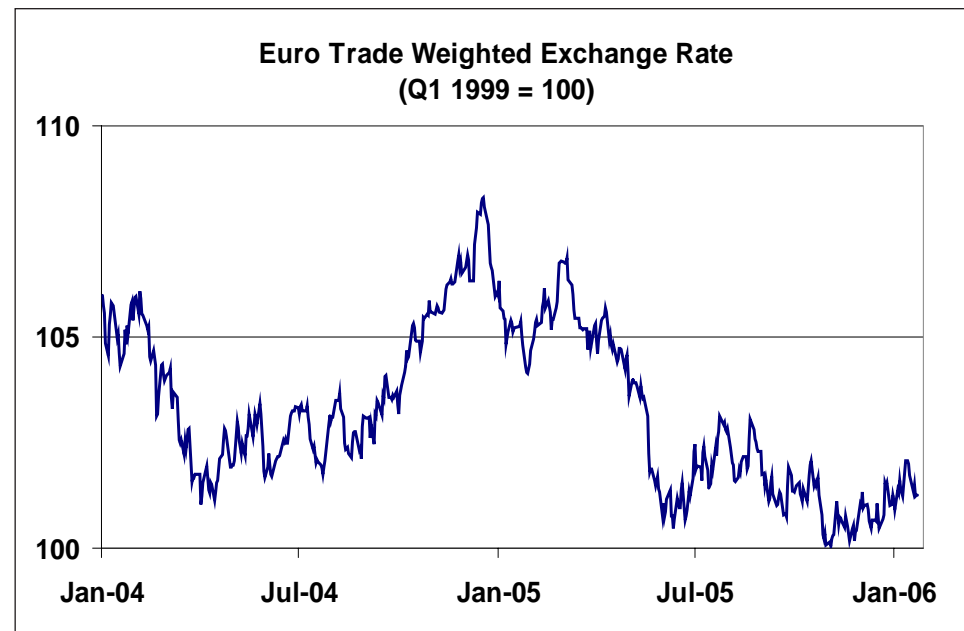
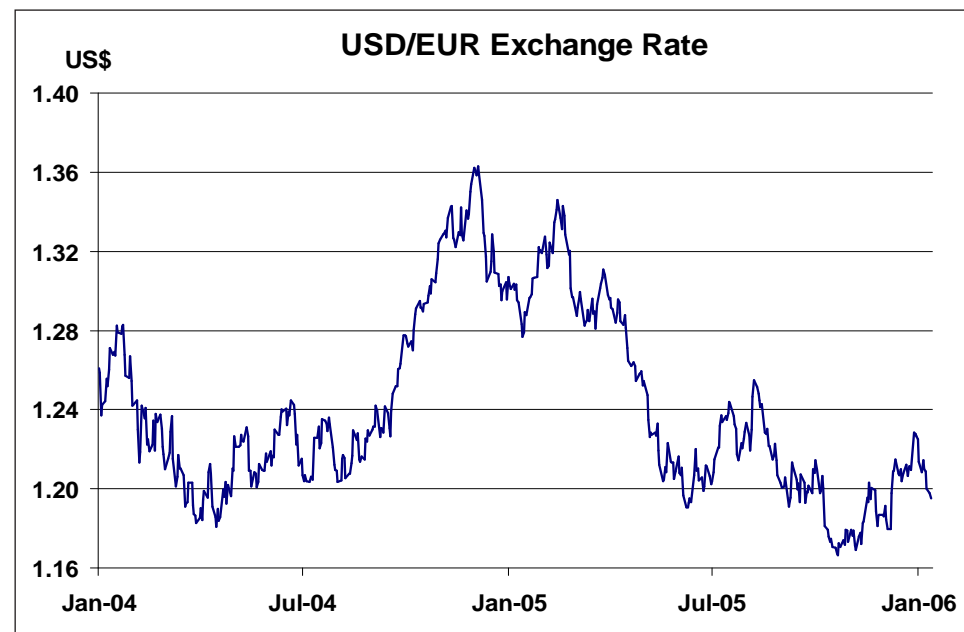
Markets expect that eurozone interest rates will be at 2.75-3.00% by end 2006. This should provide some underlying support to the euro, particularly in the second half of the year, by which time the Fed should have finished its tightening cycle. The US economy is also expected to lose momentum in the second half of the year as a much anticipated slowdown in the housing market impacts.

However, as outlined earlier, ECB rate tightening is likely to be modest. The outright US-eurozone interest rate differential also argues against a marked appreciation in the euro and upside is likely to be confined to a \$1.25-1.30 range. Furthermore, the eurozone recovery is in its early stages and is still export based. A marked rise in the euro could threaten this, causing markets to revise their expectations for eurozone interest rates.

The eurozone external balances have deteriorated. The current account deficit rose to €8.5bn in November 2005, compared with a surplus of €4.6bn in November 2004. However, higher energy prices appear to be the main reason for the increase. Thus, any further deterioration over the coming months should not have an overly negative impact on the euro.

### Key Forecasts

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GBP/EUR	0.6880	0.67-0.69	0.67-0.69	0.67-0.69	0.67-0.69
YEN/EUR	141.89	139-144	138-143	137-142	135-140
PLN/EUR	3.81	3.80	3.80	3.90	3.95



# Sterling

Sterling has weakened against the dollar of late and is currently trading below the \$1.75 level. It has also lost ground against the euro, which is looking to break through the 0.69p level. This reflects a shift in the market's view on the course of US interest rates as well as expectations of higher interest rates in the eurozone.

The correlation between UK interest rate expectations and sterling also remains high. Futures markets are no longer discounting a UK rate cut. However, there is still some uncertainty in the marketplace and this has been priced into sterling.

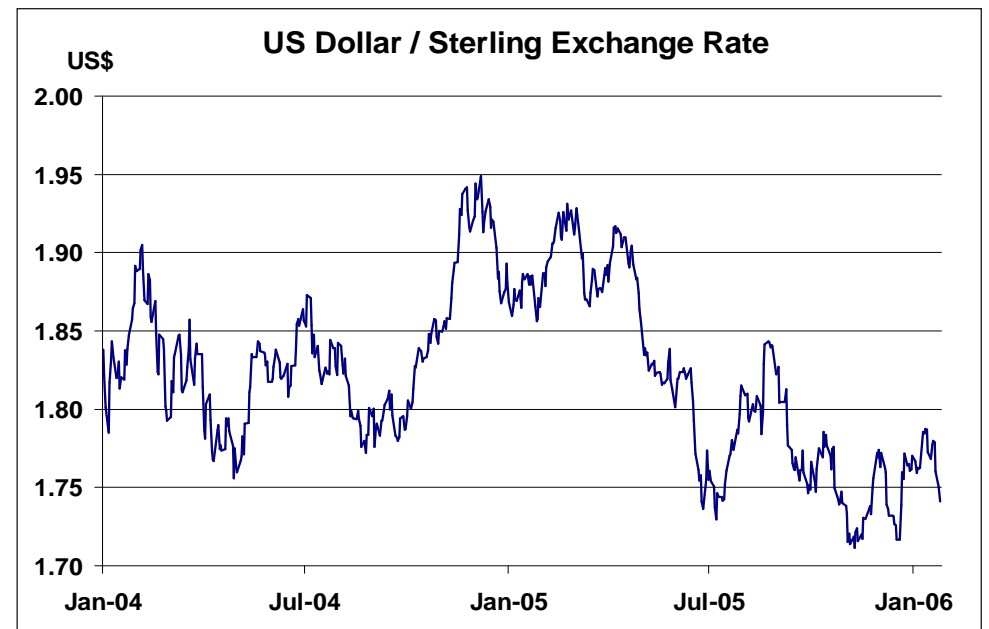
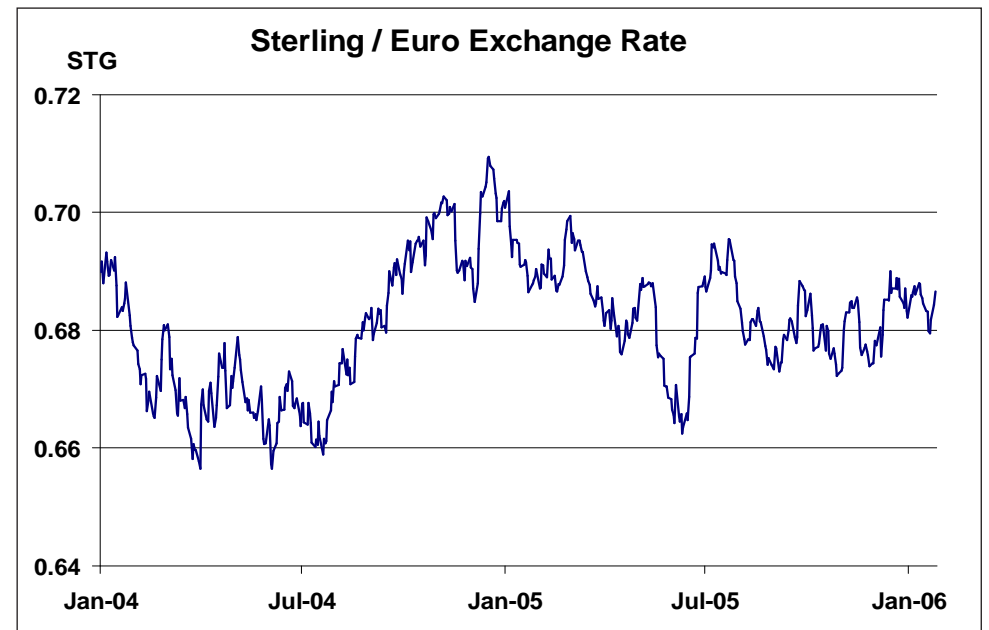
We expect sterling to remain subdued against the dollar and euro for the time being, primarily because rates in the US and eurozone are set to rise, while those in the UK will most likely remain steady. Markets will be paying close attention to January's UK retail sales numbers (due for release on February 16) for direction on the outlook for monetary policy. Renewed weakness in retail spending, in line with recent survey data, could see the sterling/dollar rate test support at \$1.73.

There should be scope for sterling to make up some ground versus the dollar in the second half of the year, when US rates have peaked. However, it is likely to prove difficult for sterling to make anything more than moderate gains. Even if UK rates remain on hold from here and the economy moves back to trend growth levels, interest rates in the US are set to overtake those in the UK. We expect US interest rates to rise to 4.75-5.00% but those in the UK to remain unchanged at 4.50%. Thus, sterling's upside could be confined to a \$1.80-1.85 range.

Much of the activity in sterling/euro should be confined to a 0.67-0.69p range. While UK/eurozone interest rate differentials will have some impact, the performance of dollar/euro continues to be a key factor in determining the direction of sterling/euro.

## Key Forecasts

	Current	Q1-2006	Q2-2006	Q3-2006	Q4-2006
GBP/EUR	0.6880	0.67-0.69	0.67-0.69	0.67-0.69	0.67-0.69
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CAD/GBP	2.00	2.04	2.08	2.10	2.10



# Japanese Yen

After its reprieve in late December/early January, the yen has resumed its downward trend versus the dollar and euro. This reflects the general rebound in the dollar but yen/euro is also edging upwards. The yen's renewed weakness comes despite ongoing evidence that the Japanese economy is picking up momentum and some relatively hawkish comments from the BoJ.

Instead, the wide interest rate gap with the US is dominating attention. With Japanese interest rates unlikely to increase for some time yet, we expect the yen to remain weak near-term with activity in yen/dollar likely to be centred around the Y118 level. Meanwhile, yen/euro could continue to drift higher as the ECB tightens eurozone interest rates.

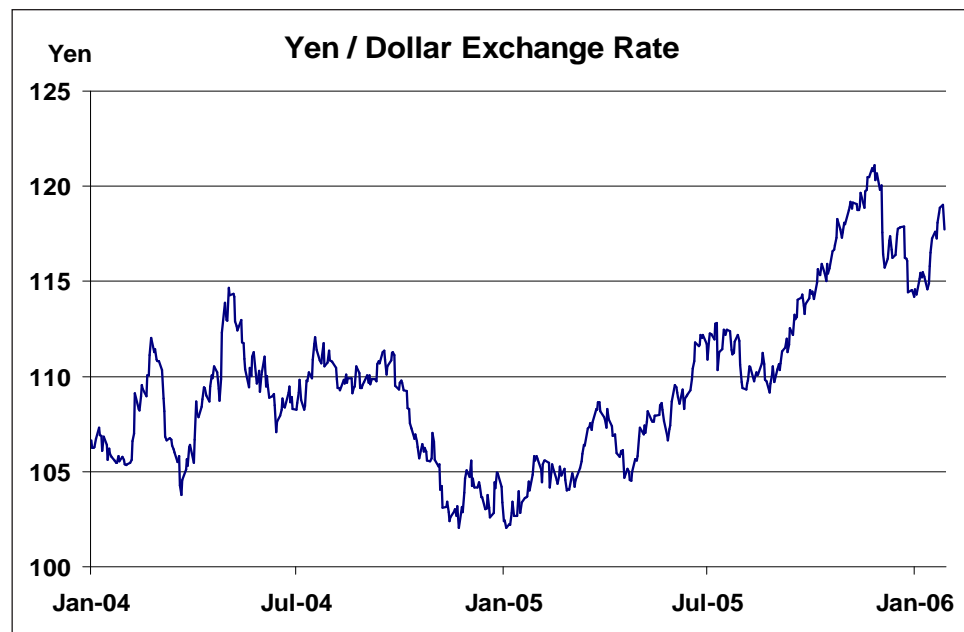
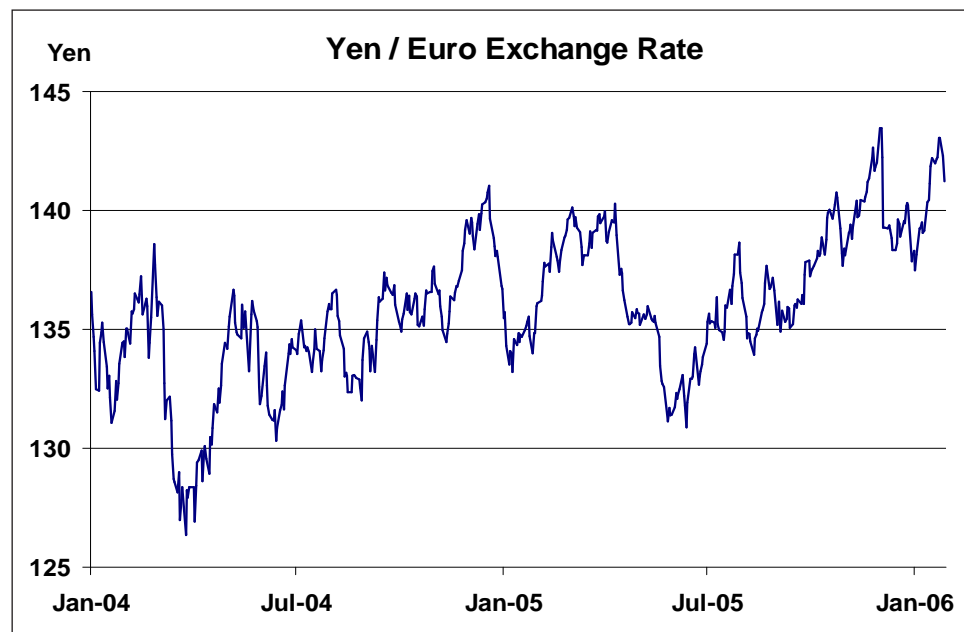
December's rebound in the yen coincided with a partial unwinding of short yen positions as the prospect of a near-term peak in US interest rates made "carry trades" less attractive for Japanese investors. However, there is now evidence to suggest that these positions are being rebuilt and this could also work against any near-term appreciation in the Japanese currency. Furthermore, after its sharp sell-off mid-January, the Japanese stock market remains volatile, which is also weighing on sentiment.

Nevertheless, we remain confident that the Japanese economy will continue to grow over the course of this year and into 2007. If this proves to be the case, the yen should be supported by expectations that the Bank of Japan will finally start rowing back on quantitative easing measures, allowing it to gradually appreciate against the dollar and euro.

The yen could also be boosted if China continues to allow its currency to gradually appreciate against the dollar. Markets expect the yuan to appreciate by about 3% over the course of the year.

## Key Forecasts

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YEN/EUR	141.89	139-144	138-143	137-142	135-140
YEN/US\$	118.56	115-120	112-117	110-115	108-113
YEN/GBP	206	206	205	205	201



# Key Events/ Diary

## Week 1 (13-17 February)

February 13	UK	Producer Prices (January)
February 14	UK	Consumer Prices (January)
	Germany	GDP Provisional (Q4)
	Germany	ZEW Index (February)
	Eurozone	Flash GDP (Q4)
	US	Retail Sales (January)
February 15	UK	Unemployment (January)
	UK	BoE Inflation Report
	US	Industrial Production (January)
February 16	UK	Retail Sales (January)
	US	Housing Starts (January)
February 17	US	Producer Prices (January)
February 18	US	Michigan Survey (February)

## Week 2 (20-24 February)

February 20	US	Market Holiday
February 21	US	Minutes of FOMC Meeting (31 January)
February 22	UK	Minutes of BoE Policy Meeting (8/9 February)

## Week 2 (contd)

February 22	US	Consumer Prices (January)
February 23	Germany	Ifo Survey (February)

## Week 3 (27 February-3 March)

February 27	US	New Home Sales (January)
February 28	Eurozone	Business and Consumer Confidence (February)
	UK	CBI Trades Survey (February)
	US	Consumer Confidence (February)
March 1	US/Eurozone/UK	ISM/PMI Manufacturing Surveys (February)
	Eurozone	HICP Flash Estimate (February)
	US	Personal Income & Spending (January)
March 2	ECB	Rate Announcement & Press Conference
March 3	US/Eurozone/UK	ISM/PMI Services Surveys (February)

## Week 4 (6-10 March)

March 9	UK	BoE Rate Announcement
	Eurozone	ECB Monthly Bulletin
March 10	US	Trade Balance (January)
March 10	US	Non-Farm Payrolls (February)

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