EXCHANGE RATE MONTHLY

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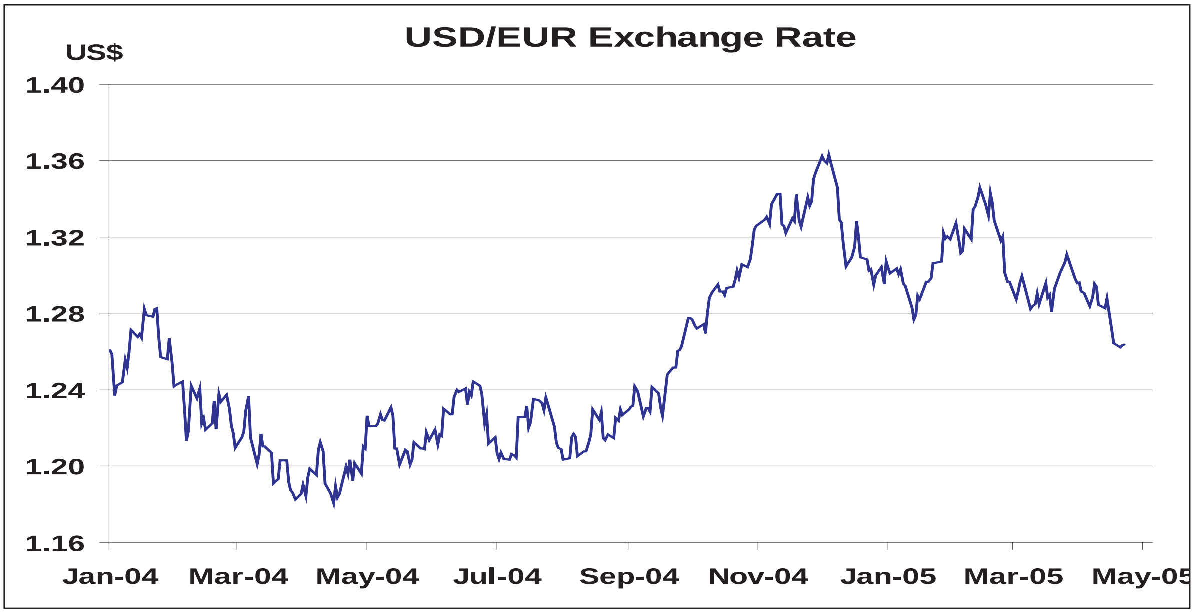
Dollar Rallies as US Economy Stays Strong

- The dollar's recovery has gained momentum on fresh evidence that the US economy is still growing at a solid pace. Data have also shown some early signs of an improvement in US structural imbalances.

- The consensus view that US interest rates will continue to rise over the coming months should provide underlying support to the dollar over the short-term. However, we have yet to be convinced that what we are currently seeing represents a fundamental change in direction.

- Sterling has come under pressure against both the dollar and euro in response to weaker UK economic data. Sentiment looks set to remain poor as markets debate the direction of the next move in official rates.



Summary of Forecasts

Exchange Rates

Euro Versus		Forecast Range Over The Period			
	Current	**Q2 - 2005**	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**
USD	1.2624	1.22-1.27	1.23-1.28	1.25-1.30	1.25-1.30
GBP	0.6875	0.68-0.70	0.68-0.70	0.69-0.71	0.69-0.71
JPY	135.67	130-135	130-135	130-135	130-135
PLN	4.1516	4.17	4.15	4.10	4.10

Dollar Versus		Forecast Range Over The Period			
	Current	**Q2 - 2005**	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**
JPY	107.46	104-109	103-108	102-107	102-107
GBP	1.8362	1.78-1.83	1.80-1.85	1.80-1.85	1.80-1.85
CHF	1.2235	1.22	1.20	1.18	1.18
AUD	0.7578	0.74	0.75	0.76	0.76

Official Interest Rates

		Forecast to End Period			
	Current	**Q2 - 2005**	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**
Euro Refi Rate	2.00	2.00	2.00	2.00	2.25
US Fed Funds	3.00	3.25	3.50	3.75	4.00
UK Base Rate	4.75	4.75	4.75	4.75	4.75
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

		GDP			**Inflation**	
Y-on-Y% Change	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
US	4.4	3.5	3.5	2.7	2.8	2.5
Eurozone	2.0	1.3	1.8	2.1	1.9	1.7
UK	3.1	2.5	2.5	1.3	1.9	1.8
Japan	2.6	1.7	2.0	-0.2	-0.3	0.1
Ireland	4.9	6.0	6.5	2.2	2.1	2.7

Our View In Brief

* **The upswing in US economic activity remains very much intact, despite the fact that some leading indicators have weakened. Retail sales rebounded in April, as did housing starts and employment. There are some concerns, however, on the manufacturing front. Nonetheless, we still expect the US economy to achieve trend growth in 2005 of about 3.5%.**

* The Federal Reserve continues to increase US interest rates at a measured pace but Fed officials are still keen to point out that policy remains accommodative. Thus, further tightening is anticipated over the coming months. We expect the Fed to hike rates by 0.25% at each of the next two policy meetings, bringing the Fed funds rate to 3.50% by the end of August. A further 0.25% hike is then expected before year end.

* **Long-term interest rates in the US fell sharply in response to weakness in March's activity data. Yields have remained low despite evidence of a rebound in activity in April. However, if growth remains robust and the Fed continues to tighten, yields should come under renewed upward pressure. Any pick-up in US yields is likely to be reflected in an upward move in European levels, though at a more modest pace.**

* **Evidence that growth in the US economy remains solid has prompted a rally in the dollar. Talk of higher interest rates and a relatively better economic performance should ensure that dollar sentiment remains bullish over the coming weeks, keeping the euro well below $1.30. However, we are not yet convinced that the US currency has definitely turned the corner.**

* **The eurozone economy grew by 0.5% in the first three months of the year. However, most leading indicators and activity data show that growth should fall back again in Q2. Domestic demand remains subdued, with high unemployment and weak income growth continuing to act as a restraint on consumer spending. Even if activity strengthens again in H2, GDP growth should still average less than 1.5% in 2005.**

* **Official interest rates in the eurozone have been on hold since June 2003. With the economy losing momentum in Q2, the possibility of a near-term move in rates has all but vanished. We see little risk to price stability given that there is considerable spare capacity in the economy. Thus, we no longer expect a rate hike in 2005, with some modest tightening now envisaged over the course of next year.**

* The Japanese economy bounced back strongly in Q1 2005, growing by an annualised rate of 5.3%. It was particularly encouraging to see that the pick-up in activity was entirely due to domestic factors. However, it remains to be seen whether or not Japan is in the midst of a domestic economic recovery. In any event, more moderate growth seems likely going forward.

* **Growth in the UK economy dipped below trend in Q1, reflecting a slowdown in consumer demand and weakness in the manufacturing sector. However, the general prospects for the economy remain favourable and we still expect that growth will be around trend levels in H2-2005. Inflation picked up sharply in March/April and is expected to move above the BoE's 2.0% target over the balance of the year. The timing and direction of the next move in UK interest rates is very uncertain but, on balance, we expect unchanged policy over the rest of the year.**

* Sterling looks set to remain under pressure as the UK consumer and housing market lose momentum, with interest rate markets now expecting the next move in official rates to be downwards. Thus, euro downside now looks well protected at the Stg0.68p level.

19 May 2005

Interest Rate Environment

Fed To Continue Raising Rates

* The Fed has increased US interest rates by 0.25% at every FOMC meeting since June of last year, taking official rates from 1% up to 3.0%. However, despite this, US monetary policy is still accommodative.

* Thus, the Fed is expected to continue to gradually remove more of its monetary stimulus at forthcoming FOMC meetings, with a further increase of 0.25% expected at the June meeting. We anticipate that Fed funds will reach 3.5% by end August and 3.75% by end 2005.

* Long-term interest rates in the US remain under downward pressure, despite signs of economic revival. However, we still anticipate a renewed rise in yields in the months ahead.

US Interest Rates

	Current	Jun 05	Dec 05	Mar 06
Fed Funds	3.00	3.25	3.75	4.00
3 Month	3.22	3.45	3.90	4.15
1 Year	3.68	3.85	4.20	4.40
2 Year*	3.96	4.10	4.55	4.75
5 Year*	4.24	4.35	4.85	5.00
10 Year*	4.53	4.65	5.15	5.25

** Swap Forecasts Beyond 1 Year*

ECB On Hold Until 2006

* Eurozone sentiment and activity indicators for Q2 have disappointed. With growth still sluggish, wage rises subdued and the euro relatively strong, we see limited upside risks to inflation.

* Thus, our current forecast is that official rates won't rise over the course of 2005. Some tightening is anticipated next year but this should still be modest. By end 2006 we see rates just 0.75% above their current levels at 2.75%.

* Long-term interest rates in the euro area remain very low, with ten year swap rates below 3.5%. These rates are likely to rise somewhat should upward pressure re-emerge on US bond yields in the coming months.

Eurozone Interest Rates

	Current	Jun 05	Dec 05	Mar 06
Refi Rate	2.00	2.00	2.00	2.25
3 Month	2.09	2.10	2.20	2.40
1 Year	2.15	2.20	2.50	2.90
2 Year*	2.39	2.50	2.80	3.10
5 Year*	2.88	3.00	3.30	3.50
10 Year*	3.44	3.55	3.85	3.95

** Swap Forecasts Beyond 1 Year*

Bank of England Also On Hold

* The BoE has left interest rates on hold at 4.75% since last August. Until recently, the market had been speculating about a rate hike over the summer months. With consumer spending and the housing market cooling, thoughts have now turned to the possibility of a rate cut.

* The direction and timing of the next move in rates is very uncertain and depends very much on the performance of the consumer. The likelihood is that with some risks on both the inflation and growth fronts, the BoE will leave rates on hold for the foreseeable future.

UK Interest Rates

	Current	Jun 05	Dec 05	Mar 06
Repo Rate	4.75	4.75	4.75	4.75
3 Month	4.78	4.80	4.80	4.80
1 Year	4.62	4.70	4.80	4.95
2 Year*	4.65	4.75	4.95	5.05
5 Year*	4.66	4.75	4.95	5.05
10 Year*	4.69	4.80	5.00	5.10

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Dollar Recovery Gains Momentum:*** Renewed optimism regarding the US economy has provided a significant boost for the dollar, which has reached six month highs versus the euro and sterling.
- ***US Fundamentals Seem to Improve:*** With some signs of improvement in US structural imbalances, dollar sentiment looks set to remain bullish for now, keeping the euro well off the $1.30 level.
- ***Sterling Hit By Cooling Economy:*** Sterling has come under strong selling pressure as the UK economy cools and the market changes its mind on the outlook for official interest rates.

Dollar Rallies on US Economy Story

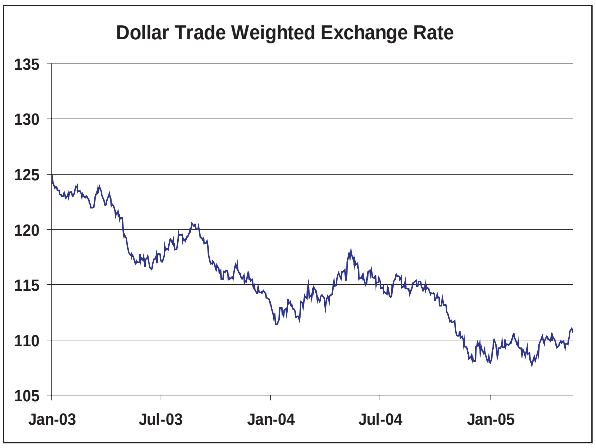
Suggestions that the US economy had cooled saw the US dollar come under selling pressure against other majors in April. However, the forex market now believes that any soft patch in the US will prove to be temporary and that the Fed will continue to increase official rates, albeit at a measured pace. Thus, we have witnessed a sizeable rally in the dollar in May.

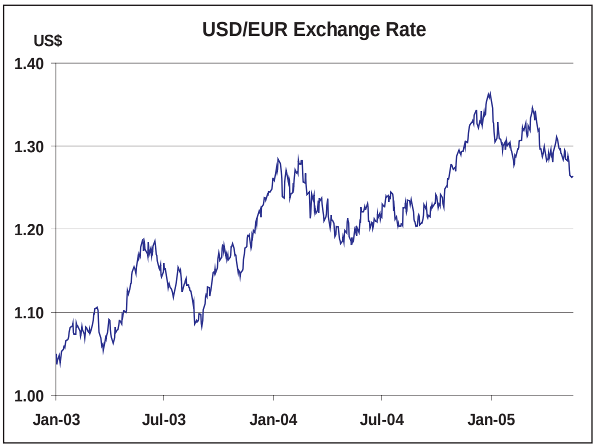
This correction has seen it break through a number of key levels against both the euro and sterling, with the euro's strong support at $1.27 finally breached. Gains have also been made versus the yen, though these have proved to be more modest.

The dollar's current revival was triggered by April's better than expected US non-farm payrolls report, which showed an increase of 274,000 jobs on the month compared to consensus forecasts of a 175,000 rise. This was followed by a strong retail sales report, indicating that all is well with the US consumer, and data showing a reduction in the trade deficit and a marked improvement in the US fiscal deficit. The latter two releases, in particular, reinforced the dollar's rally.

The trade deficit narrowed unexpectedly in March to $55bn, a reduction of some 9.2% from the previous month, when it reached a record high of $60.5bn. This was the largest drop in over three years, with exports rising by 1.5% and imports declining by 2.5%.

The news on the fiscal deficit was even better with the government posting a surplus of $57.7bn in April, the largest in three years. Tax receipts were particularly robust, supporting talk of economic revival. Both of these reports have gone some way towards easing concerns about US structural imbalances, which have weighed on the dollar for some time.





Supported by all of this good news, the dollar tested six month highs at $1.2581 versus the euro before March's weaker than expected net capital inflows report disappointed dollar bulls, injecting some caution into the market place. Net capital inflows fell to $45.7bn, down from February's level of $84.1bn. This was well short of the $55.0bn needed to match the trade deficit for the same month and was the lowest figure since October 2003. However, the fact that the dollar only fell modestly in response to the report indicates how bullish sentiment is right now.

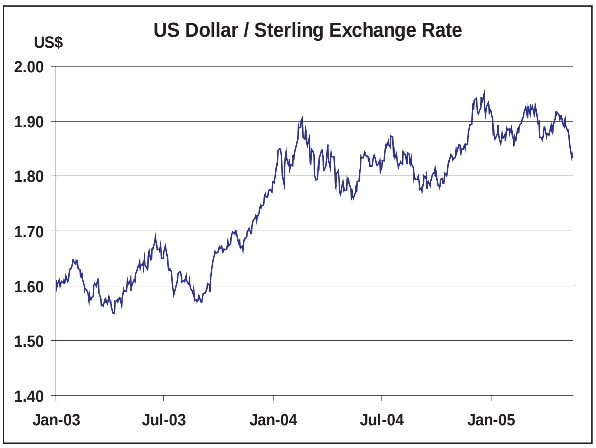
Over the coming weeks, forex markets are likely to remain volatile as they continue to react to varying short-term economic trends. At the same time, however, the consensus view that the US will achieve a relatively better economic performance compared to the rest of the world and that interest rates there will continue to rise should provide underlying support to the dollar versus the euro, thus preventing a move back above $1.30.

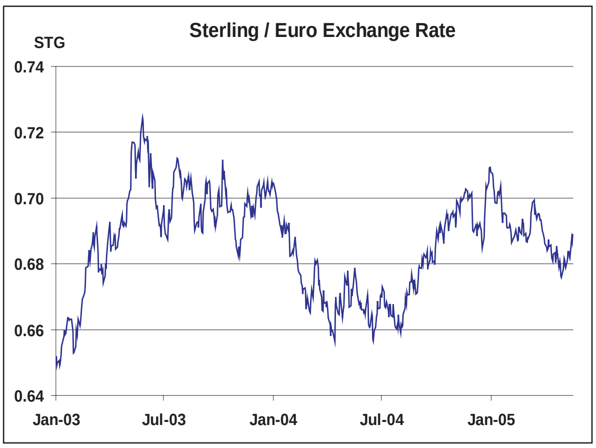
In addition to good news on the US, the euro will also be vulnerable to any negative news on the eurozone economy. GDP growth accelerated to 0.5% in Q1 (mainly due to a 1.0% increase in Germany), but Q2 should yield less impressive results. As a result, we now expect the ECB to leave interest rates on hold until 2006, keeping the rate differential in the dollar's favour for longer. The French (29 May) and Dutch (1 June) constitutional referendums also present downside risks. Thus, over the coming months we could see dollar/euro trade in a $1.22-1.27 range, with the bias in the dollar's favour.

Over the longer term, however, we are not fully convinced that the dollar has turned the corner and would need to see further evidence of a turn around in the structural imbalances to be persuaded to make fundamental changes to our longer-term forecasts. Despite the strong March trade report, it is still unclear whether the recent improvement is the beginning of a broader stabilisation in the current account deficit. The same could be said of the April fiscal deficit.

Furthermore, the positive impact of US interest rates on the dollar is likely to fade over time as expected changes are fully priced in and policy moves back to a more neutral position. Indeed, any evidence that the Fed is coming to the end of its tightening cycle could see the dollar come under renewed selling pressure, providing an opportunity for the euro to move back into a $1.25-1.30 range.

Our time path for US interest rates envisages 0.25% rate hikes at the next two FOMC meetings in June and August, but just one rate hike thereafter in 2005. Thus, we still see some scope for a rebound in the euro over the second half of the year. At the same time, however, this will be difficult to achieve if US structural imbalances are indeed on a corrective path.





Sterling Hit By Talk of Rate Cuts

The market no longer expects the Bank of England to raise UK interest rates. Indeed, the market is now starting to discount a rate cut. Negative sentiment was reinforced by the recent BoE quarterly inflation report, which announced that the central bank was cutting its growth forecasts because of the slowdown in consumer spending.

As the correlation between movements in sterling and expectations regarding the outlook for UK interest rates remains high, the pound has come under pressure in response to weaker UK economic data, particularly in relation to the consumer and the housing market. This was very evident in sterling's reaction to the Rightmove house price data, which showed house price inflation falling sharply in April.

In addition to bad news on the domestic front, sterling has also been impacted by the recovery in the dollar. As a result, sterling has fallen against both the dollar and euro, with cable reaching its lowest level in six months and sterling/euro back trading at its best levels since early April.

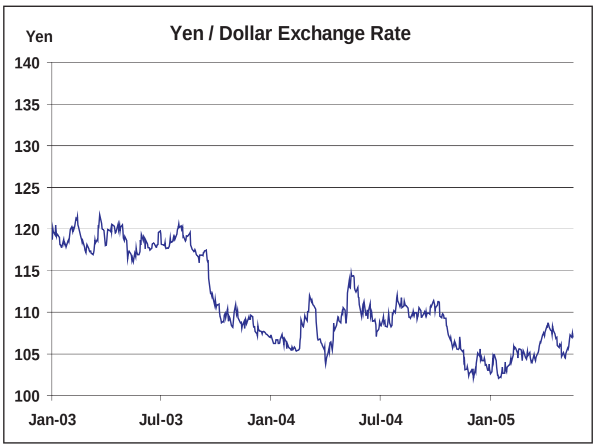
Given the current outlook for UK interest rates and the dollar, cable looks set to remain under pressure but losses could be more contained around the $1.80 level as the market has already discounted a lot of the bad news on the economic front. Thus, we anticipate a $1.80-1.85 trading range for much of the coming months.

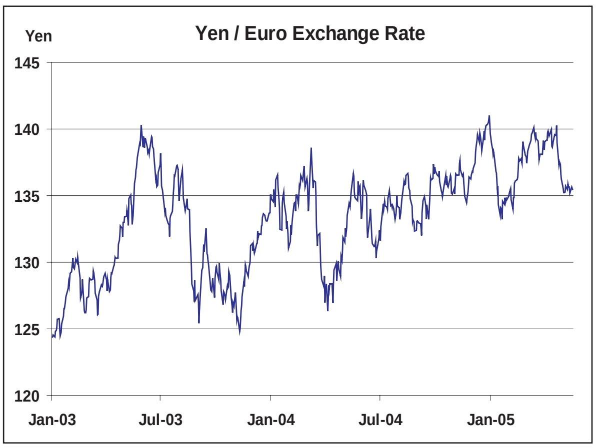
With regard to sterling/euro, much will depend on the performance of dollar/euro. However, with the market now talking about UK rate cuts rather than hikes, euro downside looks well protected at the Stg0.68p level.

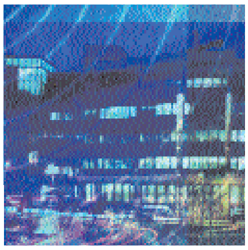
Yen Finds Strong Support Around Y108

While the dollar has made up some ground against the yen over recent times, its gains have been less impressive than those seen versus other majors, with strong resistance seen around the Y108 level. The yen has been supported by talk of a revaluation in the Chinese yuan and the rebound in Japanese GDP growth in Q1. However, if dollar sentiment remains bullish, the market is likely to test resistance at this level.

Speculation about a revaluation in the Chinese yuan continues, despite the fact that the authorities there remain adamant that they will not rush into anything and will not yield to outside pressure. As each suggested date for revaluation passes, new ones are anticipated. However, we remain of the view that a revaluation is unlikely to happen anytime soon.







KEY MARKET EVENTS

Week 1 *(30 May - 3 June)*	**May 30**	**US/UK**	**Market Holiday**
		Eurozone	**Business & Consumer Confidence (May)**
		Eurozone	**HICP Flash Estimate (May)**
		US	**Consumer Confidence (May)**
	June 1	**US/UK/Eurozone**	**Reuters Manufacturing PMI/ISM Surveys (May)**
		Netherlands	**Constitutional Referendum**
	June 2	**Eurozone**	**ECB Meeting & Press Conference**
	June 3	**US/UK/Eurozone**	**Services PMI/ISM Surveys (May)**
		US	**Non Farm Payrolls (May)**
Week 2 *(6 June - 10 June)*	**June 9**	**Eurozone**	**ECB Monthly Bulletin (June)**
		UK	**Industrial Production & Manufacturing Output (April)**
		UK	**BoE Rate Announcement**
	June 10	**US**	**Trade Balance (April)**
		US	**Federal Budget Balance (May)**
Week 3 *(13 June - 17 June)*	**June 13**	**UK**	**Producer Prices (May)**
	June 14	**UK**	**Consumer Prices (May)**
		US	**Producer Prices & Retail Sales (May)**
	June 15	**UK**	**Unemployment Report (May)**
		US	**Net Capital Inflows - TIC's Report (April)**
		US	**Consumer Prices (May)**
		US	**Industrial Production & Capacity Utilisation (May)**
		US	**Fed Beige Book**
	June 16	**UK**	**Retail Sales (May)**
		US	**Philadelphia Fed Survey (June)**
	June 17	**US**	**U. of Michigan Consumer Sentiment - Prov. (June)**
Week 4 *(20 June -24 June)*	**June 22**	**UK**	**Minutes of MPC Meeting (8/9 June)**

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