

Interest and Exchange Rate Forecast

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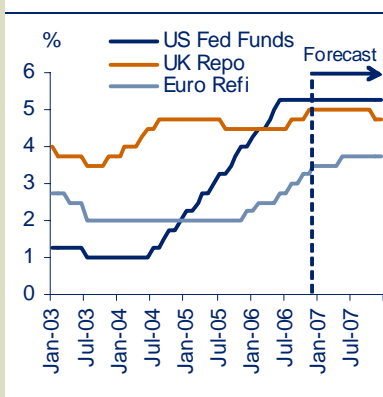
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Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The UK's Monetary Policy Committee (MPC) voted to increase interest rates to 5% at its November meeting. The MPC felt that a combination of firm economic growth and limited spare capacity would put upward pressure on inflation unless it intervened. This takes the Bank Rate to its highest level since 2001, though investors are betting that there is still more to come (futures markets are pricing in a move to 5.25% in early 2007). The decision is finely balanced, but we are sticking with our call that rates will peak at 5%. Economic growth may be brisk but, at 2.8% over the year to Q3 '06, it is not fast enough to generate much upward pressure on inflation in 2007-08. Indeed, we expect three factors to allow the MPC to turn its attention to a rate cut in the second half of 2007: the onset of slower growth next year (as this year's hikes bite); lower inflation; and the evaporation of any lingering concerns about a pick-up in wage inflation.

Weaker growth and the prospect of lower headline inflation persuaded the US Federal Reserve to sit on its hands in October, keeping rates on hold at 5.25%.

The economy has lost momentum, expanding by just 1.6% in Q3 after a sluggish 2.6% gain in Q2 – well below the economy's trend rate of 3%. However, market expectations of a near-term policy easing appear misplaced. The recent slowdown reflects a sharp downturn in residential construction activity on the back of the cooling housing market, as well as weakness in auto production (due to bloated inventories). Outside of those sectors, growth has held up well, which we expect to continue. Labour market conditions remain tight, supporting consumer spending. High rates of capacity utilisation in the corporate sector and robust profitability will continue to underpin investment. This suggests that the slowdown will prove transitory. Moreover, while plunging energy costs pushed headline inflation down from 4% in Q2 to just 1.3% in October, underlying inflation remains stubbornly above the Fed's comfort zone. This suggests that rates will remain on hold in the months ahead, with the possibility of another hike if growth picks up strongly or core inflation accelerates from already elevated levels.

A quarter-point rate increase at the December meeting of the ECB, bringing Eurozone interest rates to 3.5%, is widely expected.

ECB President, Jean-Claude Trichet, hinted as much at the November ECB press conference. There is more uncertainty on the rate outlook for 2007. We expect at least one more 25 basis point rate increase in the first half of the year bringing rates to 3.75%, given the ECB's stated desire to bring interest rates towards a more neutral level. However, given the uncertainty over the impact of the German 3% VAT increase in January and the extent and knock-on effect of the US slowdown (in terms of weaker demand for Eurozone exports), we expect the ECB to pause at 3.75% to assess the sustainability of the recovery. The bias of risks to this pause will remain to the upside and more hikes could follow if growth and inflation prove resilient.

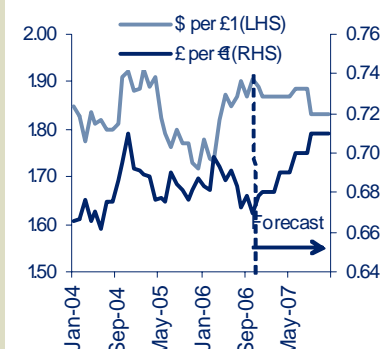
Exchange Rates

The evolution of the interest rate debate in the UK has been the key factor driving the euro/sterling exchange rate over the past month. As expectations of further rate hikes gained credence in mid-October, so sterling rose towards 0.67 against the single currency, but softer than expected inflation data and the relatively dovish tone of the Bank of England's Inflation Report guided sterling back down towards 0.68. This pattern is likely to be maintained in 2007. Investors are still pricing in another rate hike next year. But if this expectation evaporates, sterling is likely to weaken further against the euro next year, especially as Eurozone rates are expected to head higher.

A string of weaker than expected data releases out of the US have put downward pressure on the dollar against sterling and the euro over the past month. The greenback may gain ground in the months ahead if investors come around to our view that US interest rates will stay higher for longer than financial markets currently project. However, the dollar is likely to slip against the other major (particularly Asian) currencies through next year as concerns about the enormous US current account deficit remain. This trend is likely to be reinforced by the fact that interest rates are expected to head higher in the Eurozone and in Japan next year while US rates remain on hold, further reducing the relative attractiveness of the dollar for international investors.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS

	EXCHANGE RATES (End-of-Period)				INTEREST RATES (%, End-of-Period)		
	\$ per £	\$ per EUR	£ per EUR	\$/JPY	Euro Refi Rate	US Funds Rate	UK Repo Rate
2005 Q1	1.89	1.30	0.69	107	2.00	2.75	4.75
Q2	1.79	1.21	0.68	111	2.00	3.25	4.75
Q3	1.77	1.21	0.68	113	2.00	3.75	4.50
Q4	1.72	1.18	0.69	118	2.25	4.25	4.50
2006 Q1	1.73	1.21	0.70	118	2.50	4.75	4.50
Q2	1.85	1.28	0.69	114	2.75	5.25	4.50
Q3	1.87	1.27	0.68	118	3.00	5.25	4.75
Q4	1.87	1.27	0.68	119	3.50	5.25	5.00
2007 Q1	1.87	1.29	0.69	118	3.75	5.25	5.00
Q2	1.89	1.32	0.70	114	3.75	5.25	5.00
Q3	1.83	1.30	0.71	110	3.75	5.25	5.00
Q4	1.83	1.30	0.71	105	3.75	5.25	4.75

Key Central Bank Monetary Policy Meeting Dates in 2006

Bank of England	7 th December
US Federal Reserve	12 th December
European Central Bank	7 th December

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