



# International Financial Outlook

June 2010

Corporate Markets



# Latest key economic and financial market data

## Calendar of central bank interest rate meetings (as at 14 June 2010)

Region	Current rate	Date of next meeting	LTSB forecast (rate at next meeting)
UK	0.50%	8 July 2010	0.50%
US	0.0-0.25%	23 June 2010	0.0-0.25%
Euro zone	1.00%	8 July 2010	1.00%
Japan	0.10%	15 June 2010	0.10%
Switzerland	0.25%	17 June 2010	0.25%
Norway	2.00%	23 June 2010	2.00%
Sweden	0.25%	1 July 2010	0.25%
Canada	0.50%	20 July 2010	0.50%
Australia	4.50%	6 July 2010	4.50%
New Zealand	2.75%	28 July 2010	2.75%

## Key economic data releases in the month ahead (as at 14 June 2010)

Region	Indicator	Previous	Indicator	Previous
UK	Consumer prices index y/y (15/6)	+3.7%	UK Budget Report (22/6)	
	Consumer prices index (core) y/y (15/6)	+3.1%	BoE MPC minutes (June) (23/6)	
	Retail price index y/y (15/6)	+5.3%	Mortgage approvals (29/6)	+49.9k
	Unemployment rate (16/6)	4.7%	GfK consumer confidence (30/6)	-18
	Average earnings (inc. bns) y/y (16/6)	+4.0%	GDP Q1 q/q (final) (30/6)	+0.3%
	Retail sales - inc auto fuel m/m (17/6)	+0.3%	Manufacturing PMI (1/7)	58.0
	Retail sales - exc auto fuel m/m (17/6)	+0.1%	Services PMI (5/7)	55.4
	Public finances (PSNB) (18/6)	+£10.0bn	Industrial output m/m (8/7)	-0.4%
	M4 money supply y/y (18/6)	+3.3%	Trade balance (9/7)	-£7.3bn
	US	Treasury Capital Flows (15/6)	\$140.5bn	Core PCE deflator y/y (28/6)
Producer prices m/m (16/6)		-0.1%	Consumer confidence (29/6)	63.3
Consumer prices index y/y (17/6)		+2.2%	ISM Manufacturing (1/7)	59.7
Consumer prices index (core) y/y (17/6)		+0.9%	NFP change m/m (2/7)	+431k
Current account (17/6)		-\$115.6bn	Factory orders m/m (2/7)	+1.2%
Existing home sales (22/6)		5.77m	ISM non-manufacturing (6/7)	55.4
New home sales (23/6)		504k	Trade balance (13/7)	-\$40.3bn
Durable goods m/m (24/6)		2.8%	Advance retail sales m/m (14/7)	-1.2%
GDP Q1 annualised (final) (25/6)		3.0%	FOMC minutes (14/7)	
Euro zone		German Zew survey (15/6)	45.8	CPI flash estimate y/y (30/6)
	German IFO survey (22/6)	101.5	Unemployment rate (2/7)	+10.1%
	Services PMI (prel) (23/6)	56.2	Retail sales m/m (5/7)	-1.2%
	Manufacturing PMI (prel) (23/6)	55.8	GDP Q1 q/q (final) (7/7)	+0.2%
	M3 money supply y/y (28/6)	-0.1%	Industrial production y/y (14/7)	+9.5%

## Summary financial data (as at 11 June 2010)

Key equity market indices	Close	Monthly change
Dow Jones Industrial Average	10,211.07	-5.0%
S&P 500	1,091.60	-5.6%
Nikkei 225	9,705.25	-6.8%
FTSE 100	5,163.68	-3.2%
DAX 30	6,047.83	0.2%
CAC 40	3,555.52	-3.7%
Bond yields	Close	Monthly change
US 2yr Treasury	0.73%	-10.6 Bps
US 10yr Treasury	3.23%	-28.9 Bps
German 2yr Schatz	0.46%	-11.5 Bps
German 10yr Bund	2.57%	-37.1 Bps
UK 2yr Gilt	0.82%	-30.0 Bps
UK 10yr Gilt	3.46%	-42.3 Bps
Japan 2yr JGB	0.16%	-1.0 Bps
Japan 10yr JGB	1.24%	-8.3 Bps
Commodity prices	Close	Monthly change
Brent Crude Oil (active month)	\$74.4	-7.6%
COMEX Gold (active month)	\$1,228.9	0.7%
COMEX Silver (active month)	\$18.2	-5.4%
NYMEX Platinum (active month)	\$1,535.0	-9.7%
LME Aluminium (3 month)	\$1,964.0	-4.5%
LME Copper (3 month)	\$6,494.0	-6.1%
LME Lead (3 month)	\$1,703.0	-14.9%
LME Nickel (3 month)	\$19,400.0	-12.4%
CBOT Corn (active month)	\$349.50	-5.5%
CBOT Wheat (active month)	\$440.75	-8.9%
CBOT Soybean (active month)	\$946.25	-1.3%
Reuters CRB Index	255.9	-3.4%

\* All data are sourced to Bloomberg. Date of next release in brackets.

# Summary of main changes to exchange & interest rate forecasts

- Financial markets continued to gyrate wildly in the past month. That said, the package of support measures from European governments has helped to calm fears of imminent default in the so-called peripheral countries in the euro zone, like Greece, Ireland, Portugal and Spain. Nevertheless, a brief look at credit spreads, interbank rates and bond spreads over the past month suggests that these fears have not completely subsided.
- In fact, it would not be too fanciful to suggest that the risk of some sort of restructuring of Greek debt is now priced into financial markets. More worrying, recent market trends suggest that investors are questioning whether governments can actually afford the cost of the support they have given to their economies over the last two years.
- On the face of it, this creates potential for even greater problems for currency and interest rate markets, but it could be good news if it forces governments to take action to put their finances onto a firmer footing. This could help reduce future instability by avoiding the risks associated with a shock from unsustainable government balance sheets. In this regard, the recent cuts in government spending are positive.
- Still, the US and the UK have been and remain, for the moment, the recipients of monetary flows out of the eurozone economies. However, the euro has staged some sort of comeback from recent lows against the US dollar. It is also the case that the US and the UK also have their own fiscal challenges, putting a floor on investors' willingness to buy their assets.
- Tensions in eurozone financial markets have continued over the past month. Most notable was Germany's unilateral decision to impose a temporary ban on uncovered short-selling of eurozone government securities, CDS and selected financial stocks. This course of action instilled a sense of panic among official policymakers, with emerging European currencies losing further ground against the US dollar.
- Meanwhile, in China, the 'bigger picture' continues to feature the need to slow the pace of domestic economy activity. A sustained revaluation of the renminbi still seems some way off. Finally, in Latin America, the Brazilian real has gained only modestly since our last *Outlook*, despite a 75bp increase in the key Selic interest rate.
- The eurozone sovereign debt crisis looks set to remain a dominant theme in foreign exchange markets. In the short-term a number of currencies, in particular the CAD, AUD and NZD, should regain some of their recent losses. Nonetheless, a relatively stronger economic recovery in the US and rising speculation of interest rate hikes will see the USD stronger against most major currencies in 2010 and 2011.
- Our central view is for EUR/\$ to gradually move back above 1.20, however there is a significant risk that it falls beyond recent lows if markets are dealt further blows to sentiment. Sterling, while easing against the USD, should be supported by signs that the recovery is firming. Sterling could also benefit should the UK emergency Budget on June 22 provide a clearer medium-term strategy for reducing the budget deficit.

**Trevor Williams**  
Chief Economist, Corporate Markets

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Only by maximising the opportunity it currently has to boost net trade may the UK have a good chance of stronger, more balanced growth in the years ahead

### Can the UK export its way to growth?

High levels of indebtedness, credit constraints and forthcoming fiscal austerity raise the likelihood that UK domestic demand will remain relatively weak over the next few years. As such, it raises the question of where UK economic growth will come from. Hence, it is important the UK maximises the opportunity it currently has to boost net trade through a weak exchange rate and low wage inflation.

The fall in the exchange rate and the decline in relative unit labour costs provide a window of opportunity for the UK to boost its export performance

The challenge is a huge one, but not beyond the UK's capability. Over the past forty years, the UK's share of global trade has fallen from 6.1% to 2.8%. The decline has run in tandem with the relative decline of the UK manufacturing sector, which now accounts for just 13 per cent of UK national output compared with over 30 per cent in 1970. These declines, however, paint an unduly pessimistic picture of the UK's trade performance. The UK is still the world's fifth largest overall exporter - after the US, Germany, China and Japan - and the world's tenth largest exporter of merchandise goods. The decline in the UK's share of global trade has largely been due to the rapid growth of the developing world. Faced with a lack of infrastructure to support domestic growth, many of these economies have relied, in their infancy, on net exports to grow national income - China and Russia being two clear examples.

To capitalise on this opportunity, it is imperative that the UK continues to invest in those high-value added industries in which it has a comparative advantage.

Similarly, the relative decline in UK manufacturing is mostly just that, reflecting the sharp growth in UK services industries, particularly those in which the UK has a comparative advantage, notably financial, and business services. Nevertheless, the UK manufacturing sector has also been through its own transformation. The inability of traditional industries to compete on price with lower cost overseas producers has forced UK manufacturers to become more innovative

Chart b: Share of UK services exports by sector

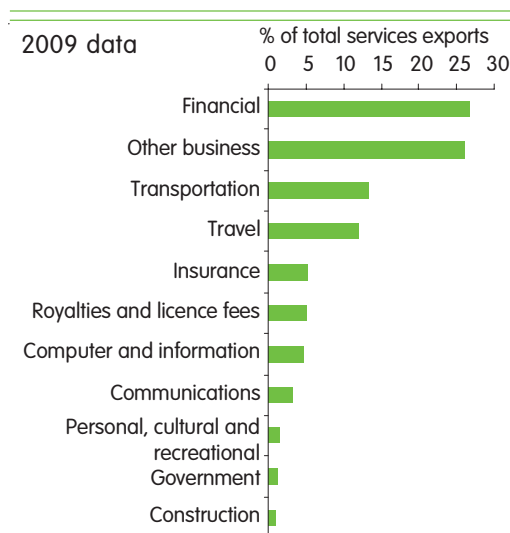
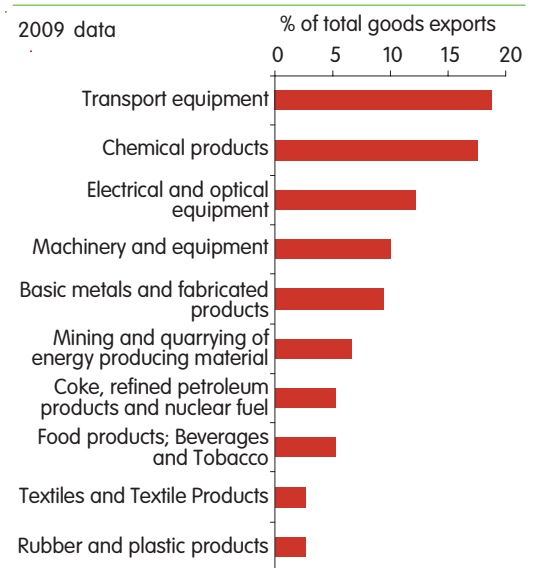


Chart a: Share of UK goods exports by sector



and more entrepreneurial, focusing on those industries and products in which it has a comparative advantage. The rapid growth of the UK's higher valued added industries, such as bioscience, engineering and chemicals has been clear evidence of this trend.

Aided by growth in these industries, the UK manufacturing sector has continued to expand. Contrary to conventional wisdom, the volume of UK manufacturing output is over 10% higher than it was in the early 1970s. Moreover, while the UK manufacturing sector accounts for a relatively small share of UK GDP at 13%, the share of total UK trade accounted for by merchandise goods is far higher, at 60%. Again, it has been those manufacturers that have focused on the production of high valued added products, where the UK's comparative advantage lies, that have benefited most from an improvement in overseas demand - see chart a.

Nevertheless, the UK continues to run a sizeable merchandise goods deficit - i.e. we import more than export. However, this is not the case for services where the UK runs a significant net surplus. Not surprisingly, exports have risen in those services sectors in which the UK has particular expertise. Together, financial, business and legal services account for over 60% of the UK's total service sector exports, and 25% of the UK's overall overseas trade - see chart b. It is important that the regulatory, tax and infrastructure remain conducive to continued growth in these areas. The challenges posed by the fallout from the financial crisis pose a clear risk in this regard.

Notwithstanding these challenges, we believe the UK now has a window of opportunity to significantly grow its exports, whether it is in

Chart c: Fall in unit labour costs has led to a marked improvement in UK competitiveness

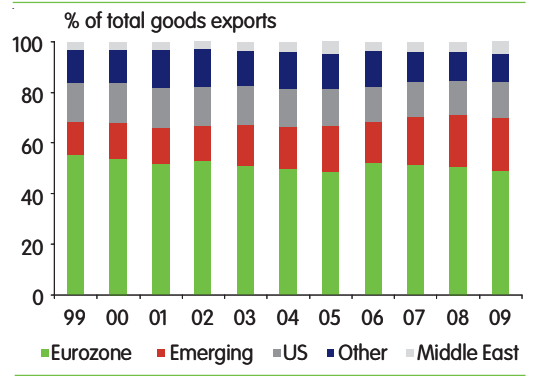


merchandise goods or services. The decline in the UK's nominal exchange rate has imparted a competitive boost to UK industry. Since peaking in mid-2007, sterling has dropped by 30% against the US dollar, by 20% against the euro and by 45% against the Japanese yen.

The improvement in competitiveness is starker when viewed in real terms. Allowing for the relative movement in consumer prices and unit labour costs, the UK has experienced one of the largest improvements in competitiveness in the OECD. The fall in the UK's relative unit labour costs has been sharper than in Germany, France, Canada, Japan and the US (see chart c). The improvement in the UK's relative competitiveness against the Eurozone has been particularly marked. This is especially important as the euro-zone is by the far the UK's largest trading partner, accounting for over 50% of UK exports. Given the economic challenges facing the single currency area, however, it is questionable whether UK companies will be able to significantly increase their exports to this market.

It is essential therefore that the UK broadens its export base away from its over-reliance on Europe. While this is a daunting challenge, there are cautious grounds for optimism that it can do so. Over the past few years, the UK has started to target more actively the growing markets of Asia. Since 2000, the proportion of

Chart d: The share of UK goods exports to the emerging world has risen, but not by enough



UK goods exports destined for the emerging markets has risen from 14% to 20%. By contrast, the UK's share of exports to the Eurozone has declined by 5 percentage points over the past decade – see chart d.

Looking ahead, we are optimistic that the UK can improve its export performance. To date, companies have seemingly held back from passing on the fall in the exchange rate through lower prices, preferring instead to bolster their profit margins as they seek to repair their balance sheets. Over time, however, we suspect the fall in the exchange rate, in both nominal and real terms, will start to have a more pronounced impact on the UK's export performance. Such a strategic shift is likely to be aided by policy, with the new coalition government indicating that it also believes the opportunity for growth lies in an expansion of exports, particularly to emerging Asia. To capitalise on this opportunity, however, it is imperative that the UK continues to invest in those high-value added industries in which it has a comparative advantage.

**Adam Chester, Senior UK Macroeconomist**

Recent trends resulting from the renewed financial market volatility have raised the US\$ and US assets are once again being bid...

### Are global imbalances returning?

After a period of narrowing, the US current account deficit may soon start widening again, if recent currency and growth trends persist. Global financial market volatility has returned with a vengeance. As a result, the US is once again seen as a safe haven, and the dollar is rising as buyers drive up the price of US assets. On one level, this could simply be seen as bad news for the sustainability of the global economic recovery. A rise in the dollar should slow US growth, give rise to protectionist sentiment and perhaps derail the economic recovery. On a deeper level, however, it also poses risks to the stability of the global financial system because of the return to excessive demand for some assets. After all, it was a rise in the demand for assets that helped to create the bubbles that then burst with such devastating consequences for the global economy. We take a look at these risks in this article.

...this could result in a widening of the US current account deficit and a return to the imbalances that gave rise to the financial crisis in the first place...

Financial markets have taken flight from exposure to highly indebted economies, particularly those in southern Europe. Greece may have been the trigger, but the focus is now on all economies that have high levels of government borrowing to GDP ratios. Of course, the rise in these deficits is largely a direct consequence of the support offered to companies during the worst of the global financial crisis. In this sense, it is a consequence of standing behind the highly leveraged parts of the private sector and guaranteeing their debts.

...there is a difference this time, however, which is that the surpluses of the large exporting economies may find a home in the other emerging economies

The question now being asked is about the ability of some of these governments to meet these guarantees, as well as their other spending obligations at the same time. In the case of Greece, the answer appears to be not without guarantees from other countries with stronger balance sheets, like Germany and France. It is this flight to quality or safe haven buying, that is driving the demand for US assets – note the fall in US bond yields and rise in the dollar. Admittedly, US equity prices

Table 1: US still the world's number 1 importer

	2009 (\$bn)	2009 Rank	2011E (\$bn)	2011 Rank
United States	1505.5	1	1787.0	1
Germany	903.3	2	985.2	3
China	880.0	3	1127.3	2
France	570.8	4	598.9	4
United Kingdom	508.2	5	546.0	6
Japan	500.2	6	575.9	5
Netherlands	447.4	7	494.2	7
Italy	410.6	8	431.0	9
Hong Kong	355.6	9	431.3	8
Canada	336.9	10	396.2	10

are falling despite this inward flow into the US, but this may be because of the rise of the dollar and the fear that its ascent will hit exports and so undermine the economic recovery underway in the US. Undoubtedly, this raises a serious cause for concern about the global economic recovery.

On the one hand, the austerity measures being put in place in Europe, 18% of the world economy, will slow its recovery and mean that the EU will contribute little to global demand (see chart a) and so economic growth. In fact, relying on a weaker euro to help foster economic recovery will not just put pressure on the US economy, but also other countries within Europe, including the UK. On the other hand, financial market volatility could persist and lead to a further collapse in financial markets, loss of confidence and a return to recession. Still, a weak economic recovery would be preferable to a fall back into recession. However, the US economic recovery will be hit by weaker growth in Europe and by the rise in the US dollar.

If the US were to grow faster than Europe and the dollar became less competitive, this would lead to a widening current account deficit in the US and rising surpluses in Europe (see chart

Chart a: EU share of import growth to fall sharply, China to rise

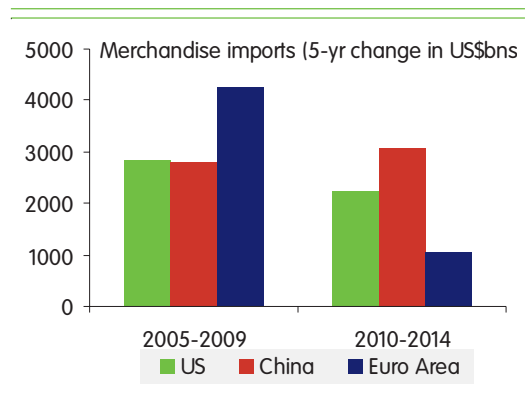


Chart b: Euro surplus to rise, China's to fall

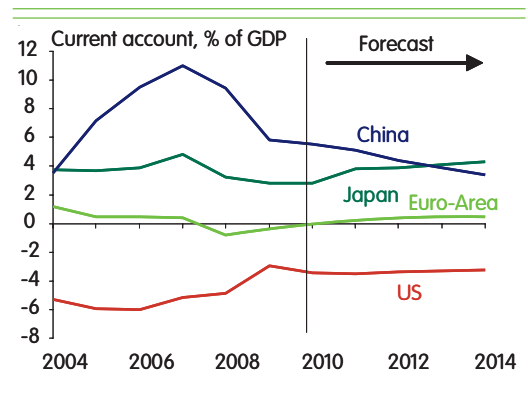
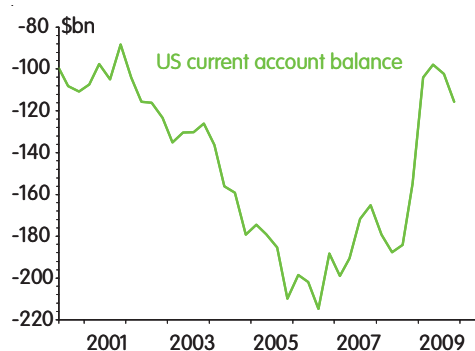


Chart c: US deficit to widen from here on?



b). This could raise protectionist sentiment in the US, posing another risk to the global economic recovery. There are already some indications from China that the fall in the euro is effectively considered a rise in its currency, which is pegged to the US dollar, and so it does not have to let the currency appreciate. Whilst there is some truth in this view, it is unlikely to stop pressure from the US for other countries to let their currencies appreciate as its trade deficit starts to widen once again. Admittedly, we look for China's trade surplus to shrink as its share of imports rises.

Our forecast shows that the narrowing in the US deficit may have ended and is reversing, see chart c. This gives rise, however, to another big concern. One of the underlying factors that led to the current global financial crisis was that huge trade surpluses in the emerging market economies were transferred to the developed world in the form of cheap liquidity. But there were insufficient good quality assets in the developed markets to absorb these flows from the saving economies. That led to the creation of assets that were structured to look high quality but, for one reason or another, were not.

The bursting of the bubble in these overbought assets is still resonating today. Also, strong flows of liquidity into the developed economies encouraged the take up of excessive amounts of debt, as the cost of borrowing was very low and credit plentiful. With this credit availability also came some lax standards, which helped result in these assets rising too fast without sufficient oversight.

How real is the risk that if the US economy started to become more unbalanced that this pattern will repeat itself in a few years? Our forecast shows some modest widening in the US current account gap and a rise in the surpluses of Japan and the Euro Area. But this will not be on the scale of those at the height of the bubble in 2007, at least not in the period we look at (chart b). China imports more, and its surplus shrinks. This means that the world economy does not become as unbalanced, see chart a.

Additionally, it could be argued that investors with money to lend have learned their lesson, at least for now. They will be unwilling to lend to overly indebted households, countries, companies or individuals. Moreover, the appetite for debt from the highly indebted economies is lower than it was, as evidence suggests that firms and individuals are intent on repaying debt and trying to put balance sheets on a more sustainable basis. A further point could be that there are now other homes for liquidity being generated by the economies with surplus savings that were not around in the decade up to 2007.

Maintaining fast growth in China is now demanding greater investment in road, rail and other infrastructure spending, for instance. The same could be said for Brazil, Russia and India. Let us not forget that the search for raw materials, and to secure access, means increased spend. In short, the amount of investment flowing into the emerging market economies is likely to be more than in the recent past.

This means that the risk of worsening global imbalances may not by itself translate into the same crises as the search for safe assets in developed economies led to in the decade or so up to 2007. There may still be a crisis, if there is excess liquidity, but the next crisis will likely take some other form, as yet unknown.

**Trevor Williams, Chief Economist**

# International Financial Forecast Commentary

The euro came under significant selling pressure, falling below \$1.20 against the USD and dipping to a record low against the Swiss franc

Despite the euro retreating from these lows, worries about debt in the region kept financial markets on edge

Economic data has played second fiddle as markets focused their attention on signals from the Fed on possible exit strategies

The latest statements by the Fed suggest rates will be raised before significant improvements in the labour market occur

The pound has performed well against the USD despite Fitch highlighting the need for fiscal consolidation

Emerging market and commodity currencies extended losses against the USD with the South Korean won particularly hard hit

## Summary of main changes in the past month

A further increase in volatility over the past month saw global equity markets and commodities fall sharply, with an associated shift into 'safe haven' currencies. Markets already jittery over the impact of fiscal austerity measures on the global economic recovery and the threat of a sovereign default in the eurozone were dealt further blows. Germany introduced a temporary ban on the so-called 'naked' short-selling of certain types of eurozone debt and credit default swaps in late May. This was soon followed by news that Spanish authorities had taken over Cajasur bank. As a consequence the euro came under significant selling pressure, falling below \$1.20 for the first time since March 2006 and dipping to a record low versus the Swiss franc. While the EUR and a number of commodity currencies have rebounded, they are still very low suggesting that investors remain cautious.

In the past month, economic news from the US has largely taken a back seat as markets have focused more on the potential nature and timing of exit strategies from the Federal Reserve. While expectations for a rate increase have been pared back to next year, Fed Chairman Bernanke did signal that the Fed is unlikely to wait until the labour market has fully recovered. Specifically he noted that 'the unemployment rate is going to be high for a while' and 'we can't wait until inflation gets out of control before...normalising interest rates'. In all, despite disappointing private sector non-farm employment numbers the US dollar rose against its main counterparts last month, with the key exception of the pound and yen.

The pound has been one of the better performers against the USD this month. This was despite a statement by Fitch Ratings, the first by a major credit-rating agency since the new government took office, that the UK needs to accelerate budget deficit cuts to protect its top AAA rating. Economic data over the past month continued to point to a steady, but sedate, pace of recovery. Positive signs from the housing sector have been partly offset by disappointing survey data on services activity.

Over the past month, most emerging market and commodity currencies extended losses against the USD. While those currencies more closely aligned with the eurozone remained under selling pressure, a number of emerging Asian currencies fell on concerns over the future strength of Chinese demand. The South Korean won was particularly hard hit, down 7.5% against the USD, in anticipation of the introduction of tighter regulation on currency trading.

Table 1: Main currency appreciation/depreciation in the last month\*, versus US\$

Biggest risers	British pound	+1.9%
	Japanese yen	+1.3%
	Chilean peso	+1.0%
	Vietnamese dong	+0.2%
	Canadian dollar	+0.1%
	Hong Kong dollar	+0.1%
	UAE Dirham	0.0%
	Venezuelan bolivar fuerte	0.0%
Saudi Riyal	-0.0%	
Biggest fallers	South African rand	-1.7%
	Indian rupee	-1.9%
	Hungarian forint	-1.9%
	Swedish krona	-2.0%
	Australian dollar	-2.1%
	Turkish New Lira	-2.1%
	Polish Zloty	-2.7%
	Russian ruble	-3.2%
	Norwegian Krone	-3.3%
	South Korean won	-5.6%

\* 17/05/10 - 14/06/10

Chart a: Global equity markets have struggled recently...



Chart b: ...while some government bond markets have strengthened



# Currency forecast summaries

## Developed countries

The sovereign debt crisis in Europe looks set to remain a dominant theme in foreign exchange markets for some time

**The sovereign debt crisis in Europe looks set to remain a dominant theme in foreign exchange for some time.** Although financial support and guarantees, including the €440bn European Financial Stability Facility (EFSF), has minimised the risk of a near-term debt default or restructuring, considerable uncertainty remains round the finer details and precise operation in practice. The crisis has also put considerable strain on leaders of the larger core eurozone economies of Germany and France to cut government spending and underline their commitment to medium-term fiscal prudence. This has the potential to hit already weak regional domestic demand as well as heighten tensions.

Prospects for the euro are more difficult to assess, particularly in the near-term. However, our central forecast looks for €/£ to gradually gravitate to back above 1.20 and then to remain relatively rangebound

**Although the sharp fall in the euro will provide a boost for exporters, we still expect weak economic growth in both 2010 and 2011.** The ECB is forecast to start raising interest rates in Q2 2011. Prospects for the euro are more difficult to assess, particularly in the near-term. Given the current intense focus on regional developments and extent of the challenge facing some of the more vulnerable countries, we believe there is a significant risk of a fall below the recent low against the US\$ (1.1876). However, our central forecast looks for €/£ to gradually gravitate to back above 1.20 and then to remain relatively rangebound.

We expect the dollar to benefit significantly from relatively stronger economic growth next year, further underpinned by rising speculation of interest rate hikes.

**The US economy appears relatively unaffected by ongoing developments in Europe.** The indications are that annualised US growth will post 3-4% in the second quarter, after rising 3% in Q1, with consumer and business spending holding firm. Although May payrolls disappointed, with just 41,000 private sector jobs added, we expect robust corporate profits to support stronger employment gains in the coming months. Inflation data have been more benign, however, indicating that spare capacity remains considerable. This has raised the probability that the Fed may postpone raising interest rates until 2011. We expect the dollar to benefit significantly from relatively stronger economic growth, further underpinned by rising speculation of interest rate hikes. We have lowered our June 2011 target for £/\$ to 1.37.

Financial markets anticipate an austere Budget but sterling could benefit from a clearer medium-term strategy for reducing the deficit and any positive reactionary commentary from the rating agencies

**The UK emergency Budget on June 22 will provide the new government with the platform to address the concerns of both investors and rating agencies.** Financial markets anticipate an austere Budget but sterling could benefit from a clearer medium-term strategy for reducing the budget deficit and any positive reactionary commentary from the rating agencies. The pound should also be supported by signs that the recovery is firming, with UK economic growth forecast to accelerate in Q2. We forecast €/£ at 0.84 by end 2010.

Chart c: £/\$ predicted to fall below 1.45

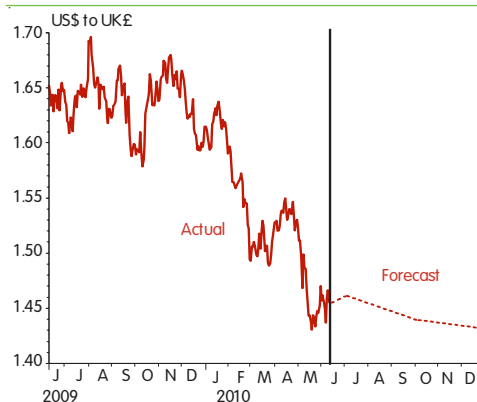


Chart d: €/£ forecast at 1.18 in a years' time

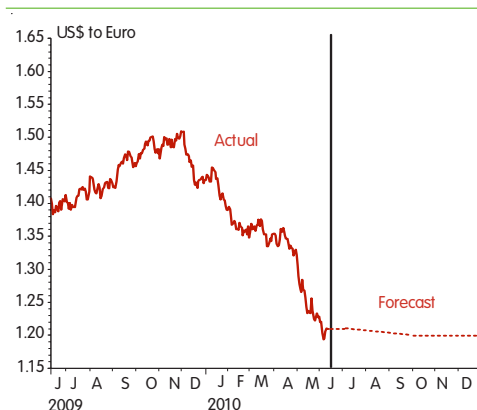


Chart e: £/€ back at 1.20 after initial pull back



Chart f: \$/¥ forecast to break 100 barrier



Event risk is elevated in Japan, with the political climate looking decidedly more fractious

**The Japanese yen has been underpinned by safe-haven flows in recent months.** However, we expect this support to gradually subside on signs that the global recovery remains on track. Event risk is also elevated, with the Japanese political climate looking decidedly more fractious. We forecast \$/Y at 96 by end 2010 and 100 at June 2011.

**The Swiss franc has been another key beneficiary of safe-haven support, notably falling to a record low versus the euro.** However, it has continued to weaken versus the dollar. While we look for this to temporarily reverse as markets regain some equilibrium in the coming months, our June 2011 \$/CHF target stands at 1.21 from 1.18 previously.

We believe that the sell-off in commodity currencies is increasingly looking overdone and that the risk of a sharp pull back is significant

**In contrast, the commodity currencies have been particularly hit hard by renewed market volatility and concerns about the global recovery.** However, we believe that this is increasingly looking overdone and that the risk of a sharp pull back is significant. The economic backdrop for Australia, New Zealand and Canada is more favourable than their larger G10 peers and we predict further interest rate hikes in all three countries in the year ahead. We look for USD/AUD to rebound to 1.16 in six months, with USD/NZD and USD/CAD seen at 1.47 and 1.07 at end 2010.

### Emerging Europe

Germany's unilateral decision to impose a temporary ban on uncovered short-selling has heightened tensions in the euro-zone...

Tensions in euro-zone financial markets have continued over the past month. Most notable was Germany's unilateral decision to impose a temporary ban on uncovered short-selling of eurozone government securities, CDS and selected financial stocks. This course of action instilled a sense of panic among official policymakers with emerging European currencies losing further ground against the US dollar. The main underperformers have been the Russian rouble and the Polish zloty - which have fallen by 2.5-3.5% since our *May Outlook*. The 'bigger picture' of countries aspiring to join the euro at some stage in the future experiencing sharp falls in their currencies, remains intact and this theme seems likely to prevail for some time yet. Reinforcing this trend, is our expectation of a stronger US dollar going forward into next year, as US economic recovery becomes better-established. Our \$/EUR forecast in a year's time stands at 1.18.

### Emerging Asia

The 'bigger picture' in China continues to feature the need to slow the pace of domestic economic activity. High house price inflation is a sign of potential over heating although the prospect of weaker growth has prompted the Shanghai Composite Index to fall by almost 20% of its value since mid-April. Higher money market rates and bank reserve requirements, along with

Chart g: EUR/CHF hit a record low last month

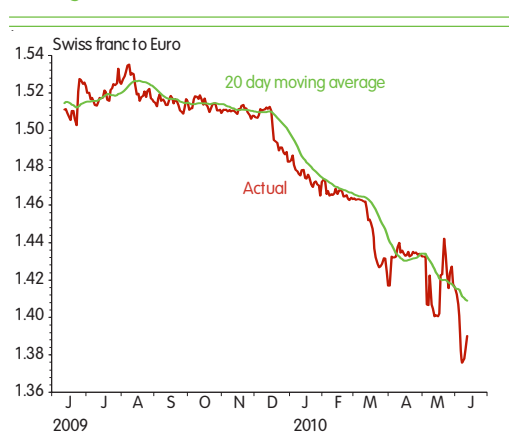


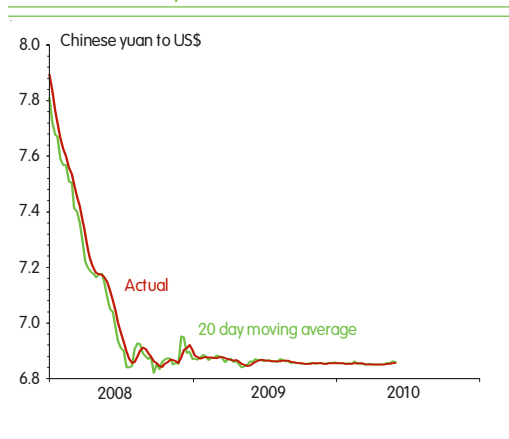
Chart h: CAD to benefit from interest rate hikes



Chart i: The US dollar's 'safe haven' status has compromised the performance of the rouble



Chart j: A revaluation in CNY versus the USD still seems some way off...



Euro-zone instability has prompted concerns about China's appetite for euro-denominated assets...

bespoke property market measures, are being employed to cool China's domestic economic expansion. This is taking place in the absence of an increase in the PBoC's main one-year lending rate that still stands at 5.31%, which potentially risks de-stabilising a still fragile global economic recovery.

Beyond this, the recent instability within the euro area has not gone unnoticed in China. In particular, there have been concerns about China's appetite for euro-denominated assets since our last *Outlook* in mid-May. However, China's State Administration of Foreign Exchange – which manages some \$2.5trn in foreign exchange reserves – recently calmed financial markets when it noted that "Europe has been and will continue to be one of the major markets for investing China's exchange reserves". Nonetheless, an outright *increase* in the proportion of Chinese reserves held in euros seems unlikely. Finally, remarks by government officials suggest that a policy shift towards sustained renminbi appreciation still seems unlikely near term. Our end-2010 \$/CNY forecast stands at 6.72.

Broadly speaking, Asian currencies have again lost ground versus the US dollar...

Elsewhere in Asia, aside from the Hong Kong dollar, Asian currencies have again lost ground versus the USD. The latter continues to assume 'safe haven' status amid ongoing market uncertainty, particularly in the euro-zone. Since our last *Outlook*, the biggest decline has been seen in the South Korean won (-5.6%). Recent developments in the euro-zone have meant that expectations for a rate rise in South Korea have been pared back from a position where a near-term tightening seemed almost inevitable. Euro-zone instability has also compromised the performance of the Philippine peso and the Indian rupee against the USD. Our end-2010 \$/INR forecast, however, stands at 45.50.

### Latin America

The Colombian and Chilean pesos have performed well over the past month, while the Brazilian real has risen only modestly despite a 75bp rate increase...

Latin American currencies have displayed contrasting performances over the past month. Among the gainers, the Colombian and Chilean pesos rose by 2.8% and 1.0%, respectively, during the period. The Chilean peso has appreciated on the back of a more positive outlook for copper prices (Chile being the world's largest producer of copper). In Colombia, on the other hand, gains have been achieved more recently on moves to tighten fiscal policy via higher taxes on alcohol and tobacco. In Brazil, the real has fallen marginally since our last *Outlook*, despite a recent 75bp hike in the Selic rate to 10.25% with a further rate hike expected before year-end. Our projection for \$/BRL stands at 1.73 by end-2010. The main underperformer over the period has been the Argentine peso (-0.7%).

Chart k: The Philippine peso has lost ground to the USD, which has assumed 'safe haven' status...



Chart l: The Indian rupee has also fallen back...



Chart m: A brighter outlook for copper prices has helped the Chilean peso...

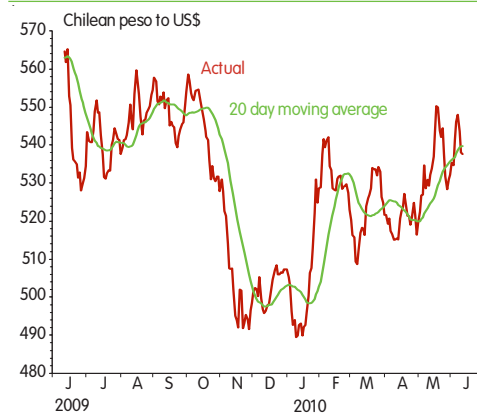


Chart n: The Brazilian real has risen only modestly in response to the recent Selic rate hike...



## International Financial Market Forecasts - June 2010

### 14 June 2010

	3.09	6.09	9.09	12.09	3.10	6.10	9.10	12.10	3.11	6.11	9.11	12.11
	actual	actual	actual	actual	actual							
US - Fed funds (target)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25	2.00	2.50	3.25
US - 3-month (offer)	1.20	0.60	0.29	0.25	0.29	0.54	0.85	1.33	2.13	2.63	3.38	3.88
US - 3yr swap rate (mid)	1.69	2.12	1.88	2.07	1.80	1.70	2.00	2.40	3.10	3.50	4.20	4.60
US - 5yr swap rate (mid)	2.23	2.94	2.65	2.98	2.73	2.40	2.50	2.90	3.50	3.90	4.50	4.90
Japan - overnight call rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.50	0.50
Japan - 3-month (offer)	0.84	0.60	0.35	0.28	0.25	0.25	0.25	0.30	0.43	0.68	0.68	0.88
UK - Base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50
UK - 3m (offer)	1.80	1.22	0.54	0.61	0.65	0.73	0.80	0.95	1.10	1.43	1.68	1.93
UK - 3yr swap rate (mid)	2.48	2.98	2.51	2.65	2.06	2.00	2.20	2.60	2.90	3.20	3.60	3.90
UK - 5yr swap rate (mid)	3.02	3.67	3.24	3.39	2.83	2.70	2.90	3.30	3.60	4.00	4.30	4.50
Euro 16 - Repo rate	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	2.00
Euro 16 - 3-month (offer)	1.51	1.09	0.71	0.66	0.58	0.65	0.70	0.80	1.33	1.66	2.16	2.66
Euro-16 - 3yr swap rate (mid)	2.14	2.25	2.13	2.25	1.79	1.60	1.60	1.80	2.10	2.30	2.70	2.90
Euro-16 - 5yr swap rate (mid)	2.67	2.86	2.71	2.81	2.39	2.10	2.10	2.20	2.40	2.60	2.80	3.00

### Exchange rates (mid-point):

#### Developed countries

\$	SDR	0.67	0.65	0.63	0.64	0.66	0.69	0.69	0.69	0.70	0.70	0.70	0.69
	Effective	92.2	86.8	82.1	83.0	84.4	87.9	89.0	90.3	92.9	93.8	93.6	92.7
	Euro	0.75	0.71	0.68	0.70	0.74	0.83	0.83	0.83	0.85	0.85	0.83	0.82
£	\$	1.43	1.65	1.60	1.61	1.52	1.46	1.44	1.43	1.36	1.37	1.41	1.45
	Effective	76.3	83.8	78.9	80.5	77.9	78.2	78.0	78.1	77.9	77.9	78.4	78.7
	Euro	1.08	1.17	1.09	1.13	1.12	1.20	1.20	1.19	1.15	1.16	1.18	1.19
Yen	\$	99	96	90	93	93	92	93	96	98	100	102	101
	£	142	159	143	150	142	134	134	137	133	137	144	147
	Euro	131.1	135.3	130.9	133.6	126.4	111.3	111.6	115.2	115.6	118.0	122.4	123.2
Euro	\$	1.33	1.40	1.46	1.43	1.35	1.21	1.20	1.20	1.18	1.18	1.20	1.22
	£	0.93	0.85	0.91	0.89	0.89	0.83	0.84	0.84	0.87	0.86	0.85	0.84
Aus \$	\$	1.44	1.24	1.13	1.11	1.09	1.11	1.14	1.16	1.20	1.20	1.23	1.25
	£	2.06	2.04	1.81	1.80	1.65	1.62	1.63	1.66	1.62	1.64	1.74	1.82
	Euro	1.91	1.74	1.66	1.60	1.47	1.34	1.36	1.40	1.41	1.41	1.48	1.53
Can \$	\$	1.26	1.16	1.07	1.05	1.01	1.03	1.05	1.07	1.12	1.14	1.14	1.15
	£	1.80	1.91	1.72	1.69	1.54	1.50	1.51	1.53	1.52	1.56	1.61	1.67
	Euro	1.67	1.63	1.57	1.50	1.37	1.25	1.26	1.28	1.32	1.35	1.37	1.40
Dkr	\$	5.61	5.31	5.09	5.19	5.50	6.15	6.20	6.20	6.31	6.31	6.21	6.11
	£	8.04	8.74	8.15	8.37	8.34	8.97	8.91	8.86	8.56	8.66	8.76	8.87
	Euro	7.45	7.45	7.45	7.44	7.44	7.44	7.44	7.45	7.45	7.45	7.45	7.45
NZ \$	\$	1.75	1.54	1.38	1.37	1.41	1.45	1.45	1.47	1.49	1.50	1.52	1.53
	£	2.51	2.54	2.21	2.22	2.14	2.12	2.08	2.10	2.02	2.06	2.14	2.22
	Euro	2.33	2.17	2.02	1.97	1.91	1.76	1.74	1.76	1.76	1.77	1.82	1.86
Nkr	\$	6.75	6.44	5.80	5.78	5.94	6.47	6.50	6.48	6.61	6.63	6.60	6.51
	£	9.68	10.60	9.28	9.33	9.00	9.43	9.34	9.25	8.97	9.09	9.32	9.45
	Euro	8.96	9.03	8.48	8.29	8.03	7.83	7.80	7.77	7.80	7.82	7.93	7.94
Skr	\$	8.27	7.75	6.99	7.14	7.20	7.93	7.94	7.92	8.01	7.81	7.66	7.34
	£	11.85	12.76	11.18	11.53	10.92	11.55	11.41	11.31	10.86	10.71	10.81	10.67
	Euro	10.98	10.87	10.22	10.24	9.74	9.59	9.53	9.50	9.45	9.21	9.19	8.96
Sfr	\$	1.14	1.09	1.04	1.03	1.05	1.16	1.18	1.18	1.20	1.21	1.20	1.19
	£	1.63	1.79	1.66	1.67	1.60	1.69	1.69	1.69	1.63	1.66	1.69	1.73
	Euro	1.51	1.53	1.52	1.48	1.42	1.40	1.41	1.42	1.42	1.43	1.44	1.45

## International Financial Market Forecasts - June 2010

		3.09	6.09	9.09	12.09	3.10	6.10	9.10	12.10	3.11	6.11	9.11	12.11
		actual	actual	actual	actual	actual							
<b>14 June 2010</b>													
<b>Emerging market Europe</b>													
Czech koruna	\$	20.67	18.55	17.32	18.40	18.78	21.27	21.18	20.78	20.90	20.62	20.01	19.41
	£	29.63	30.54	27.70	29.72	28.48	31.01	30.43	29.68	28.34	28.29	28.25	28.19
	Euro	27.45	26.01	25.31	26.41	25.41	25.74	25.41	24.93	24.66	24.33	24.01	23.68
Hungarian forint	\$	232.4	194.3	184.8	188.3	196.4	233.0	219.2	216.7	218.6	215.0	209.3	204.3
	£	333.0	319.9	295.6	304.2	297.9	339.7	315.0	309.5	296.6	295.0	295.4	296.8
	Euro	308.5	272.5	270.2	270.2	265.7	282.0	263.0	260.0	258.0	253.7	251.1	249.3
Polish zloty	\$	3.52	3.18	2.90	2.86	2.85	3.40	3.30	3.22	3.15	3.10	3.01	2.92
	£	5.05	5.24	4.64	4.62	4.33	4.95	4.74	4.60	4.28	4.26	4.25	4.24
	Euro	4.67	4.46	4.24	4.11	3.86	4.11	3.96	3.86	3.72	3.66	3.62	3.56
Romanian leu	\$	3.19	3.00	2.89	2.95	3.03	3.45	3.39	3.38	3.42	3.40	3.32	3.25
	£	4.58	4.94	4.62	4.77	4.59	5.03	4.87	4.82	4.64	4.66	4.68	4.72
	Euro	4.24	4.21	4.22	4.23	4.10	4.17	4.07	4.05	4.04	4.01	3.98	3.97
Russian rouble	\$	34.01	31.29	30.09	30.24	29.36	31.57	30.50	29.49	29.66	29.73	29.61	29.48
	£	48.13	51.68	47.73	48.04	44.20	46.03	43.83	42.13	40.23	40.79	41.80	42.82
	Euro	45.03	43.72	43.92	43.49	39.81	38.20	36.60	35.39	35.00	35.08	35.53	35.97
<b>Emerging market Asia</b>													
Chinese renminbi	\$	6.83	6.83	6.83	6.83	6.83	6.83	6.75	6.72	6.66	6.55	6.45	6.40
	£	9.79	11.25	10.92	11.02	10.35	9.96	9.70	9.60	9.03	8.99	9.11	9.30
	Euro	9.07	9.58	9.98	9.80	9.24	8.26	8.10	8.06	7.86	7.73	7.74	7.81
HK\$	\$	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
	£	11.11	12.76	12.40	12.52	11.76	11.30	11.14	11.07	10.51	10.63	10.94	11.26
	Euro	10.29	10.87	11.33	11.13	10.49	9.38	9.30	9.30	9.15	9.15	9.30	9.46
Indian rupee	\$	50.74	47.91	48.11	46.54	44.90	46.83	45.95	45.50	44.50	43.90	43.53	43.40
	£	72.72	78.89	76.94	75.15	68.10	68.27	66.04	65.00	60.36	60.23	61.45	63.03
	Euro	67.36	67.19	70.32	66.77	60.75	56.66	55.14	54.60	52.51	51.80	52.24	52.95
Indonesian rupiah	\$	11555	10208	9665	9395	9100	9200	9069	8975	8833	8950	9000	9069
	£	16562	16810	15458	15172	13803	13412	13033	12821	11980	12280	12706	13172
	Euro	15342	14318	14127	13479	12313	11132	10883	10770	10423	10561	10800	11064
M ringgit	\$	3.65	3.52	3.46	3.42	3.26	3.28	3.24	3.20	3.18	3.17	3.16	3.16
	£	5.23	5.79	5.54	5.53	4.95	4.78	4.66	4.57	4.31	4.35	4.46	4.59
	Euro	4.84	4.93	5.06	4.91	4.41	3.97	3.89	3.84	3.75	3.74	3.79	3.86
Philippines peso	\$	48.33	48.13	47.38	46.23	45.19	46.64	45.65	44.45	44.81	44.85	44.89	44.94
	£	69.27	79.25	75.78	74.65	68.55	67.99	65.60	63.50	60.78	61.54	63.37	65.27
	Euro	64.16	67.50	69.26	66.33	61.15	56.43	54.78	53.34	52.88	52.92	53.87	54.83
Sing \$	\$	1.52	1.45	1.41	1.40	1.40	1.40	1.39	1.37	1.36	1.35	1.35	1.36
	£	2.18	2.38	2.25	2.27	2.12	2.04	2.00	1.95	1.84	1.85	1.91	1.98
	Euro	2.02	2.03	2.06	2.01	1.89	1.69	1.67	1.64	1.60	1.59	1.62	1.66
South Korean won	\$	1383	1274	1178	1164	1131	1246	1185	1105	1070	1064	1058	1052
	£	1983	2098	1884	1880	1716	1816	1703	1579	1451	1460	1494	1528
	Euro	1837	1787	1722	1671	1531	1508	1422	1326	1263	1256	1270	1283
Taiwan \$	\$	33.91	32.81	32.15	31.99	31.76	32.37	31.80	31.25	30.60	30.28	29.94	29.12
	£	48.61	54.03	51.42	51.65	48.17	47.19	45.70	44.64	41.50	41.55	42.27	42.29
	Euro	45.02	46.02	46.99	45.89	42.97	39.17	38.16	37.50	36.11	35.73	35.93	35.53
Thai baht	\$	35.47	34.07	33.41	33.34	32.34	32.43	32.20	32.18	31.98	31.90	31.93	31.84
	£	50.83	56.11	53.43	53.84	49.05	47.27	46.28	45.97	43.38	43.77	45.08	46.24
	Euro	47.09	47.79	48.84	47.83	43.75	39.23	38.64	38.62	37.74	37.64	38.32	38.84

## International Financial Market Forecasts - June 2010

14 June 2010

		3.09	6.09	9.09	12.09	3.10	6.10	9.10	12.10	3.11	6.11	9.11	12.11
		actual	actual	actual	actual	actual							
Vietnamese dong	\$	17797	17773	17841	18474	19090	19550	19015	18990	18500	18570	18300	18250
	£	25509	29269	28533	29833	28958	28501	27327	27129	25092	25480	25835	26506
	Euro	23629	24929	26077	26506	25831	23656	22818	22788	21830	21913	21960	22265
<b>Emerging market Americas</b>													
Argentinian peso	\$	3.72	3.80	3.84	3.80	3.88	3.92	3.89	3.89	3.89	3.92	3.94	3.96
	£	5.32	6.25	6.15	6.14	5.88	5.71	5.58	5.55	5.28	5.38	5.56	5.75
	Euro	4.93	5.32	5.62	5.45	5.25	4.74	4.66	4.67	4.59	4.63	4.73	4.83
Brazilian real	\$	2.30	1.96	1.78	1.74	1.78	1.80	1.75	1.73	1.78	1.78	1.76	1.77
	£	3.30	3.23	2.85	2.82	2.71	2.62	2.51	2.47	2.41	2.44	2.48	2.57
	Euro	3.06	2.75	2.60	2.50	2.41	2.18	2.10	2.08	2.10	2.10	2.11	2.16
Chilean peso	\$	582.3	531.3	550.2	507.3	524.8	537.7	525.4	518.0	520.0	522.0	530.0	538.5
	£	834.6	874.9	880.0	819.1	796.0	783.9	755.1	740.0	705.3	716.2	748.2	782.1
	Euro	773.1	745.2	804.2	727.8	710.0	650.6	630.5	621.6	613.6	616.0	636.0	657.0
Mexican peso	\$	14.10	13.17	13.51	13.06	12.33	12.67	12.45	12.35	12.25	12.20	11.83	11.88
	£	20.21	21.69	21.60	21.08	18.70	18.47	17.89	17.64	16.61	16.74	16.69	17.25
	Euro	18.72	18.47	19.74	18.73	16.68	15.33	14.94	14.82	14.46	14.40	14.19	14.49
Venezuelan bolivar	\$	2.15	2.15	2.15	2.15	4.29	4.29	4.29	4.30	4.30	4.30	4.36	4.40
	£	3.08	3.54	3.43	3.47	6.51	6.25	6.17	6.14	5.83	5.90	6.16	6.39
	Euro	2.85	3.01	3.14	3.08	5.81	5.19	5.15	5.16	5.07	5.07	5.23	5.37
<b>Emerging markets - other majors</b>													
Israeli shekel	\$	4.22	3.92	3.78	3.79	3.69	3.85	3.70	3.65	3.67	3.68	3.69	3.75
	£	6.05	6.46	6.04	6.12	5.60	5.61	5.32	5.21	4.98	5.05	5.21	5.45
	Euro	5.60	5.50	5.52	5.43	5.00	4.66	4.44	4.38	4.33	4.34	4.43	4.58
Saudi riyal	\$	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
	£	5.38	6.18	6.00	6.06	5.69	5.47	5.39	5.36	5.09	5.15	5.29	5.45
	Euro	4.98	5.26	5.48	5.38	5.07	4.54	4.50	4.50	4.43	4.43	4.50	4.58
SA rand	\$	9.51	7.72	7.58	7.36	7.34	7.72	7.65	7.55	7.52	7.55	7.69	7.82
	£	13.63	12.72	12.12	11.89	11.14	11.25	10.99	10.79	10.20	10.36	10.86	11.36
	Euro	12.63	10.83	11.08	10.57	9.94	9.34	9.18	9.06	8.87	8.91	9.23	9.54
Turkish lira	\$	1.67	1.54	1.49	1.50	1.52	1.52	1.51	1.49	1.44	1.58	1.50	1.45
	£	2.40	2.53	2.38	2.42	2.31	2.22	2.17	2.13	1.95	2.17	2.12	2.11
	Euro	2.22	2.15	2.17	2.15	2.06	1.84	1.81	1.79	1.70	1.86	1.80	1.77
UAE dirham	\$	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
	£	5.26	6.05	5.87	5.93	5.57	5.35	5.27	5.24	4.98	5.04	5.18	5.33
	Euro	4.88	5.15	5.37	5.27	4.97	4.44	4.40	4.40	4.33	4.33	4.40	4.48

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