

Global Economic Outlook

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The difference between 'U' and 'V'

The global economy has already slowed and will slow further in the months ahead. The question is whether the downturn will be short-lived and followed by a sharp rebound (a V-shaped recovery), or if there will be a more protracted period of sluggish growth (the U shape). We hope for the former, but the odds are increasingly slanted towards the latter.

The US is flirting with recession, while the UK and the Eurozone have slowed below their trend growth rates. Emerging markets have so far remained relatively insulated – which helps to explain the latest surge in commodity prices. But, a synchronized slowdown in the industrialized economies will exert a drag on the developing world.

Financial turbulence is at the root of the slowdown and ongoing dislocation in credit markets remains the major threat. Policymakers are responding. Funds have been injected into the banking system and new lending facilities have been created, e.g. to swap mortgage securities for more liquid government bonds. Between September and mid-April, US rates were slashed by 300bps and by 75bps in the UK, with more cuts expected.

This time around the policy stimulus will be less potent. This is the key reason why the recovery is likely to be a gradual affair (U shaped). Rate cuts implemented during the 2001 global downturn had a powerful impact as they were accompanied by lower long-term interest rates and a narrowing of spreads on household/corporate lending. This led to a sharp rise in asset prices (especially housing), boosting net wealth and providing much needed support to consumers at a time when labour market conditions were deteriorating.

Yields on long-term government bonds have fallen, but the cost of borrowing for households/firms hasn't. Subprime losses have eroded bank capital, reducing the scope for fresh lending. Risk aversion is limiting the appetite for new bond issuance and widening credit spreads (chart 1). Asset prices are correcting, undermining household balance sheets just as labour markets are softening (or are about to). There is a risk of a downward spiral, where falling asset prices lead to deteriorating credit quality, and further restrictions on credit supply, which dents economic activity, triggering more asset price declines.

Rebalancing will also limit the speed of the recovery. In the US and UK there has been an over reliance on consumer spending, while in Asia and parts of Europe (especially Germany) growth has been too dependant on exports. Exports are growing rapidly in the US and UK, providing support to key parts of the economy. But achieving the necessary shift of resources (e.g. away from services to tradable goods production in the US/UK) is rarely a smooth process and is likely to act as a drag on growth during the transition.

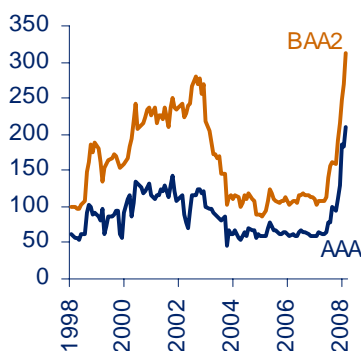
We look for a slow grind higher in the developed economies over the next two years. Emerging markets will slow, but growth is likely to prove more resilient – especially in Asia. The risks to the outlook still appear firmly skewed to the downside. (RG)

GDP growth forecasts (%)

	2007	2008	2009
US	2.2	1.7	2.2
Eurozone	2.6	1.4	1.5
UK	3.0	1.8	1.9
Japan	2.1	1.1	1.6
Emerging Asia	9.4	8.8	8.2

Chart 1: The cost of credit has risen for many (Bond spread over US Treasuries)

Source: Moodys' Default Report



US – Flirting with recession

There is a strong chance the US economy will contract in the first half of 2008. Key surveys of business and consumer activity are consistent with an economy that has stalled and could slide into recession. In particular, labour market weakness has spread from residential construction to other parts of the economy.

Labour market deterioration points to weak consumer spending

Employment is falling for the first time since 2003 (chart 2), and unemployment is rising (5.1% in March 2008 compared to 4.6% mid-2007). At the same time, elevated inflation is eroding purchasing power (CPI inflation was 4.2% in Q1 up from 2.9% in 2007). As a result, consumer spending growth is slowing sharply. Consumers are the motor of the US economy (accounting for 72% of all spending). Combined with tighter credit conditions and falling asset prices (both housing and equities), this suggests consumer spending growth will be extremely weak in 2008.

The rate of house price decline is accelerating and the excess supply of homes suggests that the market is still some way from finding a bottom. In January, US house prices were down 11% y/y in the major 'metro areas' and 3.0% y/y in the country as a whole (chart 3). The supply of existing and new homes is enough to meet around ten months of demand, still well above the six month level that represents a normal balance in the market.

Delinquency (i.e. arrears) and foreclosure (i.e. repossessions) rates also continue to rise, especially for riskier mortgages. Sub-prime mortgages represented 13% of all mortgages in Q4 2007, but 54% of foreclosures. Stabilisation will come only once the supply of housing comes back into line with demand. Due to the increased number of foreclosures and forced sales adding to supply while tighter credit conditions and the uncertain economic outlook are constraining demand, this may not happen until 2009.

Policymakers have reacted aggressively to the slowdown

The speed with which US policymakers have reacted to the slowdown is encouraging. The Federal Reserve has slashed interest rates and is providing extra liquidity in the inter-bank market. The White House has also pushed through a fiscal stimulus package in record time. The package should inject around \$150bn (1% of GDP) into the economy. **This could help a return to modest growth in H2 2008.** However, ongoing problems in credit markets suggest a slow grind higher in H2 2008 and 2009, rather than a quick return to robust growth. A downward spiral of falling credit quality, reduced supply of credit and the knock on impact on the wider economy remains a risk.

Exporters still doing well, corporate balance sheets in good shape

On the positive side, US exporters are getting a boost from the weaker dollar and still solid global growth, especially in emerging markets. Export growth was running at 19% y/y in the first two months of 2008. If export growth continues at this pace for the rest of the year, while imports remain subdued, this could add more than one percentage point to overall US GDP growth in 2008. China is now the third most important export destination for US goods and services, ahead of Japan and the UK.

The implication is that US companies with exposure to the global economy could continue to do well, despite slowing domestic demand. Corporate profit growth has been strong in recent years, allowing companies to strengthen balance sheets and improve leverage ratios. Companies are in better shape than they were going into previous downturns. In the 2001 recession in particular, many companies had over-extended themselves through investment in technology during the dotcom bubble. This time around, firms appear better placed to deal with a more challenging economic environment.

Shift in composition of US growth long overdue

In the longer-term, the composition of growth in the US needs to change, with less reliance on the consumer and business investment and the export sector in particular doing more. This will be an important part of the correction of global economic imbalances. The share of consumer spending in the total economy has been well-above its long-term average for a number of years, and consumers have been spending more than they have been earning since 2005. An adjustment was long overdue. (JS)

US: Main macro economic forecasts

	'07	'08	'09
Real GDP % y/y	2.2	1.7	2.2
CPI Inflation % y/y	2.9	3.7	2.8
Unemployment %	4.6	5.2	5.4
Curr Acc/GDP %	-5.3	-5.0	-4.8

Source: RBS Group Economics

Chart 2: Change in Non-farm payrolls (000s)

Source: Thomson Datastream

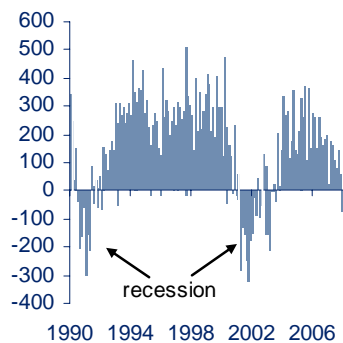
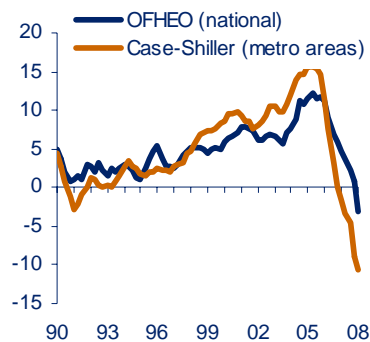


Chart 3: US House Prices (%/y)

Source: Thomson Datastream



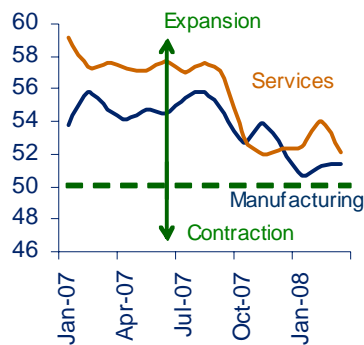
UK: Main macro economic forecasts

	'07	'08	'09
Real GDP %	3.0	1.8	1.9
CPI Inflation %	2.3	2.6	2.0
Unemploy %	5.4	5.4	5.9
Curr Acct/GDP %	-4.2	-4.0	-3.4

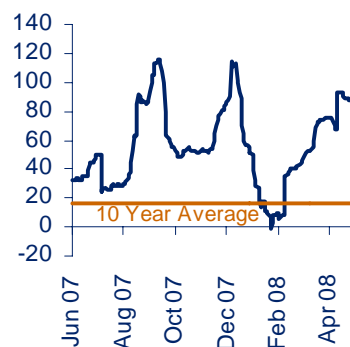
Source: RBS Group Economics

Chart 4: Still growing but at a sluggish pace relative to 2007 (Index)

Source: Thomson Datastream

**Chart 5: Inter-bank rates under pressure (Spread between Bank Rate and 3M LIBOR, bps)**

Source: Thomson Datastream



UK – shifting gears

The UK economy has so far been surprisingly resilient. But the shocks that have hit the world economy – record commodity prices, a US downturn and turbulence in financial markets - will take their toll in 2008. Households are being squeezed by higher food and energy costs, a wave of refinancing to higher mortgage rates as well as the drag from a cooling housing market. Firms are grappling with a more challenging external environment, surging input costs and more restricted access to credit. We expect 1.8% growth this year – a significant slowdown from the 3% recorded in 2007, but not catastrophic. Policymakers may have to become more aggressive to secure a soft landing, especially if tensions in money markets persist.

Consumers about to tighten their belts

Consumer spending remained surprisingly strong in early 2008. Retail sales rose by 5.8% y/y in the first three months of the year, above the average of 4.4% recorded in 2007 – hardly signs of a consumer collapse. But the pressure on household budgets is building. Average earnings were rising at a respectable 3.7% y/y in the three months to February, but sharp increases in the price of everyday staples are eating into discretionary spending. Food prices, which increased by just 1% a year in the decade to 2006, were up 5.7% y/y in Q1 after a 5% rise in 2007. Energy prices are also surging - up 10.7% y/y in Q1.

Moreover, around 1.5 million households are due to come off fixed rate mortgages on to higher rates this year. For an average borrower refinancing from a two-year fixed rate, this equates to a rise of around £100 a month. A sharper than expected slowdown in the housing market (prices were down 2.5% m/m in March) is also likely to dent confidence. **A robust labour market is providing a powerful offsetting force.** In the twelve months to March 2008 total employment has increased by a remarkable 456,000 or 1.6%, with full-time employees up even more rapidly (1.8%). The labour market reacts with a lag to any slowdown in economic activity, but so long as employment conditions remain fairly solid, a slowdown rather than a slump in consumer spending appears more likely.

Businesses becoming more cautious

Purchasing managers' indicators suggest there has already been a clear downshift in corporate activity. Manufacturing and service sectors are both still expanding, but at a much more sluggish pace relative to 2007 (chart 4). Still, it's not all doom and gloom. Profitability is high by historic standards and balance sheets appear to be in good shape. The sharp decline in sterling is also helping to provide a lift by boosting competitiveness. In early April sterling was down 11% y/y on a trade weighted basis and 18% against the euro – an important stimulus, since the Eurozone receives over half of UK exports. Moreover, growth is holding up Germany and France, our key continental trade partners - Italy and Spain are slowing more sharply, but together receive just 7% of our manufactured exports.

Monetary conditions providing little support

Tensions have re-emerged in money markets, partially offsetting the Monetary Policy Committee's (MPC) efforts to loosen financial conditions. The difference between the Bank Rate (set by the MPC) and the rates that banks charge each other for three month loans has increased sharply again in recent months (chart 5) This is important, since inter-bank lending rates are a key determinant of the cost of funds for households and firms. Moreover, at 5%, interest rates could hardly be described as overly accommodative – we estimate that the neutral interest rate (which neither stimulates nor restricts the rate of activity) is around 5%.

Efforts to lubricate the financial system by pumping funds into the banking system and allowing banks to swap mortgage securities for government bonds should help unblock credit markets. But this is likely to be a gradual process. The longer the cost/availability of credit remains constrained, the greater the chance that the MPC will have to ease policy more aggressively to secure a soft landing (the risks to our forecast of a 4.5% trough in rates are skewed to the downside). Inflation risks remain, with higher food/energy prices likely to push CPI towards 3% in the months ahead. But this reflects trends in global commodity markets – underlying inflation remains subdued and is unlikely to prevent the MPC from shifting its stance if activity weakens more sharply than expected. **(RG)**

Eurozone – the north/south divide

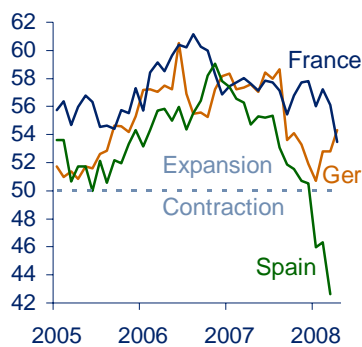
Eurozone: Macro economic forecasts

	'07	'08	'09
Real GDP % y/y	2.6	1.4	1.5
CPI Inflation %y/y	2.1	3.1	2.0
Unemploy. %	7.4	7.3	7.5
Curr. Acct/GDP %	0.0	-0.3	-0.3

Source: RBS Group Economics

Chart 6: PMIs indicate divergence (Index)

Source: Thomson Datastream



The summer of 2007 marked the high water mark for Eurozone growth for this business cycle. Following a strong performance in Q3 2007, growth was back to trend in Q4 and leading indicators suggest that growth slowed below trend in early 2008. The euro remains close to all time highs against the dollar and sterling, tensions remain in money markets and continued high inflation is constraining the European Central Bank's willingness/ability to trim interest rates. It'll be tough going in 2008. Within the region, the divergence in performance is becoming more pronounced, with Germany and France leading the pack, while Italy and Spain are heading south.

Recent survey data point to a north/south divide

Purchasing managers' indices (PMIs), a key leading indicator of economic activity, are hovering around 52, above the 50 level which separates growth from contraction, and consistent with growth modestly below its long-term trend rate of c2.2%. Industrial production has also stabilised at a similar level. But this aggregate picture masks mixed fortunes. The region's two largest economies, France and Germany, appeared to shrug off the worst effects of credit market turmoil. By contrast, the region's other large economies, Italy and Spain, have both recorded a sharp slowdown, with PMIs suggesting that manufacturing and service sector activity is contracting (chart 6).

European housing markets and lending patterns provide further evidence of growing regional disparities. House prices are now falling sharply in those economies that previously experienced the sharpest run up in property valuations and construction led-growth, namely Ireland and Spain. Corporate lending remains buoyant in Germany, France and the Netherlands (where economic growth is also robust), but is slowing sharply across much of the rest of the region. The sharp decline in Spain's PMI suggests problems in the housing market are filtering through to the wider economy.

How durable will growth be?

Survey data suggest that even Germany and France started to give ground as we headed into Q2. The region as a whole is likely to slow further as the year progresses since monetary conditions continue to tighten, putting upward pressure on the cost of borrowing. Inter-bank lending rates have increased, even though the European Central Bank (ECB) has kept short-term interest rates on hold since August last year. The euro remains close to all time highs against the dollar and sterling. The negative effects on the region's exports are being partly offset by continued strong demand from Central/Eastern Europe, Russia and Asia. Nevertheless, as growth in these areas is also expected to moderate and the strength of the currency takes its toll over time, export growth will slow.

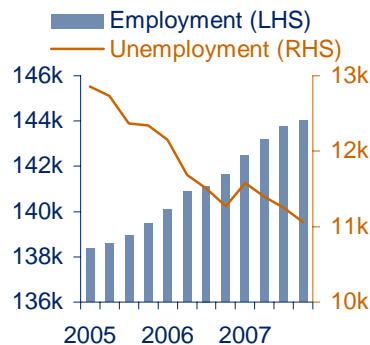
Structural reforms are starting to pay dividends. Faster growth has played a key role in spurring employment, but a more flexible labour market has also made hiring more attractive. Unemployment in the region has fallen steadily to a fifteen year low. At the same time, employment continues to rise with six million additional jobs created in the past year to bring the total number in employment to a record 144 million (chart 7). In Germany, which accounts for around a quarter of these jobs, wage growth is set to be the strongest in a decade this year. This helps to explain why consumers' willingness to spend has started to recover after a long period of retrenchment – good news for the region if domestic demand in the region's largest economy has finally managed to achieve self-sustaining momentum.

All of which puts the ECB in a dilemma

It will probably be several months yet before the ECB decides to lower interest rates – even though the economy is clearly slowing. The main barrier is the continued high level of inflation, which reached 3.6% in March, a record high and well above the 2% target ceiling. But eventually slower growth and the strong euro (which helps reduce the cost of imported goods) should bring down inflation and persuade the ECB to lower rates. Greater resilience in the north will help to offset a sharper slowdown in the south, but growth will be relatively weak at around 1.4% this year and 1.5% in 2009. (Robbie Denoon)

Chart 7: Eurozone labour market strong

Source: Thomson Datastream



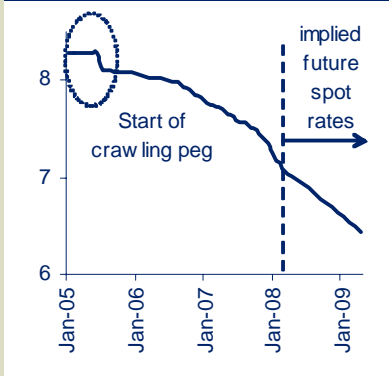
Asia GDP Growth forecasts (% y/y)

	2007	2008	2009
Japan	2.1	1.1	1.6
China	11.4	9.5	9.0
India	8.7	8.3	8.2

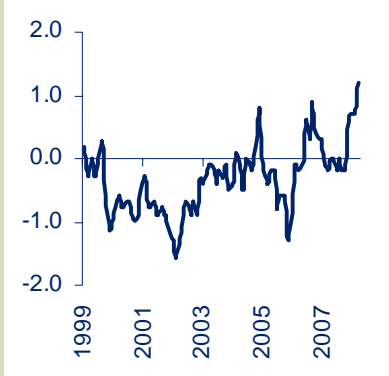
Source: RBS Group Economics

Chart 8: More currency appreciation expected (Yuan/US\$)

Source: Thomson Datastream

**Chart 9: End of deflation in Japan? (CPI Inflation, %)**

Source: Thomson Datastream



Asia – holding up?

The Asian economies continue to power ahead, led by surging consumer demand and upbeat sentiment in the corporate sector. The financial sector appears to have avoided the worst of the fallout from the US subprime crisis. With banks ability to extend credit intact, there is less chance that Asian households and firms will have to revise down their spending plans due to tighter credit conditions. This is not to say that Asia will remain completely insulated from the slowdown in the US and Europe. The Asian export sector is starting to feel the pinch as consumers in its most important markets tighten their belts.

Inflation is the biggest worry across much of the region, fuelled by rapid growth, a lack of spare capacity, high commodity prices and strong money supply growth. The poor are hit disproportionately hard and the scope for social tensions to build suggests that the authorities will make fighting inflation a top priority. Exchange rate policy is likely to be an important tool. Allowing currencies to appreciate against the dollar will help lower the cost of imported commodities, curb the export growth (lessening bottlenecks in the wider economy) and reducing the need for intervention in FX markets (which contributes to inflation by spurring money supply growth).

China – A new area dawning?

China has long been synonymous with rapid growth and the supply of cheap exports. There is still no argument on the first count. GDP growth is expected to remain robust at 9.5% this year. But 2008 could mark the beginning of the end of China's deflationary impact on the world economy. A decade-long boom has created bottlenecks in the supply of labour and raw materials, and prices for both are being bid up sharply as a result. Combined with a strong level of domestic demand, this creates significant pressure on domestic firms to increase prices. CPI inflation was running at 8.7% y/y in February. So far, measures to curb inflation – hikes in official interest rates, increases in banks' reserve requirements, price controls and currency appreciation – have been largely ineffective. More and quicker renminbi appreciation is likely – predominately against the dollar but also against the euro. Futures point to a 9% gain verses the dollar over the next twelve months.

India – Inflation gives policymakers headaches

After nine rate hikes between 2004 and early 2006, the Reserve Bank of India called a time-out on its policy tightening amid signs that price pressures were beginning to subside. But inflation has returned with a vengeance, and is now running at 7%, well above the Central Bank's 5% ceiling. As in China, rapid growth, high commodity prices and strong capital inflows are the root cause. With the outlook for the global economy (and financial conditions) so uncertain, policymakers are reluctant to raise interest rates further. Instead, they are more likely to opt for further currency appreciation. This will help to cool growth, which is expected to continue to run at a healthy 8% pace, while at the same time dampening inflation directly, by reducing the price of imported goods.

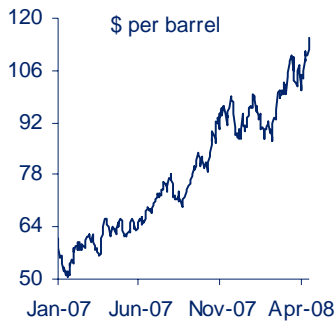
Japan – Rising commodity prices help dispel deflation threats

In a number of respects the obstacles facing Japan are the inverse of those facing China and India. Growth needs to be supported rather than tamed, the authorities are keen to see higher inflation and view a stronger currency as a problem, rather than part of the solution to current challenges. Higher commodity prices are not entirely unwelcome, as they are helping to end a prolonged period of deflation. Inflation was 1.2% in March, very soft by international standards but a decade high for Japan (chart 9).

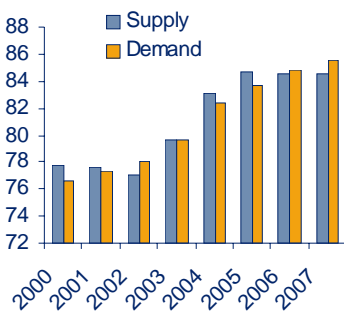
Nevertheless, it is unlikely that the authorities will be able to 'normalise' monetary policy and raise official rates from their current ultra-low level of 0.5%. Exporters, a key growth engine, face testing times due to the marked slowdown in the US, their most important market, and the strength of the yen. High input prices are also squeezing profit margins, and denting the appetite for new investment. However, the tight labour market and a continuous shift toward more workers in full-time employment should lend support to domestic demand, mitigating the headwinds from overseas. Overall, Japan's growth is likely to slow from the 2.0% level achieved in 2007, but remain above 1% - just. **(RB)**

Chart 10: Excelsior? (Oil Price, WTI))

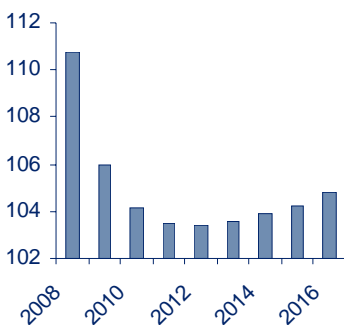
Source: US Department of Energy.

**Chart 11: After strong additions, supply has stagnated (mn barrels/day)**

Source: US Energy Department

**Chart 12: The future lies north of \$100—if you believe investors (Oil futures, \$/barrel)**

Source: Nymex; crude for Dec. delivery



Oil prices – defying gravity

Oil prices have continued to reach new all time highs, despite clear evidence that the global economy is losing momentum. There are a number of developments that explain the latest surge. Supply disruptions are part of the story, but the more fundamental factor appears to be financial – relating to the weakness of the US dollar and the emergence of commodities as an asset class.

Weaker dollar contributing to higher oil prices

Crude oil prices approached \$120/barrel at the end of April (chart 10), setting a new record high in real and nominal terms. The immediate causes were short-term supply disruptions due to bad weather in Mexico and worries about long-term supply security. The rally can also be linked, at least in part, to actual and anticipated dollar weakness (since the oil market is dollar denominated, a weaker dollar makes oil “cheaper” in other currencies, spurring demand).

As a result of financial market turmoil, oil has emerged as an asset class in its own right. It is viewed by investors as an inflation hedge (rightly or wrongly, oil prices are expected to outstrip the rise in overall inflation). Also, it doesn't hurt that recent returns have been very attractive (crude has risen 30% in just three months), particularly when compared with fixed-income securities and equities.

There is more evidence that financial considerations have been driving the most recent rally. Price rises have occurred against a background of deteriorating demand conditions. Since the start of the credit squeeze last summer, which has weighed on growth expectations throughout the developed world, crude oil prices have actually risen by some 40%. This is materially different from historical experience, when a slowdown in demand tended to result in lower prices. Now, even a sharp downward revision of the International Energy Agency's demand growth forecast has failed to dent the crude rally.

Demand/supply fundamentals are also at play

But financial factors alone fall short of explaining the rally. Demand growth in emerging market economies, where end-users are often shielded from price increases due to subsidies, remains strong. Supply has had a hard time catching up with demand. From 2002 to mid-2005, supply rose by some 12%. Since then, however, supply growth has been much slower (chart 11). The reasons are a more aggressive OPEC, which has been reluctant to boost output further, and a slow capacity build-up outside the cartel.

The issue is not a physical shortage of oil—there is plenty of oil in the ground - but a shortfall of investment in the infrastructure needed to extract it. Nominal investment spending has been strong, but rapid cost inflation has undermined its real value. According to the IMF, investment grew to about \$250bn in 2006 from about \$80bn in the early 1990s – a rise of \$170 bn. In real terms, however, investment was up only \$115bn over the period.

Political and economic uncertainties cloud the outlook

The outlook for investment is also clouded by geopolitical instability, which threatens to deter foreign investment in many key oil-producing regions. These deterrents foreshadow a prolonged period of underinvestment with severe consequences for supply growth. As a result, capacity is likely to remain well below the level that would be achieved in a competitive and developed market, given current high prices. Financial markets certainly appear to think so. Futures prices out to 2016 are now above \$100 per barrel (chart 12), a clear message, even if one allows for the facts that futures markets move closely with spot prices and that markets that far out are very illiquid.

We continue to believe that slower global growth will help to narrow the gap between demand and supply in the years ahead and exert downward pressure on prices. Nevertheless, we fully recognise the risks around that forecast, where the sluggish response of the supply side (despite high prices), further dollar weakness and/or any potential upside demand surprises could keep energy prices at elevated levels for a prolonged period. (TF)

Chart 13: Commodities—the third bubble? (Index)

Source: CRB Index

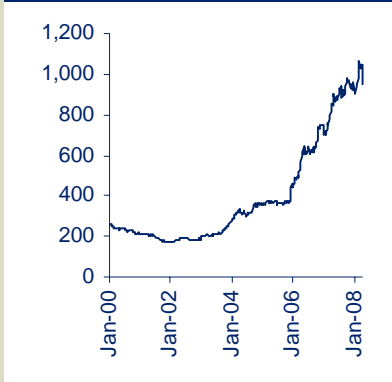
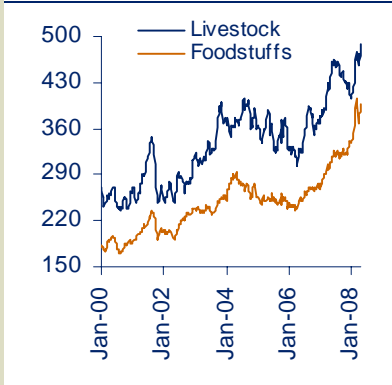


Chart 14: Low interest rates, strong demand and market distortions drive food prices (Index)

Source: CRB Index



Non-oil commodities - in line for a correction

Metals and soft commodity prices remain near record highs. Many metals prices are within striking distance of new records (chart 13). Many of the factors that have driven energy prices higher have also been leading commodity prices towards record highs. Most prominent is the weaker dollar and the low level of US interest rates which increases the incentive to shift investment from low-yielding treasury bills into commodities (which are increasingly being viewed as an alternative asset class in their own right).

Base metals

Strong demand growth was pivotal in triggering the surge in commodity prices back in 2003, but prices have continued to rise after August of last year, when the credit squeeze hit in earnest. That is to say, prices for industrial metals have failed to reflect sharply deteriorating expectations for demand growth. Demand will certainly slow in developed economies, and it is difficult to see how emerging markets could be completely unaffected, even if one allows that most of the growth in Asia is self-sustaining.

The message for industrial and base metal markets is clear. A strategy that relies on low real interest rates and uses commodity investment as a hedge against inflation and further dollar weakness is unsustainable in an environment where support from the real economy is ebbing. We continue to believe that commodities have entered a stage which has some characteristics of a bubble, that is, where future price expectations are closely related to past appreciation. Most industrial metals will likely undergo a correction.

Agricultural commodities

The prices of foodstuffs and livestock have increased by more than 60% since 2006 (chart 14). There are a number of factors at play. On the demand side the weaker dollar has stimulated demand by lowering the local currency cost in some economies. Strong economic growth has boosted purchasing power in recent years, where much of the additional discretionary income has been spent on food. At the same time bad harvests have dented supply and the drive towards biofuels has also had an impact on the price of some food staples. As shortages have emerged some major producing countries have restricted exports, exacerbating problems in importing countries.

There are also longer-term structural factors to consider on the supply side. Agriculture markets have a long history of state intervention that has resulted in severe price distortions. Until recently, developed countries routinely dumped excess supply resulting from heavy domestic subsidies on the world market, while closing their markets to imports from developing countries.

The combination of domestic subsidies and protectionism depressed world prices for foodstuffs and has reduced incentives for developing countries to invest in agriculture. Now, food prices are rising, and developing countries relying on imports feel the pain. With higher prices, former net exporters have resorted to export controls as the preferred policy tool.

Food prices may take longer to fall

In a largely free market, high prices would result in more land made available for agriculture while also attracting investment and ultimately boosting new supplies. At the same time high prices would also curtail consumption. However, this adjustment will take longer in global agricultural markets with its regulations, subsidies and controls. Therefore, while prices will come down eventually, as fundamentals reassert themselves, it may take longer than in the case of metals. (TF)

Box: A primer on Sovereign Wealth Funds

Sovereign Wealth Funds (SWFs) have hit the headlines after injecting almost \$60 billion into western financial institutions over the past six months. This box explores their origins, investment objectives and their impact on financial markets.

What are they?

SWFs are government-sponsored investment vehicles that currently control capital of around c. \$2.5tn. This is significantly more than the \$1tn - \$1.5tn managed by hedge funds, but less than the \$53tn assets under management with traditional asset managers (mutual funds, pension funds and insurance companies). The IMF predicts that total capital under management by SWF-like entities will grow to more than \$10tn by 2012. No other investor class is likely to see its capital under management growing at such a rapid rate. The oldest funds have existed for several decades, even though they went largely unnoticed in financial markets until recently. SWFs in Kuwait and Singapore date back to 1951 and 1974, respectively. The majority of SWFs are domiciled in the Middle-East and Asia (including Russia).

Motivations for running SWFs vary

Some aim to smooth income streams from volatile commodity prices, while others wish to spread current wealth across generations. But in all cases, governments have accumulated foreign assets to a level above and beyond what they deem necessary to conduct short-term stabilisation policies. Their *raison d'être* is therefore to actively invest the excess foreign exchange reserves accumulated by their respective governments.

Considering the Middle-East and Asia alone, the pool of foreign assets classified as reserves is currently \$3.7tn deep (7% of world GDP). These countries accumulate foreign assets because they are large net sellers of goods, including commodities, to the rest of the world. In some cases, intervention in foreign exchange markets further accelerates the build-up.

Impact on financial markets

These "excess" foreign exchange reserves were traditionally dollar-denominated (the international reserve currency) and holdings were slanted towards risk free government bonds. Subsequently, SWFs have aimed to diversify along two dimensions: asset class and currency. As SWFs receive more funds from their sponsoring governments this implies a declining appetite for government bonds, which will put upward pressure on yields in developed economies. The flipside is that riskier assets, equities and commercial property for example, may receive support as inflows from SWFs increase.

SWFs aim to reduce the dollar exposure of their parent governments. However, only the euro, yen and sterling have capital markets that are deep and liquid enough to easily absorb the cash withdrawn from dollar markets. This could put further pressure on an already weak dollar. However, the switch is likely to be gradual. Moreover, foreign exchange markets have a daily turnover of \$3.2 trillion - much larger than US government bonds and equity markets, where \$500bn and \$100bn are traded daily, respectively. This also limits the scope for SWFs to move currency markets.

Reducing volatility? SWFs have so far focused on acquiring non-voting, minority equity stakes in Western companies. Moreover, they normally abstain from short-term speculative trading and hold their stakes over long horizons. This behaviour should smooth volatility. There may be exceptions to this rule, however. Due to their size, a sudden change in investment strategy could kick-start herding behaviour.

Profit maximisation? Almost all SWFs claim to invest under the principle of profit-maximisation. However, governments in recipient countries have highlighted possible non-commercial motives, such as gaining access to scarce knowledge or safeguarding the supply of strategically important resources. As a result, numerous policy-makers have called on SWFs to increase the transparency of their investment activities. **(RB)**

Interest and Exchange Rate Forecasts

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 Bank Rate
2007 Q1	1.96	1.33	0.68	118	3.75	5.25	5.25
Q2	2.01	1.35	0.67	123	4.00	5.25	5.50
Q3	2.04	1.42	0.70	115	4.00	4.75	5.75
Q4	1.99	1.46	0.73	112	4.00	4.25	5.50
2008 Q1	1.99	1.58	0.80	100	4.00	2.25	5.25
Q2	2.03	1.60	0.79	99	4.00	1.75	5.00
Q3	2.01	1.55	0.77	98	4.00	1.75	4.75
Q4	1.99	1.49	0.75	95	3.75	1.75	4.75
2009 Q1	1.96	1.45	0.74	95	3.50	2.00	4.50
Q2	1.93	1.41	0.73	93	3.50	2.50	4.50
Q3	1.89	1.36	0.72	90	3.50	3.00	4.50
Q4	1.89	1.36	0.72	90	3.50	3.50	4.50

Please see our monthly Interest and Exchange Rate Forecast document for regular updates

Key Central Bank Monetary Policy Meetings in 2008	
Bank of England	8 May, 5 June, 10 July, 7 August, 4 September, 9 October, 6 November, 4 December
US Federal Reserve	30 April, 5 August, 16 September, 29 October
European Central Bank	8 May, 5 June, 3 July, 7 August, 4 September, 2 October, 6 November, 4 December

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