

US Quarterly Economic Update



Analysis by RBS Group Economics

Interest Rates

US interest rates look set to remain on hold at 5.25% for a while yet, but we believe the next move is more likely to be up than down. Recent data releases will have proved uncomfortable reading for US policymakers, with sluggish growth on the one hand and mounting inflation risks on the other. The economy grew by just 1.3% in Q1, the fourth quarter in a row below its 3% long-term average. However, strong jobs growth pushed the unemployment rate down to 4.4% in March – the lowest reading since 2001 and well below the 5% “full employment” level (the lowest level consistent with stable inflation). This is a worry for the Fed, since inflation is already too high. A situation of rising employment and slowing economic activity is not a sustainable combination – either the pace of activity will pick up or employment will start to fall. The outcome will determine whether the next US interest rate move will be up or down. The outlook is uncertain, but we continue to expect economic activity to rebound in the latter half of the year as the housing market stabilizes. Indeed, we expect further modest policy tightening next year in order to ensure inflation moderates towards the 2% level the Fed wants to see over the medium term.

Exchange Rates

The pound moved sideways against the Euro in April, but rose above the \$2 level, touching its highest level against the greenback for 26 years. The Euro also gained ground against the dollar, reaching an all time high in the process. Press articles were awash with stories of “dollar weakness”, but it would be more appropriate to talk about sterling and Euro strength, since upward adjustments to interest rate expectations in the Eurozone and the UK appear to have been the main driving force behind the currency moves. Concerns about the US economy don’t appear to be the major driver – in fact, equity market developments point in the opposite direction, with US stock market indices reaching an all time high towards the end of April,

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Exchange Rates

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thanks to a series of strong profit announcements by US firms. Indeed, the extent of the dollar decline is a little surprising, but once again serves to illustrate the vulnerability of the dollar to shifts in investor sentiment. The enormous US trade deficit translates into a borrowing requirement from the rest of the world of around \$2.5 billion every working day – a significant sum by any standard. ■

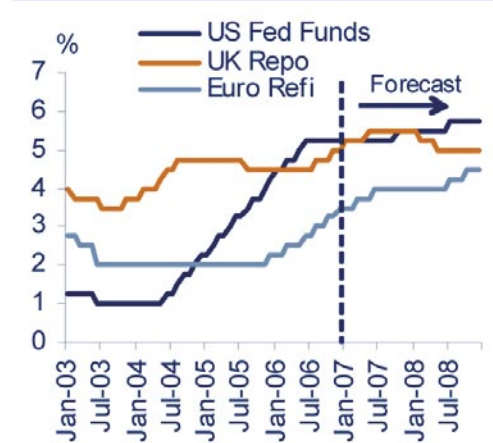
Oil and Gas Index

Crude oil prices have been driven higher in recent weeks, averaging in the mid-\$60s range. The most noteworthy phenomenon during the most recent run-up in prices is the widening premium of Brent over West Texas Intermediate. Normally, the North American benchmark trades at a premium of about \$1 to \$2 over Brent, mainly because it is a higher-quality crude. It is slightly lighter and sweeter which makes it easier and cheaper to refine and allows for a slightly higher output of gasoline as opposed to middle distillates.

Not only has the spread reversed recently, but the Brent premium widened to a new record last week, before narrowing slightly. Three factors are at play: First Brent is even more responsive to geopolitical tensions in the Middle East and Africa than WTI. Unrest in Nigeria and continuing tension in the Middle East undoubtedly contributed to the rising premium of Brent over WTI. Second, outages and breakdowns have adversely affected US refinery operations, adding to already tight capacity. This has weighed on demand for crude oil from refineries in the US. At the same time, demand growth for gasoline is robust and the US continues to import European gasoline cargoes to meet demand, thereby driving up gasoline prices in Europe, which in turn supports European crude. The third factor is a mere technical issue, namely the glut of oil at the delivery hub for the WTI contract in Cushing, Oklahoma. ■

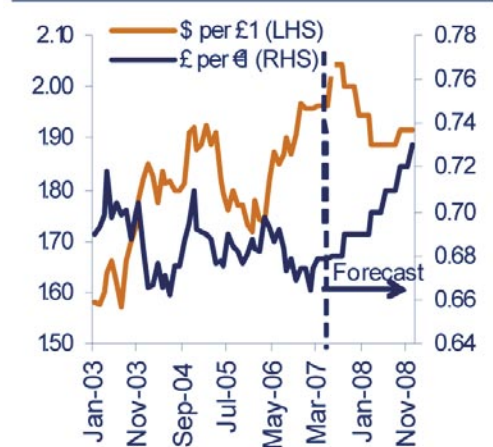
Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Economic Commentary

Housing market trends dominated the calendar in the US. With the data sending mixed signals, the fog is yet to lift on the true state of the market. Data on new home sales in April showed they were 13% higher than the monthly average prevailing in the first quarter of the year – a significant rebound on the face of it. However, the bounce in sales must be kept in perspective – the sales figures were better than Q1, but remained more than 10% below the total recorded in April 2006. Existing home sales were the lowest since June 2003. Problems in the sub prime mortgage market may not be resulting in a credit crunch, but uncertainty surrounding the sub prime situation is encouraging potential buyers to sit on their hands a while longer to see what the market will look like when the dust settles. There is also still little evidence that the weakness in the US housing market is spilling over to the rest of the economy in any meaningful way.

We anticipate crude oil prices to moderate to the mid-\$50s range with further downside potential in the medium term, as the global market is moving toward excess capacity. One reason is growing supplies in response to the price signal; another is our expectation that economic activity in the US, by far the largest consumer of crude oil, should remain sluggish in the near-term as the housing market adjustment continues. Slower economic growth in the US will weigh on demand growth for crude oil and refined products this year. Demand growth in 2008 will be slower than in the previous boom years, but it will remain robust since the softness seen this year should prove transitory, with the economy accelerating back to its trend growth rate of 3% in 2008. ■

Chart 1: RBS Oil & Gas Indices

Source: Group Economics

