

Interest and Exchange Rate Forecast

September 16, 2005

- **The US has proved to be remarkably resilient in recent years and we are optimistic that the economic impact of Hurricane Katrina will prove to be predominantly temporary.** However, the US data-flow will be severely disrupted for the remainder of 2005. This tragic event has caused great anguish but has not led to the economy-wide anxiety witnessed after 9/11. We therefore doubt the Fed will relax its policy of raising interest rates at each of its meetings. The disruption caused to the nation's energy infrastructure has resulted in a sharp increase in fuel prices, and this is a more enduring source of risk. However, there are grounds for optimism. Infrastructure is being repaired and imports will help cover any domestic shortfall. Gasoline prices look to have peaked (albeit at a record high) and crucially, consumers seem willing to go about their driving as usual, betting that prices will moderate.
- **The hurricane will have a negative impact on near-term growth, but this will fall a long way short of pushing the economy into recession.** Louisiana and Mississippi together account for around 2% of US GDP. The sharp decline in activity in these regions in the September to November period (perhaps by as much as 40 or 50%), together with the dampening impact of higher fuel costs on activity across the nation, is likely to knock around 0.5 percentage points off the economy's annualized growth rate in Q3 and 1.5 percentage points off the Q4 number. Prior to Katrina we had penciled in 4.5% growth for each quarter, so growth is now likely to come in at 3.5% in Q3 and 3% in Q4. Further out the hurricane will actually boost GDP growth as the reconstruction effort gets into full swing – GDP growth could reach 4% in 2006.
- **On the inflation front, the Fed will be watchful.** Gasoline constitutes around 4% of the CPI index. Even before Katrina hit, gas prices were running 35% above last year's levels - they are now running 65% higher. Before taking any second round effects into account, the hurricane-related jump in prices, if maintained, would add 1.2 percentage points to US CPI in September, perhaps pushing headline inflation above 4%. The Fed will only be concerned, however, if higher energy prices feed through to wages and other prices. The risks are mounting. Labour market conditions have tightened (unemployment dipped below 5% in August), increasing the risk that elevated energy costs will pass through to wage claims. Moreover, productivity growth has started to slow, which will further curb the economy's capacity to grow without generating price pressures. In our view, a fiscal rather than a monetary response is more appropriate in this situation given the localized nature of the shock and we expect the Fed to hike rates by another 25bps at its meeting next week and at the rest of its meetings this year, taking rates to 4.25% by end-2005. Further hikes are expected next year as the economy regains momentum, with the fed funds rate peaking at 5.5% in late 2006.
- **The dollar weakened sharply in the wake of the hurricane as investors marked down their forecasts for GDP growth and interest rates.** The greenback briefly fell below 1.25 against the euro and 1.84 against sterling in early September. However, as evidence of the strength of the economy (pre-Katrina) emerged, along with more positive news about the clean-up operation, so the dollar re-traced most of its losses. We expect the dollar to remain close to current levels in the near term, especially against the euro, since short and long term interest rates remain significantly higher than their Eurozone counterparts. Interest rates are still higher in the UK, but the Bank of England cut its policy rate in August and a further cut looks likely (though probably not until early next year). The Homeland Investment Act is also encouraging US firms to repatriate profits, providing additional support for the greenback. Nevertheless, the major currencies are expected to recover ground against the dollar in the latter part of 2005 and in 2006 as concerns over the US current account deficit resurface. The deficit reached a record \$195 billion in Q1 2005, and is likely to widen further given the elevated level of oil prices, and more fundamentally, since US domestic demand growth continues to outpace that of its major trade partners.

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End of Quarter	€/\$	\$/¥	£/\$	\$/C\$	-----US-----		
					Fed Funds Rate	3-mo LIBOR	Treasury 10-yr Note Yield
2004 Q1a	1.23	104	1.84	1.31	1.0	1.1	3.9
Q2a	1.22	109	1.81	1.34	1.3	1.6	4.6
Q3a	1.24	110	1.81	1.27	1.8	2.0	4.1
Q4a	1.36	102	1.92	1.20	2.3	2.6	4.2
2005 Q1a	1.30	107	1.89	1.23	2.8	3.1	4.5
Q2a	1.21	111	1.79	1.22	3.3	3.4	4.2
Q3	1.24	110	1.82	1.20	3.8	4.0	4.5
Q4	1.28	107	1.83	1.19	4.3	4.5	5.0
2006 Q1	1.32	105	1.83	1.18	4.8	4.9	5.5
Q2	1.30	104	1.78	1.17	5.0	5.1	5.8
Q3	1.29	103	1.77	1.17	5.3	5.4	6.0
Q4	1.28	98	1.78	1.18	5.5	5.5	6.0
2007 Q1	1.26	95	1.75	1.18	5.3	5.4	5.8
Q2	1.24	95	1.72	1.18	5.0	5.1	5.5
Q3	1.22	95	1.72	1.18	5.0	5.1	5.5
Q4	1.20	95	1.69	1.18	5.0	5.1	5.5

a: actual

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