global forex outlook

Q1 2006

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Q1 2006 GLOBAL FOREX OUTLOOK

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Forward Rates as of 5th December, 2005

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OVERVIEW

2006 promises to be a year in which FX volatility will make a comeback, especially as the outlook for the Fed funds rate becomes more data dependent and thus less predictable. We look for the Fed to pause at 4.50% and hold rates steady throughout 2006, and any surprises on inflation risks/expectations as well as developments in the US housing market will be a test for the Bernanke-Fed.

Even with a funds rate at 4.50% and a likely ECB refi rate at 2.50%, global liquidity will be nowhere near restrictive, especially as the BoJ is still expected to keep the zero rate policy in place even after abandoning quantitative easing early in the year. The role of liability currency has been taken up by the JPY, which will no doubt be used for carry trades. The JPY is also a funding vehicle to play Japan/Asian equities as well as commodities (especially gold). The Nikkei should head above 18,000. However, as has been the case this year with inflows hedged and still firm bond outflows (including Uridashis), the JPY will remain under pressure. At the same time, we remain concerned about MoF/BoJ intervention on the JPY as this could be a way through which the issue of greater CNY-flexibility is kept on the table.

With US mid-term elections in 2006, calls for greater CNY-flexibility will likely gather momentum and will also be combined with increasing protectionist noises from the US. The post July price action showed that the Chinese authorities were able to deliver CNY adjustments in an orderly manner without disrupting global financial markets and this is likely to remain the case during 2006. Key dates here will be the end of Q1 when US Senators Schumer and Graham have threatened to bring their bill back onto the floor, and April, when we get the next US Treasury report on FX manipulation. The November report has suggested action unless further CNY appreciation is forthcoming. Our house call is for the CNY to be allowed to appreciate 3-5% in the course of 2006, more than the 1.5% delivered since July 21, 2005; the risk is that this is front-loaded early in the year given the need to stall US protectionist pressures.

Greater flexibility from China does not automatically translate into pressure on $/Asia where intra-regional FX performance has become uncorrelated and this is likely to remain the case during 2006. The impact of oil on c/a balances and the differing CBK responses to energy related inflation pressures will help to keep $/Asia uncorrelated. The higher oil price has also meant that the oil producers have become important providers of savings to the global economy. Petrodollars proving to be very interest rate sensitive, the outlook for Fed policy, and concerns over the US housing/consumption outlook could help to put the US c/a deficit story back in the spotlight -- a theme that we see dominating in H2 2006.

Un-hedged exposure to Turkish bonds as well as the attractive carry offered by the BRL remain attractive EM trades. Given that liquidity will continue to support the global economy, we do not expect any hiccups in EM and would need to see a more significant unwinding of the 'conundrum' in order to increase this risk more significantly.

Summary of IDEAglobal's FX forecasts

		Mar-06	Jun-06	Dec-06
Majors:	*Vs USD*			
	EUR	1.1800	1.1800	1.2500
	JPY	119.00	117.00	110.00
	GBP	1.7100	1.6900	1.7900
	CHF	1.3100	1.3000	1.2200
	CAD	1.1500	1.1300	1.0600
	AUD	0.7300	0.7400	0.7600
	NZD	0.6800	0.6800	0.6300
	Vs EUR			
	GBP	0.6900	0.7000	0.7000
	CHF	1.5400	1.5300	1.5250
	SEK	9.3000	9.2000	9.0000
	NOK	8.1000	8.0500	8.0000
Other EM:	*Vs USD*			
	RUB	29.05	29.65	29.25
	ZAR	6.3500	6.5500	5.9000
	TRY	1.5100	1.4100	1.3500
	ILS	4.7200	4.5800	4.2000
Latam:	*Vs USD*			
	MXN	10.85	11.05	11.16
	BRL	2.2600	2.3000	2.4000
	ARS	3.0500	3.0700	3.1800
	VEB	2150.00	2236.00	2325.00
	COP	2320	2345	2380
Asia:	*Vs USD*			
	KRW	1020	1010	985
	SGD	1.6650	1.6450	1.5850
	THB	41.30	42.20	42.80
	PHP	54.00	54.50	55.50
	MYR	3.7500	3.7000	3.6000
	IDR	9750	9650	9300
	TWD	33.30	33.20	33.00
	CNY	8.0200	7.9600	7.8400
	HKD	7.7500	7.7600	7.7600
	INR	46.30	47.00	47.50

EUR/USD

An increasing yield advantage and HIA related repatriation flows helped to keep the structural USD-bears on the defensive during 2005. However, 2006 promises to be a different story. An expected pause from the Fed early in the year coupled with our forecast for a steady trajectory on the Fed fund rates for the rest of 2006 is likely to see attention turn back to concerns over the US economic outlook, with most of the focus on the US housing market (soft or hard landing?). This will give room for USD structural issues to come back into the EUR/USD equation.

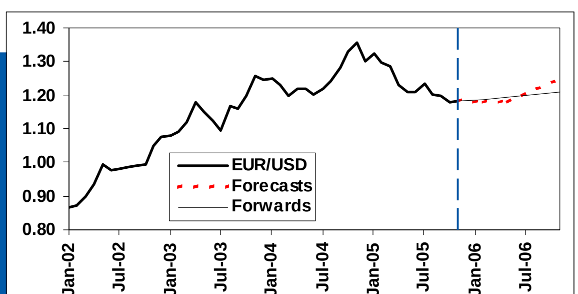
What happens with Fed policy after the long expected pause is thus important in setting direction for EUR/USD. Our view is that the US economy will grow at a still firm pace of around 3.5% during 2006 with risks of a print below this during H2 2006. The biggest uncertainty remains the housing market and related consumption; while we can't rule out a hard landing, this is not our central scenario, which is for a soft landing. Given that some local markets are hot, there is likely to be news on difficulties and localised sharp declines, and these should maintain concerns over the US economic outlook. The latter along with a Fed on hold should put the structural USD story back on the radar screen, namely the US current account deficit amounting to 6% of GDP. However, this is more likely to be a H2 rather than a H1 2006 story.

Closely linked to the USD yield story is the question of petrodollar diversification. High oil prices mean Asian savings have increasingly been transferred away from US assets to oil producing countries. Fears were the latter could diversify out of the USD. However, there seems to be little indication of reduced demand for USD-denominated assets. Indeed, the BIS highlighted in its Dec quarterly report that by mid-2005, the proportion of OPEC petro-deposits in USDs had risen while the share in EURs had fallen significantly. This is believed to be largely a function of higher US yields. There are two risks emanating from the current petrodollar situation: a) The BIS states there is still a higher proportion of petrodollars than previously that are left unaccounted for. b) If the USD loses its relative yield advantage, oil producing countries might start diversifying out of the USD. However, in our view, as long as US yields don't collapse completely, any petrodollar diversification out of the USD should help limit EUR/USD downside rather than provide an independent avenue for USD weakness.

Developments in the Eurozone economy and ECB policy will likely have limited impact on EUR/USD. While we expect the ECB to provide another 25bps hike at end-Q2 2006, further rate hikes will be restricted by the lack of 2nd round effects on inflation and the lack of a proper recovery in European consumer spending. Our point forecast is for 1.2500 for end-2006 as the market focuses on the outlook for the US housing market and structural factors come back into play in an environment of a steady Fed. With the US rate outlook dominating, the risk to our forecast is that the Bernanke-Fed will continue to hike interest rates beyond 4.50% and thus extend the duration of the yield story for the USD.

	Forecasts	Forwards
Q1 06	1.1800	1.1870
Q2 06	1.1800	1.1930
Q4 06	1.2500	1.2100

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/JPY

In our previous quarterly we grossly underestimated the extent to which the JPY would be converted to a liability currency, weakened by hedging, funding activity and carry trades. As we write the outlooks for 2006, the risk remains that we once again underestimate the extent to which the JPY weakens and this partly reflects our concerns that Japan might ultimately be forced to keep a lid on USD/JPY in order to keep the issue of CNY-flexibility on the table.

In our previous quarterly report, we had highlighted two themes (1) watching whether the JPY retains the status of an attractive funding currency and (2) the attractiveness of the JPY-crosses in particular AUD/JPY, NZD/JPY and ZAR/JPY. The latter is reflective of Uridashi issuance (bonds targeted to the Japanese retail market) that has mushroomed this year especially on the NZD. With the BoJ not expected to deviate from ZIRP during 2006 this factor should remain supportive of increased outflows with strong demand of financial institutions for foreign bonds also continuing especially as JGB yields stay below 2.00%. Between Jan-Nov 2005, Japanese investors poured some JPY 14.5tn into foreign bonds and much of these were with lower hedge ratios, creating a greater currency impact. These bond outflows are more than likely to continue especially as the BoJ maintains its commitment to keeping ZIRP after QE.

In addition to the mainly bond related domestic outflows, there has also been continued demand for Japanese equities that helped to take the Nikkei above 15,500 very quickly after resistance at 12,500 was breached in Sept. Between Jan-Nov, there were some JPY 11tn in foreign inflows much of which was increasingly being hedged especially during Q3/Q4 2005 as a USD based investor gets an additional yield pick-up by not holding on to the currency risk.

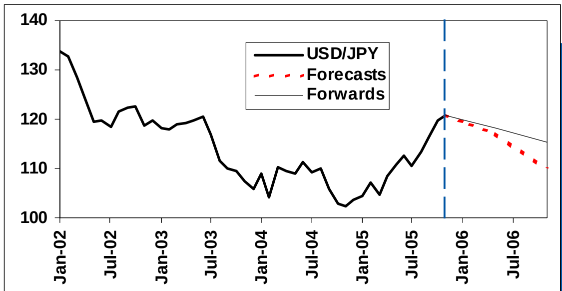
With the Japanese economy expected to slow to a still strong 1.8% from around 2.5% this year and core CPI seen moving into positive territory the dynamics are in place for the economy to surprise to the upside. This could come especially in the form of consumption demand where consumers now have to deal with a likely environment of increasing prices as opposed to decreasing prices when making their consumption decisions. We look for the BoJ to end their quantitative easing policy during Q2 2006, but due to intense government pressure, along with threats to rewrite the BoJ law, the period over which ZIRP is maintained will likely extend until Q1/Q2 2007.

However, the big issue for global policy makers is that of greater CNY-flexibility, and while the post-July 21 price action has done much to sever the automatic link between CNY expectations and $/Asia trading, the Chinese authorities will likely be averse to providing substantial flexibility when the JPY is weakening. Japan might have to cap USD/JPY in order to keep CNY-flexibility on the table especially as US protectionist pressures will likely be on the rise ahead of the mid-term elections in Nov. This along with likely concerns over the US growth outlook (soft or hard landing for the housing market and thus the US consumer?) will also help to put the structural c/a financing story back on the radar and a reason for why we have opted for a USD/JPY rate back to 110 by end-2006.

	Forecasts	Forwards
Q1 06	119.00	119.53
Q2 06	117.00	118.11
Q4 06	110.00	115.33

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005

A Bernanke-Fed that takes the funds rate beyond 5.00% is likely to only intensify the pressures that aided JPY-weakness during Q3/Q4 2005 and this is the biggest risk to our forecast on USD/JPY.



GBP

Modest GBP losses are expected over the next quarters against the euro, as IDEAglobal sees another 25bps BoE easing in the course of 2006 and higher ECB interest rates.

Since the BoE lowered the repo rate by 25bps to 4.5% in August, most of the economic data have been stabilizing. Private consumption has improved slightly, but industrial and manufacturing production have been rather disappointing. The housing market continues to post slightly positive y/y growth rates (estimated to end Q4 2005 at around 4.0% y/y on the combined Nationwide/Halifax measure), against previous expectations that prices could actually start a gentle annual decline. In line with these developments, the BoE has reverted to a resolutely neutral stance in Q4, which has supported GBP as well.

However, looking into next year, IDEAglobal still sees the possibility of another 25bps cut, probably in Q2. The main reason is that GDP growth is unlikely to accelerate to more than 2.2% in 2006 (1.6%/1.7% expected this year), which would still be below potential UK growth of around 2.5% - 2.7%. And given that targeted HICP inflation is expected to come down to around 1.8% y/y at some point during the course of 2006, this actually gives some room for another BoE repo rate cut.

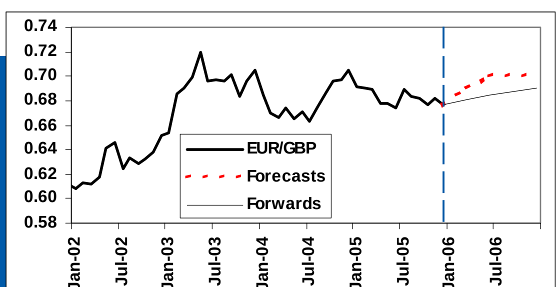
In terms of GBP, this means although the extent of GBP weakness induced by its absolute yield loss should be limited, the spot will repeatedly go through phases of weakness when the market speculates on a rate move by the BoE or when the BoE actually delivers the cut. Furthermore, given that the ECB is expected to deliver at least another +25bps hike in 2006, EUR/GBP should actually stay supported.

Throughout Q3 and Q4, GBP was stronger against the euro than suggested by money market futures' implied yield differentials three and four quarters ahead. Indeed, there is some evidence that EUR/GBP tracked more closely implied yields suggested merely by Short Sterling contracts in three and four quarters. One explanation could be that "chasing for yield" meant even a reduced yield advantage was still sufficiently currency supportive. Another (independent of yield differentials) GBP positive factor over the last months might have been numerous announcements of M&A deals involving the takeover of UK companies. Looking forward, there is a risk that yield differentials could play a greater role and with it GBP would be at risk. Indeed, we factor some positive euro news into our quarterly forecasts for EUR/GBP.

Paying tribute to its status as a yield currency, cable trades roughly in line with 10 yr government yield differentials since January 2001, yielding a correlation of 0.55. Also real 10 year yield differentials and cable co-move with a correlation of 0.77 since August 2001. In Sept. and Oct., the relatively friendlier inflation picture in the UK actually meant that real interest rate differentials pointed to a stronger cable. Looking forward, continued Fed rate hikes to 4.5% should mean that the USD remains comparatively well supported against GBP in the beginning of 2006. However, IDEA expects the UK-US 10 yr government yield spread to narrow to 10bps by the end of 2006 from currently 30bps, which should provide support to GBP/USD.

	EUR/GBP	GBP/USD	EUR/GBP Forwards
Q1 06	0.6900	1.7100	0.6810
Q2 06	0.7000	1.6900	0.6840
Q4 06	0.7000	1.7900	0.6900

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



A lingering topic for GBP is the UK's current account deficit of around 2% of GDP and the deteriorating public finances. Although these are underlying currency negative factors, it seems yield differentials will remain the dominant input into the GBP equation over the forecast horizon.

EUR/CHF

The SNB is expected to continue its rate normalisation process into 2006 which should result in modest CHF gains against the euro. The CHF outlook assumes that the encouraging global growth environment means a (sharp) rise in risk aversion is unlikely. Hence extensive CHF gains should not occur.

The Swiss economy surprised to the upside in the second half of 2005: with +1.0%q/q and 2.3%y/y, Q3 GDP came in well above expectations. Surprisingly, the main positive impetus emanated from private consumption and investment activity actually disappointed to the downside. However, recent leading indicators, namely the KOF index and the PMI, paint a rather upbeat picture of the industrial sector as well. GDP growth in 2005 is now likely to be close to 2.0% and the economy is expected to continue its expansion at this pace into 2006.

This was the slate of data the SNB has been waiting for to resume its rate normalisation process, and consequently the SNB raised the CHF 3mth LIBOR target by 25bps to 1.0% in December. The Central Bank will continue its moderate monetary tightening process in the course of 2006. Due to well-controlled CPI inflation, IDEA sees Swiss interest rates not going above 1.75% during 2006, with even the last +25bps being very data dependent.

Higher Swiss interest rates are CHF positive, but the ECB is also bound to hike interest rates by at least another +25bps in 2006. So CHF gains are unlikely to be massive, but EUR/CHF spot should settle a bit lower over the next quarters. However, the biggest impact of the comparatively higher CHF yield is probably on CHF funding plays: EUR/CHF spikes on the back of carry trades are likely to be less numerous and lower in their extent. Moves to 1.5700 as seen in Q1 and the beginning of Q3 2005 are likely to be rare. Especially in the run up to quarterly SNB meetings, EUR/CHF will have a downside bias.

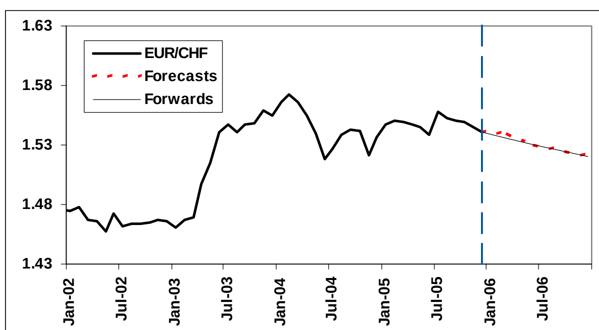
Global liquidity is bound to decline, as even the most hesitant (industrialised) Central Banks have started a modest tightening cycle (ECB, Norges Bank) or have resumed their tightening cycle (BoC, SNB) or are expected to start a tightening cycle (e.g. the Swedish Riksbank). Other CBs keep the liquidity tap closed (Fed, RBA, RBNZ). Some might fear that this could lead to tighter treasury swap and credit spreads / equity volatility and hence lead to increased risk aversion, a potential CHF positive element. However, it is important to bear in mind that the world economy is still in a growth phase, with global trade expected to pick up to 9.1% next year (OECD). Hence risk aversion is likely to continue to fluctuate around risk neutral levels in the next quarters, which should avoid any pronounced CHF safe haven buying. Should the latter occur nevertheless, the SNB will be quick to pronounce its dissatisfaction.

In the long-run, some fundamental factors argue for a continued bias to CHF strength: a) Switzerland's self-sustained current account surplus, which reached 14% of GDP from Q3 04 to Q2 05, is the main CHF positive b) some also see the Balassa-Samuelson effect behind the Swiss franc's trend real appreciation. The theorem stipulates that a currency can experience a higher real appreciation than implied by its inflation rate differential on the back of higher productivity in the tradable than in the non-tradable sector.

Overall, the quarterly EUR/CHF outlook factors in a marginally stronger CHF, but given that the world economy is expected to expand again at a solid pace in 2006, CHF appreciation should be modest.

	EUR/CHF	USD/CHF	EUR/CHF Forwards
Q1 06	1.5400	1.3100	1.5350
Q2 06	1.5300	1.3000	1.5300
Q4 06	1.5250	1.2200	1.5200

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/CAD

While USD/CAD was supported in Q4 05 by political instability in Canada, crude under $60 a barrel, and independent USD strength related to HIA flows, the pair will be weighed on in 2006 by the continuation of the BoC's monetary tightening, the strengths of the Canadian economy (increased domestic demand and rising terms of trade), and the resumption of the USD's structural decline.

Canadian core CPI inflation (the BoC's operational guide for its 2.0% target) remains subdued at +1.7% y/y. However, the Bank of Canada predicts the rate to rise to 2.0% by mid 2006, and has now repeatedly stated that the Canadian economy is operating at capacity. In line with this, 2005 GDP growth of 2.8% is well above the 2.5% level identified by the BoC as potential GDP growth, and this is going to continue in 2006, when GDP growth is likely to increase to 3.3%. Accordingly, IDEAglobal sees the overnight cash rate rising another 25 bps to 3.50% in Q1 2006, followed by a second 25 bps hike by the end of Q3 2006. On the other hand, with the US Fed Funds rate currently at 4.25%, IDEAglobal sees it peaking at 4.50% on January 31st, and remaining there through year-end. Significant risks remain for a follow up hike in March to 4.75%, but one additional hike in the US is unlikely to derail our forecast for CAD appreciation.

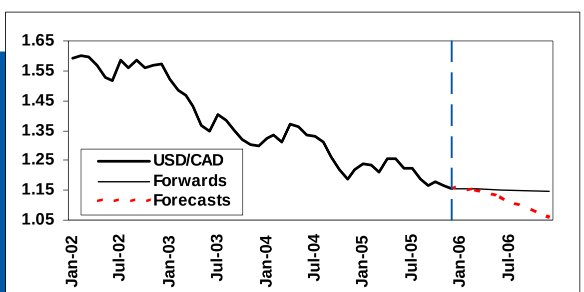
As research from Statistics Canada has concluded in the past, broadly speaking, Canadian terms of trade and the Canadian dollar move together, with the terms of trade often shifting slightly in advance of the dollar. The recent improvement in the terms of trade has been driven by a drastic rise in commodity prices, which has seen the BoC Commodity Index rise 33% y/y, while crude jumped 19% y/y. Our baseline scenario implies a leveling off of crude prices around $55 a barrel with a very limited risk of sustained sizeable decline in energy prices in 2006. The BoC projects Canadian terms to trade to rise from 108.9 in 2005 to 110.1 by the end of 2006, lending greater support to the Canadian currency.

Despite the BoC's keen eye on CAD trajectory, the Bank neither targets the currency nor is likely to be in the least tempted to intervene in the FX markets. As such, CAD should remain at front line for USD adjustment when the USD's structural decline resumes, as it compromises the single largest portion in the USD REER basket (21%). IDEAglobal therefore sees the continuation of USD/CAD depreciation to 1.1300 by H1 2006 after the Fed tightening cycle draws to a close. As the Bank of Canada views fair value of USD/CAD in a range of 1.1700-1.1800, the drop to 1.1300 will certainly not be testing the limits of severe overvaluation.

Political risks should remain subdued throughout 2006. Canada will see a federal election on January 23rd as Prime Minister Martin's Liberal Government lost a vote of no confidence at the end of last November. However, current opinion polls indicate that Canadian voters will send another minority Liberal Government back to Ottawa, unlikely to result in any substantial changes to the country's current loose fiscal policy. More worrisome is the increased popularity of the separatist movement in Quebec. A recent poll conducted by CROP-La Presse revealed that 52% of Quebecers would vote to break away, taking with them 20% of overall Canadian GDP. The Leader of the Bloc Quebecois, Gilles Duceppe, has vowed to hold a referendum on Quebec's sovereignty after the next provincial election, but that will not take place until 2007.

	Forecasts	Forwards
Q1 06	1.1500	1.1540
Q2 06	1.1300	1.1500
Q4 06	1.0600	1.1500

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



AUD/USD

Over the coming year the AUD faces countervailing forces: shrinking interest rate differential vis-à-vis the US putting downward pressure on the currency while strong commodity prices and the associated terms of trade support pulling it up. We expect the RBA which is at the very end of its tightening cycle to remain on hold well into 2006 while the US is set to raise rates to 4.50% with some risk for another +25bps. This is likely to lead to an AUD under-performance in Q1 06. However, the Aussie should gain over the next 6-12 months as concerns about US structural imbalances return to the haunt currency markets.

The RBA's cash rate remains at 5.5% and in its November Policy statement the RBA maintained its neutral stance but established its readiness to pull the trigger if demand and inflation pressure turned out stronger than its expectations. Q3 CPI touched 3% y/y though underlying inflation was well contained at 2.4%. Q3 GDP printed a weaker than expected 0.2% q/q though 2.5% y/y is still below trend growth. Over 2006 we expect the economy to expand at an annual rate of 3% with the main impetus coming from exports and business investment.

We believe the housing market to be the key factor determining policy going forward. Given the over-extended state of household balance sheets a sharp slowdown could lead to a substantial fall off in domestic demand, which would then require policy easing, though this is not our central case scenario. However, high fuel costs, strong wage growth and now fading effects of Aussie strength pose upside risks to inflation. We expect underlying inflation to reach 3% in Q2 06, headline inflation to be above 3% over the next few quarters. However, assuming no further oil price shocks, both should converge towards the end of 2006 to a rate well within the RBA's 2-3% target band.

The external environment continues to be favourable with above trend global growth, on-going gains in Terms of Trade (TOT) and slowing imports, which should help reduce the burgeoning current account deficit (7% of GDP) over the next few quarters. AUD nominal TWI remains near multi-decade highs on the back of substantial improvements in the TOT. Going forward the RBA's central projection is for Chinese-led resource demand to remain robust over the next decade, which will see TOT gains extend.

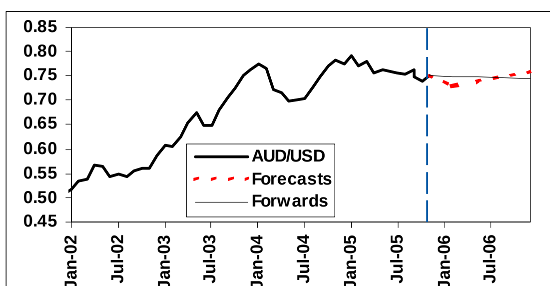
An indirect effect of high commodity prices has been a boost to corporate profitability especially in the mining and of late construction sector – with the AXJO index gaining 17% over the year. One big story for 2006 will be the government's proposed sale of its 51.8% stake in Telstra – currently worth AUD 25bn – towards the end of the year. We expect Uridashi issuance to provide some support to the Aussie in 2006 though continuing with ongoing trend kiwi denominated bonds should be more popular with Japanese investors on the back of a more lucrative yield differential.

	Forecasts	Forwards
Q1 06	0.7300	0.7489
Q2 06	0.7400	0.7473
Q4 06	0.7600	0.7444

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005

Our core view of higher USD real rates should pressure AUD/USD close to 0.7300 in Q1 06 despite continued terms of trade support. However in Q2 06 – with Fed policy becoming more data dependent and RBA rates remaining steady – we expect the Aussie to gain trading around 0.7400. The gains should extend over the second half of the year on account of strong commodity prices taking the Aussie to 0.7600, consistent with our general bearish USD outlook as the structural imbalances in the US economy again come to fore.

The risks to our AUD/USD profile are probably skewed to the downside. A sharp slowdown in the housing market could lead to the RBA shifting to an easing bias pushing the Aussie downwards as would any concerns that the Fed hikes beyond 4.5%.



NZD/USD

With official rates now at 7.25% the NZD remains an attractive high yielder especially in an environment where the Fed is expected to pause in its 'measured' campaign early 2006. However, short-term optimism over the NZD does not extend into H2 2006 especially as the RBNZ seems intent on relieving the economy of inflation pressures by targeting a slowdown in what they consider to be a 'still-buoyant' housing market. While we look for a soft landing for the housing market this does not necessary translate into a soft landing to the economy with the risks skewed to the downside creating a sizeable correction on both the NZD TWI as well as underperformance vs the AUD.

New Zealand, unlike their neighbor Australia, does not have an export mix that can take advantage of another year of firm global growth during 2006. It's not surprising that NZ's terms of trade (ToT) have lagged behind those of Australia given the heavy weight of meats, dairy and other agricultural sectors. But the greatest vulnerability for NZD comes from what has been regarded as its greatest strength over the last 3-4 years and this is RBNZ policy.

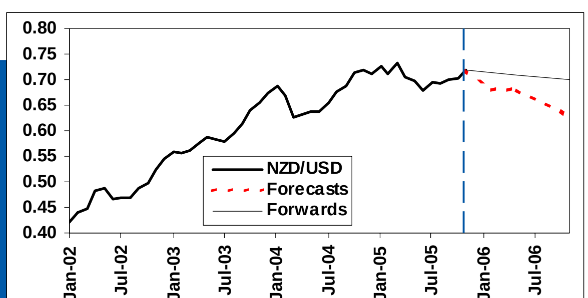
With the RBNZ setting its sights on achieving a moderation in the housing market, and in turn demand pressures, the risks to the economy are all weighted to the downside. We expect final 2005 growth to register annual growth of 2.8%, after 4.4% during 2004, but see a considerable slowdown to 2.0% in 2006. The assumed soft landing for the housing market means that the risks to our growth forecast are to the downside — a view supported by a steeply inverted yield curve (2/10yr spread of over 100bps).

Slower growth along with a leveling off of high oil prices should allow inflation to move lower and the RBNZ is already factoring this in by revising down the inflation peak from 4.0% in Sept to 3.4% most recently. We expect CPI ex-energy to peak at 3.0% in Q1 2006 and headline inflation to touch 3.5% in Q1 2006, but both to fall below the RBNZ's upper limit of 3% by year-end. Given our inflation outlook we expect the RBNZ to remain on hold keeping rates at 7.25% well into 2006. Our house view is that the RBNZ will not start cutting interest rates until Q4 2006, but the market has a tendency to expect more aggressive cuts. Along with the high level of foreign participation in NZ's bond market, this poses significant risks to the NZD in the latter half of 2006.

Easing cycles over the last 4-5 years have not had much of a negative impact on the USD but this was in an environment where the USD was effectively a liability currency with US official rates at 1.0%. But things are a little different now and thus downside risks to the NZD are similar to those during the late 1990's, especially given the weight of spec/foreign positioning. We have gone for a point forecast of 0.6300 for end-2006 but until the housing/growth risks appear the NZD should find support from an expected Fed pause and continued Japanese retail demand for yield (Uridashi). The latter should see NZD trade around 0.6800 end-Q1 06 and end-Q2 06.

	Forecasts	Forwards
Q1 06	0.6800	0.7100
Q2 06	0.6800	0.7100
Q4 06	0.6300	0.7000

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



EUR/SEK

After its autumn sell-off, the Swedish krona is set to continue recovering in 2006. Most important, Sweden's relative interest-rate prospects have turned around recently. After the SEK-EUR official interest rate premium dropped from 0 to -75bps during H2-2005 (as the Riksbank cut and the ECB hiked rates), the Swedish CB has now signalled that it is about to play catch-up. We are looking for 50bps worth of rate hikes in Q1-06. Although the subsequent pace of tightening should be more gradual, Swedish rates should match ECB rates by late 2006 and move higher thereafter.

Economic fundamentals remain in SEK's favour. Sweden's Q3 GDP accelerated to rates as high as 1.0% q/q and 3.4% y/y, and 2006 growth should amount to at least 3.0%. Robust domestic demand is keeping the economy expanding at an above-trend pace, in contrast to the Eurozone average. The labour market remains stubbornly soft but is starting to tighten gradually. Inflation is running at about half its target rate, due mostly to benign structural disinflationary forces, but should gradually pick up going forward.

Sweden's current account surplus of 5-6% of GDP doesn't get much attention despite being the mirror image of the deficit in the US. It provides direct evidence of SEK's undervaluation and argues for appreciation over the medium-/longer-term. The public sector budget balance also remains impressively (if marginally) in the black.

Other factors include equity markets, but SEK has effectively lost the linkage that existed earlier in the decade. Generally speaking the currency still benefits from a low-risk-aversion market environment, though. Another relationship that has diminished over the past several years to virtually zero is EUR/SEK's correlation with EUR/USD. This means there is no reason these pairs cannot diverge over the long run or even the short run.

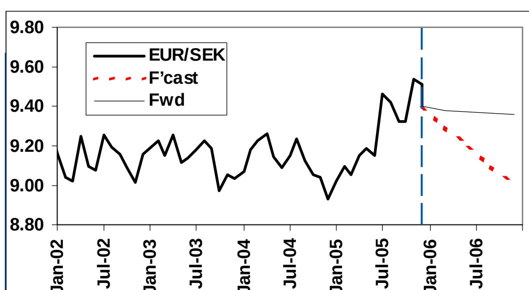
As we approach Christmas, it is worth noting SEK's distinct seasonal patterns. The currency has a particular tendency to weaken during the low-liquidity, holiday periods of July and December. Over the past decade EUR/SEK has posted median increases of 0.8% and 0.9%, respectively, in these months, then tends to fall back in April and September. (But considering its recent price action and CB developments, we do not expect much SEK selling this time around.) Another seasonal factor to watch out for is the annual distribution of national "premium-pension" contributions to various private asset managers in late Jan/early Feb, much of which is invested in foreign equities.

In terms of politics, Sweden's general election in September 2006 will be closely fought between PM Persson's Social Democrats and the opposition centre-right coalition led by the 'Moderate' (Conservative) party. Polls have shown the latter in the lead, and a switch in government for the first time since the early '90s would not be a surprise. Implications of this would not be especially large, other than the right wing's budget priorities favouring both lower taxes and spending, as well as less govt regulation. Market interest in the election will be limited until close to the time, but a Moderate party win could be expected to be marginally SEK-positive.

While most fundamental valuation models suggest that EUR/SEK should be trading well below 9.00, the pair has shown recurring difficulty staying below this key level over the past four years. (Interestingly, the Riksbank has initiated a research project involving outside academics to investigate why SEK is not stronger.) With Swedish EMU membership firmly off the agenda no matter who wins the election, we would no longer count on a historical break lower in EUR/SEK. Nevertheless, the downside is where the longer-term risks lie.

	Forecasts	Forwards
Q1 06	9.3000	9.3800
Q2 06	9.2000	9.3700
Q4 06	9.0000	9.3600

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



EUR/NOK

Norwegian krone strength should continue to be supported by a strong economy and steadily rising interest rates, but less so than during the second half of 2005.

In contrast to the Eurozone, Norway's economy is booming. "Mainland" GDP (excluding the offshore oil and shipping industries) should have grown by almost 4% in 2005, although it will decelerate to closer to a trend rate in 2006. Private consumption is strong and high oil sector investment provides some spill-over effect to the rest of the economy. Norway's large petroleum sector also means that its exports are less sensitive to global demand conditions. Core inflation is running at about half the CB's 2.5% target, but is on a gradually increasing track.

To pre-empt economic overheating, the Norwegian CB began an explicitly-gradual process of normalising interest rates last June, and followed this up in November taking the deposit rate to 2.25%. We look for further rate increases of 25bps in conjunction with the next Inflation Reports in March, June and November -- with the risks on the side of an acceleration in the pace of tightening. While Norway's key rate now just matches the ECB's, the NOK-EUR rate differential will only expand on a trend basis, and this should be clearer as we move into H2-2006. Norges Bank notably sees the neutral interest rate as high as 5-6%. Despite Norway no longer providing the only tightening game in town, rates will continue to be a background positive factor for NOK.

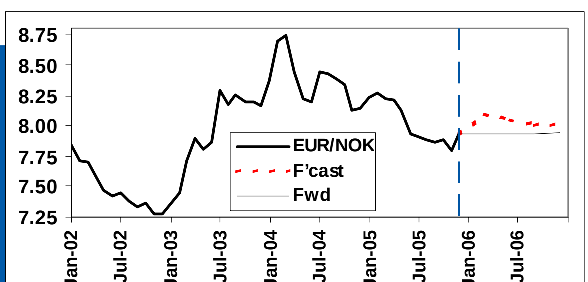
Norges Bank would be sensitive to further NOK strength, should a renewed NOK rally appear in the new year (not our central scenario but a real risk). That would make it harder for the CBK to reach its inflation target, and it could consequently threaten to put tightening on ice. Verbal intervention would also not be surprising from government officials as well -- though no actual intervention is likely.

Oil-price developments can also buffet NOK on a short-term basis, considering that Norway is the world's third-largest crude exporter. Nevertheless, the oil-NOK link is not what it used to be, and the fundamentals do not actually warrant a tight relationship -- as can be explained as follows. Oil revenues do maintain the country's extraordinary structural surpluses in the current account and government budget -- which amount to around 15% and 10% of GDP, respectively. However, the economic and FX implications are largely offset by the government's prudent use of most of the windfall to accumulate foreign assets for its Govt Petroleum Fund. In fact, considering also private oil companies' tendency to keep USD oil revenues in FX, Norges Bank has estimated that the country's 'adjusted basic balance' actually hovers close to zero.

	Forecasts	Forwards
Q1 06	8.1000	7.9300
Q2 06	8.0500	7.9300
Q4 06	8.0000	7.9400

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005

The market is also sensitive to Norges Bank's monthly FX-buying schedule, but overly so. These daily purchases (pre-announced on the last day of every month for the following month) are just mechanical estimates designed to offset the increased oil company taxes/royalties paid in NOK to the government, and thus cancel out on balance. The timing of the aforementioned semi-annual oil tax deadlines -- 1 Apr and 1 Oct -- sometimes precipitate some last-minute NOK buying, though no effect has been observed recently.



Political postscript: Norway's Sep '05 election has resulted in power reverting from the centre-right to the Labour party under Jens Stoltenberg. But government policy changes are minimal other than slightly more expansionary fiscal policy. One key distinction is that the Labour party is keen on EU/EMU membership. But its coalition partners are not, and the public is ambivalent on the question. So there are no plans to try another EU referendum.

EUR/DKK

The Danish krone can effectively be considered a quasi-euro in that it has been successfully linked to the single currency since the latter's launch, and was previously stable vs DEM since 1982. Politically, a stable EUR/DKK has long been the consensus policy in Denmark, and the exchange rate regime is highly credible. We expect this unexciting state of affairs to continue until the country finally joins EMU at some point in the future.

Technically, DKK participates in the ERM2 arrangement, which limits deviations vs EUR to +/- 2.25% of the central parity of 7.4604. In reality, since the start of EMU the Danish National Bank has kept EUR/DKK in a much narrower range between 7.42 and 7.47 (i.e. 0.5% below to 0.1% above the central parity). We expect EUR/DKK to continue trading close to, and generally just below, its central parity, where the CB seems to prefer it.

Danish monetary policy is oriented exclusively to the exchange rate and closely shadows the Eurozone's. For example, it matched the ECB's Dec 1 rate hike on the same day, as per normal practice. The National Bank's tools are (1) FX market intervention, which it carries out periodically and undramatically, and (2) adjustment of the DKK-EUR key interest rate premium. Such independent rate adjustments, which are often of a magnitude of only 5bps, usually occur on the first Friday of the month in response to pressure on EUR/DKK and the extent of FX inflows/outflows, as reported on the 2nd working day of the month. In the unlikely event of extraordinary pressure on DKK, the ECB would be obliged to step in to help defend the krone.

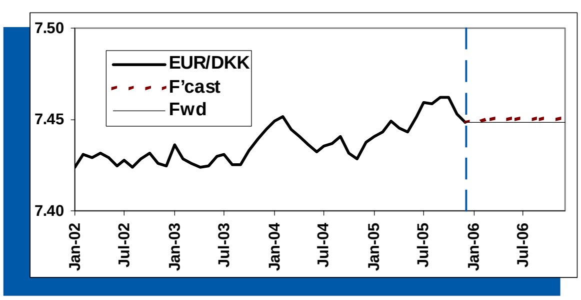
In recent months, FX inflows have been close to flat, keeping the Danish National Bank's reserves at historically high levels. This means the CB need not be concerned if/when outflows develop. With the key Danish lending rate only 15bps above the ECB's minimum-bid refi rate (where it has been since 2003), the next move in the DKK-EUR rate premium is likely to be to widen -- but almost imperceptibly as far as the markets are concerned. It should be noted that despite the official rate differential, actual money-market rates are nearly on par.

Fundamentally, Denmark's economy has converged with the Eurozone for all practical purposes, though its fundamentals are arguably superior. Growth is running slightly stronger and inflation lower than the EMU average. The overall public-sector budget is actually in the black. The current account is in surplus, which is a good indicator that DKK is not overvalued (which could potentially prompt a speculative attack).

The next and final step will of course be EMU membership. After the narrow 'no' vote in the 2000 referendum, the government has occasionally talked about another try, but there are no current plans to do so. Public opinion is volatile and the common currency's decisive rejection by neighbouring Sweden in 2003 doesn't bode well. In the event of a successful referendum in future, final EMU membership could follow 2-3 years later, since Denmark meets all the Maastricht Treaty criteria. Nevertheless, with DKK widely expected to be converted to EUR at its central ERM2 parity, and the Danish yield curve in line with other Eurozone countries, market implications of EMU membership are extremely limited.

	Forecasts	Forwards
Q1 06	7.4500	7.4500
Q2 06	7.4500	7.4500
Q4 06	7.4500	7.4500

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



EASTERN EUROPE

AND OTHER EMERGING MARKETS

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USD/RUB

Three months after adjusting the EUR weighting higher in the intraday basket, the CBR has lifted it yet again to EUR 0.40 while reducing the USD weighting to 0.60 (from EUR 0.35 and USD 0.65), as part of its long-term effort to adjust its FX regime to better reflect Russia's trade-weighted basket. The shift probably also expresses a preference for a more stable EUR/RUB rate, but we would hesitate to read overly into the adjustment of what remains technically an intra not inter day target. Probably a more interesting recent policy shift is the CBR's move to reduce fx intervention, and leave the money market increasingly short RUB, via more aggressive repo placement. The result: higher interbank o/n rates, which backed up 8.0% for the first time in over three years last week, without a stronger nominal rouble. The move seems to show greater CBR ambition to constrain REER appreciation, which looks likely to top 10.0% for all of 2005. As a reminder, note that on an interday basis, the CBR does not target the EUR/USD basket but a TWI where EU25 countries make up 54.7%, FSU currencies 18.3%, Asia 13.2%, the US at 4.3%, and Switzerland, Turkey, Brazil forming the remaining 9.4%. As one of the few remaining double-digit inflation countries in the world, Russia, unsurprisingly suffers most of its losses in competitiveness (REER appreciation) via the inflation differential, which tends to be particularly acute during the fourth quarter. This may explain the apparent increased seriousness in sterilizing fx inflows.

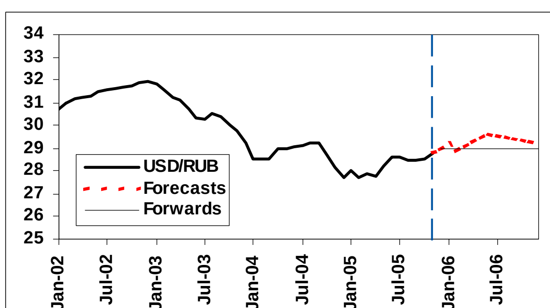
Despite some tweaking of monetary mechanisms, however, the overall strategy to keep the nominal RUB as flat as possible versus the basket appears more or less intact. While there has been talk of easing capital controls as soon as next year (and a tentative commitment to lifting them completely in 2007), the CBR remains very much opposed to any mechanism that would stoke capital inflows. The govt is, moreover, already pressuring corporates to reduce their FX borrowing levels, and we don't ourselves anticipate much in the way of liberalization in 2007 (or before). The hope at the CBR is that interest rates in the US and the Eurozone will back up sufficiently next year to dampen any portfolio inflows. But officials' acknowledged reliance upon external factors to deflate fx pressures won't increase market confidence that there is a dependable disinflationary anchor other than fiscal policy.

While the government can be expected to run a healthy 2006 fiscal surplus and transfer windfall oil receipts into the Fiscal Stabilisation Fund next year, the budget includes very generous expenditure hikes, particularly public sector wage and pension increases. These threaten to create more intense inflationary pressures next year, even as there is some evidence of increasing money velocity. Political constraints ahead of 2007 parliamentary and 2008 presidential elections roughly rule out any significant fx adjustment over the next two years; we are not among those analysts forecasting a revaluation despite a clear-cut case of an overvalued currency, with the c/acct surplus likely to end this year at 12.5%/GDP.

What we can say is that our G7 desks outlook for a backup in US 10yr Treasury rates to 5.00% by end Q106 could remove a certain degree of upward pressure on the nominal exchange rate over the near-term. Moreover, their outlook for a much stronger end 2006 EUR/USD level of 1.250, might feed through into a certain degree of nominal USD/RUB weakness, but again we anticipate that the CBR's interventionist instinct will neutralize these factors' impact on the exchange rate.

	Forecasts	Forwards
Q1 06	29.05	29.00
Q2 06	29.65	29.00
Q4 06	29.25	29.00

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/ZAR

Favourable commodity prices and domestic developments as well as downside on the USD are likely to push the ZAR to levels stronger than 6.00 by the end of Dec-2006.

Demand-supply fundamentals indicate that the bull run is set to continue well over the coming year. Continued prosperity in centres such as China, India and the Middle East will keep demand well buoyed, which will be further augmented by central banks such as Russia, South Africa and Argentina looking to increase the proportion of gold in their reserve holdings. Having said that, we expect some correction in gold prices in Q1 (technical target of USD 450/oz) from the drying up of festival related demand as well as some correction in speculative positions.

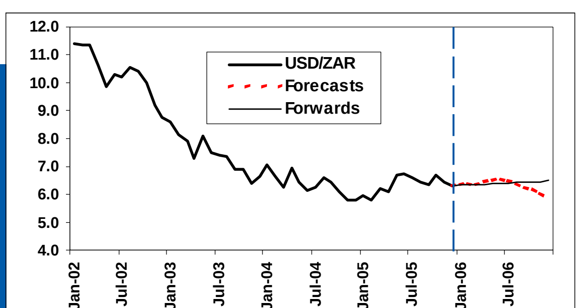
In the absence of favourable impetuses from international currencies our moderately bullish ZAR outlook for Q1 primarily hinges on favourable domestic developments. Seasonal trends are likely to improve current account performance in Q1, as exports pick up and imports moderate. More importantly, ongoing discussions on foreign investments in the local economy including Indian Tata Steel's possible acquisition of 79% stake in Highveld Steel are likely to be completed in Q1. While bulky inflows may still be managed behind the market by the cenbank, it is likely that relatively medium-sized inflows will be allowed to flow through the market, buffering the ZAR against pressures for depreciation. On a longer-term basis, while strong growth and rising capital-intensive imports is expected to result in a current account deficit close to 3.7% of GDP (IMF forecast of 3.5%), this deterioration will be easily financed by capital inflows.

Along with favourable BoP trends, we also expect the CBK to exhibit continued comfort with ZAR appreciation. Indeed, while Governor Mboweni has said that he wants a 'competitive exchange rate', he also emphasised that market fundamentals will drive direction and that market participants have to 'live with the reality' of the stronger ZAR. The CBK has consistently indicated that it is more likely to take pre-emptive rather than corrective measures for any threat to its inflation target range of 3-6%. Given our oil analyst's view that prices will average USD 60 p/b over 2006 due to demand-supply imbalances and with expectations of stronger domestic demand, pressure on the inflation target is likely to sustain. As a result we expect the CBK to lean favourably towards continued orderly strengthening of the ZAR as an effective anti-dote.

Overall we expect a relatively flat EUR/USD and short-term correction in gold prices to temper ZAR strength fuelled by improving FX inflows into the economy and expect USD/ZAR to end Q1 06 at 6.35 levels. Thereafter however, even international trends are expected to turn favourable with a surge in commodity prices, quickening the pace of appreciation to allow a move below 6.00 levels by the end of 2006.

	Forecasts	Forwards
Q1 06	6.3500	6.3550
Q2 06	6.5500	6.3980
Q4 06	5.9000	6.4850

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/TRY

Commencing end October the Turkish lira embarked on a period of unprecedented stability book-ended inside a very narrow 1.350-1.365 range on the one side by CBRT (Central Bank Republic of Turkey) willingness to intervene (near $15.0bn in reserves amassed this way so far this year) and on the other by very positive EM sentiment amid extremely robust FDI inflows, and the persistence of a rewarding carry. 3-m USD/TRY vols repeatedly hit all time lows over the period most recently touching 8.09% in intraday trade.

At 925bps (going into this Friday's MPC rate announcement) the interest rate differential remains very attractive. While leaving aside the concern over a current account deficit of 6.6% of GDP, most of the other fundamental macro trends are very positive. Here we would include fiscal outperformance, the contemplated use of privatization receipts to pay down debt, successful moves to lengthen the average maturity of the debt profile while reducing the FX linked component, and a raft of successful big ticket privatizations and FDI projects (ensuring near 40% coverage of this year's c/acct gap).

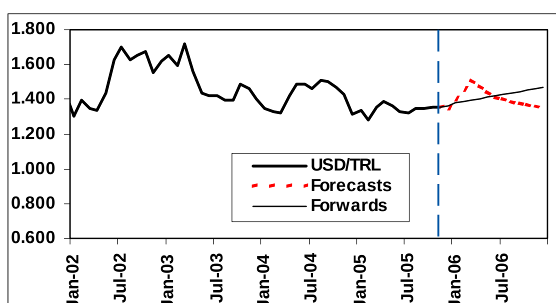
Towards the latter part of Q106, the lira looks vulnerable to two risks. The first and principal driver of our outlook for Q106 nominal lira weakening is exogenous: i.e. our US desk's expectation that 10-year Treasury yields will back up to 5.00% in March, unleashing another round of EM risk aversion, even as the rate differential narrows. The second factor is the gradual erosion in Turkish competitiveness. Most REER models imply that the lira is anywhere from 15-20% overvalued. On the other hand we can call upon some forceful arguments against relying solely on REER to assess TRY fair valuation. Here we would note: this year's c/acct erosion is primarily due to: 1. Energy price effects 2. Explosive growth in capital goods imports. Moreover, Turkey continues to run an enormous $20.2bn (5.6%/GNP) surplus in consumption goods. That Turkey is growing much more rapidly than most of its trading partners (ex China) and is attracting a much higher level of FDI coverage of the c/acct (to exceed 50% this year and next vs 11% in 2004) is further fodder for c/acct apologists. FINALLY, our unit labour cost adjusted valuation model implies that the lira is probably overvalued by no more than 7.5% (ULCs have plummeted 44.5% since the financial crisis of 2000), which converts into 1.460 level in nominal USD/TRY fair value, assuming no major EUR/USD volatility. Should 10-year Treasury yields back up towards 5.00% as we expect them to by end March, 2006, we anticipate that the lira would end Q106 somewhere on the weaker side of 1.50.

After correcting some 11% in nominal terms during Q106, we expect the lira to rally back in H206. For all of next year, the growth/productivity/FDI story ought to persist, while during Q306, seasonal tourism inflows should pick up again, and the success of the inflation targeting regime can be expected to draw a steadier flow of portfolio inflows. We might also look forward to some degree of improvement in export performance. Note that our G7 desk's call for a year-end EUR/USD rate at 1.25 would further feed into USD/TRY downside at year end back towards 1.350.

	Forecasts	Forwards
Q1 06	1.5100	1.3940
Q2 06	1.4100	1.4220
Q4 06	1.3500	1.4700

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005

While November saw a slight back up in headline CPI thanks to food inflation in particular, the overall tone of the inflation data has been supportive of meeting the 5.0% midpoint of the Dec-06 CPI target (the range was broadened to +/- 2ppts earlier this week in a move that seems to imply greater monetary flexibility). We anticipate another 200-250bps in rate cuts over the next 12 months. There may be a preference to front load these cuts, given the possibility of a bias at the CBRT to lessen the carry early on in 2006.



USD/ILS

The ILS has continued to depreciate despite strong economic fundamentals including solid growth as well as a healthy BoP surplus. GDP growth is expected to touch 5.1% for 2005 and 4.5% in 2006. But greater financial assistance especially from the US and improved equity inflows should boost overall financial and capital inflows. At the same time, a current account surplus at 1% of GDP, will imply an overall BoP surplus of USD3.5 bn during 2005. The current account surplus is expected to widen further in 2006, rising to 1.3% of GDP, providing support to the local currency.

Our flat outlook for EUR/USD implies that the local currency is unlikely to receive direction from this quarter in Q1. Having said that, the unresponsiveness of ILS to EUR strength since 2000 has largely been a result of political instability. Given our core view of an improvement in the political situation, we expect an increase in sensitivity to EUR/USD. Consequently, a move on the major rate to 1.25 levels by December-end will be positive for ILS strength.

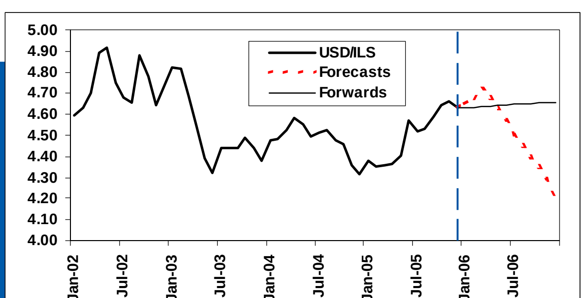
Political uncertainty has been the biggest constraint on ILS strength. Incessant political bickering and ideological conflicts saw PM Sharon quit the ruling Likud to establish a more centrist Kadima party. The move has resulted in the parliamentary elections being brought forward by six months to March 28, 2006. Bitter infighting for Likud party presidency and a change in Labour Party's leadership imply that the current political situation remains one of chaos. With lines being drawn on basic ideological issues such as the continuation of the peace plan with the Palestinians, political uncertainty is likely to rise in the run-up to the elections, exerting further weakening pressure on the ILS. Our core scenario is one where PM Sharon's Kadima party wins the elections, allowing further progress to be made on the peace plan. Such an outcome will return focus on strong growth fundamentals and current account surplus prompting ILS strength.

The CBK's attitude towards ILS weakness has clearly been one of strong discomfort largely on account of its direct feed through into higher inflation rates, with a few components of the CPI including housing being indexed to the USD. Indeed, in order to arrest ILS depreciation, the CBK has explicitly indicated its willingness to raise interest rates and maintain a positive differential with the US. We expect the central bank to raise rates to 5.0% (currently at 4.25%) by March-06. A positive differential is expected to temper the pace of ILS depreciation in the run-up to the elections and forms the basis of our call for only a modest weakening of the currency from current levels.

Overall we expect depreciation in the ILS in light of political uncertainty to be moderated by continued increases in the base rates and expect USD/ILS to touch 4.72 by March-06. Thereafter, however we expect both domestic and international factors to favour an appreciation of the ILS and expect USD/ILS to touch 4.20 by end-2006.

	Forecasts	Forwards
Q1 06	4.7200	4.6350
Q2 06	4.5800	4.6500
Q4 06	4.2000	4.6560

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



LATIN AMERICA

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USD/MXN

The Mexican peso (MXN) has appreciated by 2.2% to MXN 10.49 from MXN 10.72 per USD so far during Q405. MXN strengthening occurred on the back of external factors, particularly the combination of higher global liquidity and a lessening of risk aversion, as well as a seasonally driven increase in private remittances destined to Mexican homes due to the onset of the holiday season. The peso's appreciation has had little to do with improvements in macroeconomic fundamentals. This is the case despite the downward trend of inflation, which has been moving lower towards the mid-point of the Central Bank range target of 2% - 4%, though we believe that 12-m CPI will ultimately bounce back and end the year at 3.3% (3.05% y/y in Oct). Simultaneously, GDP growth has accelerated (3.3% in 3Q05 vs. 3.1% in 2Q05) albeit somewhat moderately, perhaps closing 2005 at 3% y/y. Concurrently, domestic interest rates have been declining, as Banxico has cut the reference rate by 50bps so far in Q405 to 8.75% due to the aforementioned reasons, consequently, shrinking the interest rate differential with the FED Funds rate, which currently stands at 4%, by 75bps to 475bps.

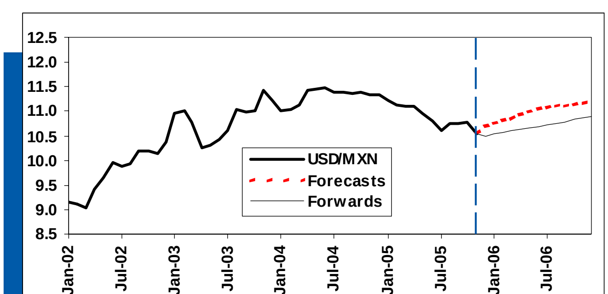
In our view, the MXN will weaken against the USD during Q106 mainly in response to a loosening monetary policy stance and, to a lesser extent, to the deterioration of the political environment, notwithstanding the fact that the economic fundamentals look to be on the mend. We believe that during Q106, Banxico will continue cutting the reference rate by 50 - 75bps to 8.25-8% to stimulate the economy and the US Federal Reserve will keep raising the FED Funds rate to 4.5%; thus, narrowing the rate differential to 375bps, close to our theorized neutral stance for Banxico of around 300-400bps. Furthermore, we expect political volatility to exert a somewhat decreased amount of pressure on the local currency during Q106, as the Presidential race will most likely be highly contested, making the outcome less certain in favor of AMLO.

In the first quarter of 2006, we believe inflation will rebound to about 3.5% y/y and economic activity will also regain momentum with GDP growing at a clip of 4.5% y/y, supported by domestic demand and the reconstruction of those areas affected by the hurricanes. Furthermore, the external accounts should stay healthy because global demand ought to remain robust and the price of commodities relatively high. At the same time, foreign direct investment to Mexico and workers' remittances ought to continue expanding. All this is good news and rides as support for the local currency.

	Forecasts	Forwards
Q1 06	10.85	10.60
Q2 06	11.05	10.70
Q4 06	11.16	10.89

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005

Overall, we believe the depreciative pressures will prevail during H106, unless the political dynamics shift in favor of a more centrist approach. We expect the Mexican peso to touch MXN 10.85 per USD by the end of Q106. The NDF market expects MXN 10.6 per USD by the end of Q106.



USD/BRL

The Brazilian currency's remarkable strength has outlasted the recent corruption scandals (from which neither President Lula nor his Finance Minister Antonio Palocci have been completely immune) and the COPOM's monetary policy easing in conjunction with the U.S. Federal Reserve's long and straight interest rate increase – presumably to last for a few months more. So far, these conditions haven't reduced the real's attractiveness, and in our view medium-term future conditions are not likely to affect the currency's performance.

The key to the recent currency appreciation comes not on the capital account side, where foreign direct investments inflows have been offset by net public and private sector debt repayments, which alone would tend to depress the real. Brazil watchers, though, have been astonished by the country's current account. Exports (measured in US dollars) have surged 22.5% year-over-year in 2005 through November. Despite accelerating import growth, the merchandise trade account has remained well in surplus (we project US$44 bn for the full year 2005). On the service side, the tourism and freight deficits have barely responded to the real's appreciation and secularly declining external debt has helped contain the foreign interest burden.

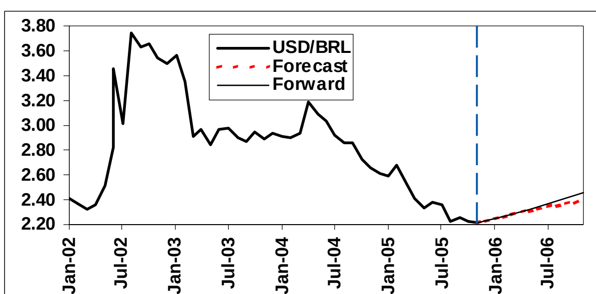
The central bank has again – since early November -- been intervening on the FX market and recently even more aggressively through reverse swaps. The monetary authority's strategy is not entirely clear, as the BCB is ideologically committed to an unfettered foreign exchange market, characterizing previous interventions as a means to build reserves rather than exercises in currency protection. However, foreign exchange reserves have by now reached a very comfortable US$64.7bn. Moreover, the argument that the exporters are suffering from the real's strength does not jibe with the numbers noted above. Given the BCB's renewed inclination to intervene, we would not expect a real stronger than BRL2.16/USD. The recent intervention may serve as the catalyst for a small correction toward the end-2005 BRL2.21/USD that we are now projecting.

Looking forward, we see few major changes in the composition of the capital account as net debt repayment continues. However, a more aggressively falling SELIC (the first of the long awaited 75 bps cuts is expected for the first meeting of 2006) and rising Fed Funds rate is likely to weaken somewhat the demand for Brazilian currency. And amortizations of medium- and long-term debt should easily exceed new borrowing.

But the key to the real's progression will again be the current account, which is already responding, however slowly, to the currency's prolonged firmness. Merchandise exports should grow at a much slower pace next year in delayed response to this year's appreciation. Moreover, since we see Brazilian domestic demand rising faster than in 2005 (helping fuel the 3.0% GDP growth we project), the merchandise import expansion is likely to be robust. Service imports too should advance rapidly, with many Brazilians taking relatively inexpensive vacations abroad. Accordingly, we see a contraction of the current account surplus from this year's projected US$14.5 bn to about US$7 bn in 2006. The real should depreciate for most of 2006 to BRL2.40 by year-end.

	Forecasts	Forwards
Q1 06	2.2600	2.2680
Q2 06	2.3000	2.3200
Q4 06	2.4000	2.4500

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



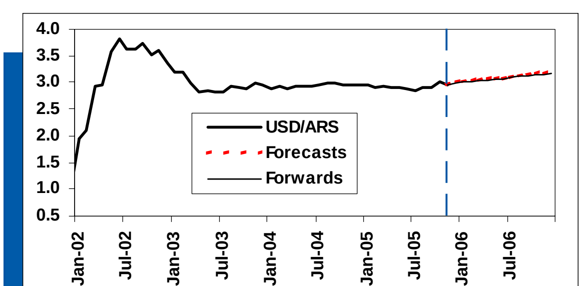
USD/ARS

The Argentinean peso (ARS) has depreciated by 2.9% to ARS 2.991, from a prior ARS 2.909 per USD so far during Q405. The weakening of the peso has occurred in response to a deteriorating inflation outlook and a decrease in investor confidence due to changes in the make-up of the Executive branch, namely the resignation of Finance Minister Roberto Lavagna and his replacement by market-unknown Felisa Micheli. The markets viewed Mr. Lavagna as a professional economist with the technical skills to react promptly to escalating inflation by using more or less orthodox monetary tools. On the contrary, the market has classified the new Finance Minister, Mrs. Felisa Miceli, as supportive of Mr. Kirchner's heterodox methods in fighting inflation, employing extensions of price settings arrangements with the private sector, as well as implementing incentives to expand aggregate supply, namely, easy access to credit. Furthermore, recent comments from Mrs. Miceli appear to suggest that the government believes that strong economic growth may be achieved despite the likelihood that inflation could reach 15%-20% rate by the end of 2006, a possibility which we very much doubt. The long-term consequences of President Kirchner's politically driven economic agenda are unlikely to prove favorable. The reversion of the current economic panorama into one where higher inflation supercedes retreating GDP growth, is sure to impact Mr. Kirchner's heading into the long run of the 2007 campaign.

In our view, the ARS will weaken due to inflation and growth concerns; however; the weakening may be partially fenced in, however, by the Central Bank intervention. We expect higher inflation readings in the months to come as history suggests that price setting agreements may only work in the very near term; however, they most likely will exacerbate inflationary expectations going forward and eventually distort economic growth. Recall that Argentina is facing structural bottlenecks as some sectors of the economy such as oil refining and textile manufacturing are facing capacity constraints. We are expecting inflation to be about 12% y/y and GDP growth to be about 5.3% y/y by end Q106, ending 2006 at about 13.5% y/y and 6.4% y/y respectively. Nevertheless, working in favor of the ARS will be regular Central Bank intervention in order to protect the ARS 3.00 per USD soft target. Furthermore, external conditions will remain beneficial to Argentinean exports likely dampening excess volatility. Based on the departure of Mr. Lavagna and the unknowns this generates in terms of economic performance going forward, we are modifying our prior bullish assessment of the ARS to a more defensive position. Thus, we now expect the Argentine peso to end Q106 at ARS 3.05 per USD. The NDF curve implies ARS at 3.03 per USD by end Q106.

	Forecasts	Forwards
Q1 06	3.0500	3.0250
Q2 06	3.0700	3.0650
Q4 06	3.1800	3.1650

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/VEB

The Venezuelan Bolivar spent another quarter without any adjustment in the official peg at 2144.60/2150.00, and little mention on the part of domestic authorities on possible modifications to the fixed rate come 2006. The parallel rate described by the CANTV ADR arbitrage exhibited some increased volatility, perhaps as a pass-through from the ongoing confrontation of the government and the local business establishment after unease generated by the administration's moves to take over or expropriate facilities deemed unjustifiably idled. Currently the quasi-black market rate resides at VEB 2537, implying an overvaluation in the fixed rate of approximately 18%.

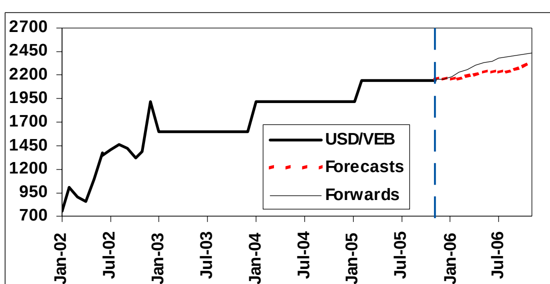
Aside from the clash that has occurred between the administration and local entrepreneurs (with the most relevant episode the expropriation of grain facilities/silos belonging to the influential Polar group) and international oil concerns (on back taxes owed), the Chavez Administration has been quite busy on the external front. Government purchases of debt instruments issued by Argentina (US$1B) and Ecuador (US$300MM), as well as motions to join the Mercosur trade block have characterized the latest shift by the Chavez administration, with the benefits of the former still a question mark. The exchange of barbs with the US has yet to recede; on the contrary, tension between the two continues to swell as a consequence of arms and ammunition purchases for the military ranks. The recent legislative elections are likely to assume the role of main point of contention with the international community. With the boycott of the proceedings by the political opposition, Mr. Chavez now essentially controls Congress. However, the paltry electoral turnout (25% in the best estimation) allows the legitimacy of any Congressional decisions to be doubted by the international community. With Legislative cohorts of Mr. Chavez now intent on proposing legislation that would allow the President to run for continuous reelection into the mid 2020's, weakening international confidence in the Chavez administration could drag on future currency expectations.

The domestic economic front has been marked by an over-abundance of liquidity, with the surplus on the money market reaching a record VEB 60B over the latest three-month period. To offset this major engine of inflationary expectations, the government has embarked on a large USD denominated external debt issuance program (US$3B in its latest incarnation, which covers only about 1/10 of liquidity float), which has attempted to accomplish the dual feat of shrinking surplus local liquidity, while allowing access to much needed foreign exchange. In sync with the risks of excess cash in circulation, consumer price inflation shows no signs of slowing, with cumulative CPI reaching 13.5% for the Jan./Nov. period. More positively, Q305 GDP reached a still impressive +9.8%, while international reserves are still at near all time highs of US$29.29B. Currency expectations have also moderated since the debate of the 2006 budget, which proposes retaining the current VEB2150 fixed exchange rate against the USD.

NDF pricing has started to assimilate decreased devaluation expectations for 2006. Bids for mid-year VEB levels are drawing much closer to our projections of VEB2236, with the six-month NDF bid now at 2330. We remain comfortable with our forecast for a VEB at 2325 by end Q406, always subject to crude oil prices holding above US$40 p/barrel for WTI.

	Forecasts	Forwards
Q1 06	2,150.00	2,228.60
Q2 06	2,236.00	2,329.60
Q4 06	2,325.00	2,429.60

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/COP

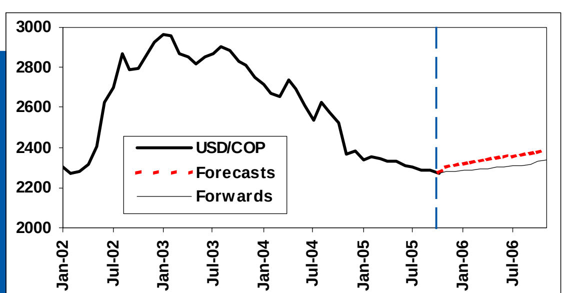
The Colombian peso (COP) has appreciated 0.6% to COP 2,274.5 from 2,287.4 per USD so far in the fourth quarter of 2005. The strengthening of the COP is owing to improvements in fundamentals as a result of enhancements on the domestic security front. Colombian GDP growth rebounded during Q205 (5.3% y/y vs. 3.9% y/y in 1Q05 and 4.8% in 2Q04) and it will likely close the year at about 4.4% y/y. At the same time, inflation is under control at 5.1% y/y in November and may end 2005 within the Central Bank target range (4.5% - 5.5%). At the same time, domestic demand remains well supported by improvements in the labor market and healthy business confidence. Furthermore, portfolio investment, foreign direct investment, and private remittances, along side high commodity prices, have all supported the currency. Importantly, the current economic expansion is providing the Uribe administration with fiscal resources to maintain security as a high administration priority, thus making economic growth potentially more sustainable in the future.

Looking forward, however, we believe the Colombian peso will weaken in the first quarter of 2006, as a result of the Central Bank foreign exchange policy of keeping the Colombian peso at around the benchmark (COP 2,300 per USD) and because political volatility will likely increase as next year's elections approach. We anticipate that President Uribe will most win the next presidential term. However, investors should bear in mind that Legislative elections in March 2006 will determine the structure of congress and will define the probabilities on passage of the much-needed structural reforms, namely fiscal reform. Provisional taxes will start to expire in January 2007. Furthermore, insurgency violence will probably increase in an attempt to way lay the election process and discredit the domestic security policy implemented by the Uribe administration. Furthermore, we anticipate that peace negotiations with terrorist groups will probably remain in limbo due to the lack of cooperation from these groups, mainly based on the US extradition requirements. In turn, this will further exacerbate the domestic political debate and make it difficult for the Bush Administration to convince the US congress, during an electoral year, of the need for additional support in favor of the current Colombian government.

Finally, the FED's hawkish actions in regards to interest rates and the possibility that the free trade agreement with the US will not be signed in the near term will place additional pressure on the COP. We expect the Colombian peso to end the Q106 at COP 2,320 per USD. The NDF market expects a COP 2,286.8 per USD by Q106.

	Forecasts	Forwards
Q1 06	2,320.00	2,286.80
Q2 06	2,345.00	2,300.80
Q4 06	2,380.00	2,339.80

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



ASIA

IDEAglobal

USD/KRW

A revival in domestic demand will reduce Korea's current account surplus in 2006 - the underlying reason for KRW gains in recent years. But the CNY adjustments and sporadic inflows will still keep the appreciation pressure intact. Intervention will however continue to restrict downside, notably at the 1000 level on USD/KRW in the coming year.

Strong global growth keeps the export outlook intact. Exports are expected to have risen by 12.5% in 2005, and should be able to sustain the momentum into 2006, particularly with Chinese imports accelerating once again. This will remain the underpinning factor that drives GDP growth, which is likely to continue too hover in the 4-5% range in 2006. Import growth however is finally picking up as domestic demand recovers. As yet this hasn't shown signs of a strong recovery, but with the continued growth in outbound tourism and high oil prices, demand be enough to reduce the current account to US$10-15bn, down from US$16bn in 2005 and US$27.6bn in 2004.

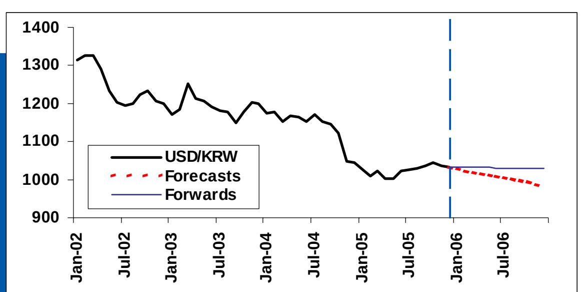
This weakness opens up the scope for more two-way price actions in 2006, as opposed to the almost continuous pressure for appreciation in recent years, and will make the KRW more susceptible to financial flows. A maturing of the growth cycle and tightening of global liquidity implies that conditions are less favourable than in 2005. Overall however we do not see a severe fall-out in global risk aversion, and inflows should remain positive, if more sporadic than in previous years. Local rate will lag those in the Fed, but should top out much later. This would mean that the rising rate differentials built up in Q1 will start to be reduced by Q2 and should turn positive in H2. Inflows furthermore should be assisted by ongoing speculation in the CNY. The idea that the CNY revaluation will set off similar adjustments in the rest of Asia is now looking slightly dated, but holds enough to see the KRW reacting to large CNY moves. The USD/JPY will as always be important and should similarly be supportive for the KRW as the JPY corrects from the dismal end-2005 showing.

The authorities have shown themselves resolute to resist the KRW appreciation pressure. They have been and should be able to handle relatively large inflows when necessary and, in particular, look likely to resist any appreciation beyond the 1000 mark on USD/KRW in early 2006. They are less focussed on NEER or JPY/KRW moves although they may use key technical levels on the latter when it would help. The 1000-mark though is a lower bound for now, and a break is contingent on the USD/JPY moving lower, substantial gains in the CNY, or simply a surge of inflows that could push the BoK aside as happened at the turn of 2004/05. Overall though the authorities are in a much stronger position to resist appreciation than before, even as the pressure is unlikely to be great. We therefore look for a sustained period above the 1000 mark, before eventually moving lower.

The risks to this scenario are anything that would a) see the global growth cycle slow significantly, particularly if driven by China, b) see tight enough liquidity conditions to cause a reversal of capital flows, c) sustained dollar gains.

	Forecasts	Forwards
Q1 06	1020	1033
Q2 06	1010	1032
Q4 06	985	1029

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/SGD

Theoretically Singapore's monetary policy has been on a tightening bias since April 2004. But it has only been in the last couple of weeks that the SGD has noticeably appreciated against its currency basket. This could kick-start a good round of NEER appreciation in 2006, with the economy likely to be boosted by the rebound in the electronic cycle and strong global demand.

Singapore's economy has rebounded strongly from the surprising contraction in Q1 2005. Through the middle six months of 2005, the economy grew at an average annualized rate of 13% – a pace only matched by the H2 2003 post-SARS recovery and the run-up to the IT boom in H1 1999. While this blistering pace may moderate in 2006, the growth trend should remain bullish particularly given our view that the electronic sector is in for a good year.

Although there are lingering concerns that the Singapore electronic sector is losing out to its Taiwanese and Korean counterparts, electronic production and exports are increasingly showing signs of reinvigoration in recent months. The electronic output grew 16.4% y/y in October and seems set for a run of double-digit annual growths for the next 12 months. This sector should take the slack from the marine engineering industry, which is already producing at near-capacity levels, and underpin the manufacturing sector's growth going forward. We expect the manufacturing output to grow at 10-15% in 2006 versus 9% in 2005.
This optimism is guided by our view of strong global demand - particularly from China, the US and Japan. We are generally in agreement with the IMF's view of a potentially stronger global growth rate in 2006 than this year's estimate of 4.3%, with growth from Singapore's key trading partners crucial in this outlook. Export growth should therefore rebound to 12% in 2006 from 5.5% in 2005. We look for the domestic economy to grow particularly strongly in Q1 2006 at around 8% y/y, while full-year growth of around 5-5.5% seems likely versus the official growth forecast of 3.0-5.0%.

With strong growth, unemployment numbers should fall while prices should remain supported. We are looking for the unemployment rate to dip to 3.0% in 2006. Even with a more benign price trajectory through 2006 than that seen in Q3 2005, we are expecting inflation to exceed the government's forecast range of 0.5-1.5% at 1.7% in 2006. The key MAS' underlying CPI, which directly shapes the central bank's policy decision, should then rise to 2.0% in 2006 from 1.0% this year.

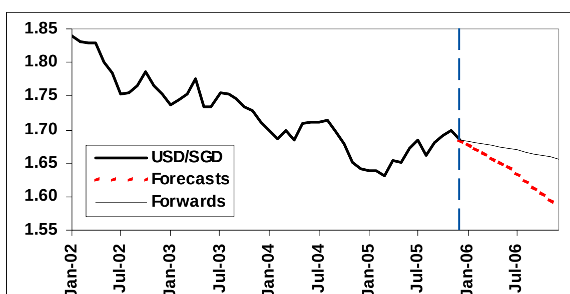
With this, the question is whether the MAS needs to drop the "gradual and moderate" phrase from the current tightening bias. While we were of the opinion that this will become necessary in the April 2006 meeting given the policy's lack of teeth for 19 months since April 2004, that view may have somewhat been rendered invalid by the 1% appreciation of the SGD NEER in December, although our inflation outlook has remained equally firm.

When the SGD NEER wasn't appreciating under the current regime, it was perhaps logical to consider a more aggressive tightening bias to enforce the SGD NEER to be pushed higher by the bottom end of the fast rising policy band. That though is no longer a concern. From the current point after the appreciation in December, the SGD could still appreciate by a further 2.8% without being bounded by the crawling top-end of the policy band.

We look for the SGD NEER to appreciate by another 2% in 2006. While a sharply tightening global liquidity remains a potential risk for Asia, a debilitating global rise in global interest rates is not our core view with oil prices expected to remain buoyant but benign. We therefore look for the USD/SGD to end 2006 at 1.5850.

	Forecasts	Forwards
Q1 06	1.6650	1.6790
Q2 06	1.6450	1.6720
Q4 06	1.5850	1.6560

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/THB

The THB is expected to be the worst performer in emerging Asia in 2006, affected by a wider trade deficit and risk of equity outflows. Despite our view for about a 10% downside in the USD/JPY, we still expect to see USD/THB higher at 42.80 by year-end.

Strong global growth and a pickup in the tech sector should boost Thai exports by 15% in 2006. From the Thai manufacturing production data, it seems like Thailand is rapidly shifting out of production of computer peripherals and shifting instead into electronics and more value added segments. This growing trend should boost export growth in 2006 more than we otherwise would have expected. Meanwhile, the removal of fuel subsidies means that oil import growth should be in single digits after 70% y/y growth in Jan-Oct 2005. This is in part a correction since part of 2005's imports were probably resold illegally, particularly those imports before June when the Thai local oil price was heavily subsidized. Nevertheless, non-oil imports should remain strong. We expect only a modest softening in consumption and investment, which together with strong export growth should mean total import growth of 16%. These figures would imply a wider trade deficit of almost US$10bn in 2006. However, we expect the Thai tourism industry to recover in 2006. This should mean that we see a much smaller current account deficit of circa US$4bn.

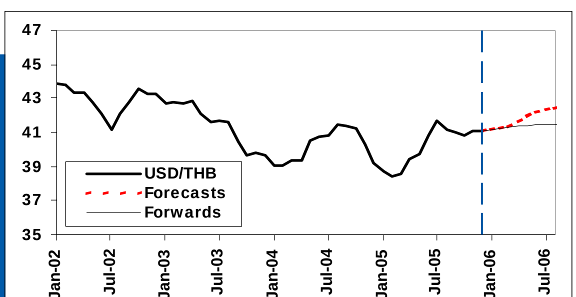
The outlook is not great for the capital account either. First, although Thai rates are expected to be close to those in the US, there is the risk of interest rate sensitive capital leaving Thailand (we expect the policy rate, which is the 14-day repo, to be hiked to 5% in 2006, lifting real repo rates in the +2% territory). Second, local equities have seen about US$5bn in foreign portfolio money in 2005 but no rally in the SETI at all. We notice that the SETI's earnings projections have typically been unattractive even in periods of strong GDP growth. Hence, there is a risk of equity outflows, leading to a larger THB depreciation.

The first quarter of 2006, however, is expected to be a strong exception to the trend of BoP outflows. We expect Q1 06 to be a period where exports safely outpace imports leading to trade, current account and BoP surpluses. In fact, this is just a continuation of the trend in Q3 05 and Q4 05 and is explained in part by high inventory levels in Thailand as well as by seasonally strong exports and tourism. The opposite is the case for Q2, which we expect to be the worst quarter in 2006 in terms of the BoP picture and the THB outlook. That said, the risk of equity outflows may be quite high in Q1 as funds re-arrange their country allocations.

All considered, we expect to see USD/THB at 41.30 by end-Q1 06 and then higher at 42.20 by end-Q2 06, sharply underperforming the other regional currencies. Following that, despite significant broad USD downside, the pair is expected to rise slightly to 42.50 and 42.80 by end-Q3 and end-Q4 respectively. Relatively higher interest rates though should imply larger carry costs for bets against the THB.

	Forecasts	Forwards
Q1 06	41.30	41.35
Q2 06	42.20	41.45
Q4 06	42.80	41.60

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/PHP

Underlying decent current account flows, underpinned by workers' remittances, keeps the PHP strong, but as always the PHP is susceptible to a loss of confidence and a rush of capital outflows. Barring any surprises we expect the USD/PHP to hover between the 54 and 55 mark through the early part of 2006 before higher inflation and a loss of competitiveness starts to bite.

The Philippines has been unique in Asia in that it has not been able to leverage off the acceleration in global growth and the rise of China. Export growth in 2005 is expected to be less than 2%. Import growth has also been constrained, although the country has felt the pinch from higher oil prices. This still leaves the trade account in a deficit, running at around US$4bn in each of the past 4-years and looking to continue into 2006. The Philippines though has gained massively from a growth in workers' remittances, which are expected to be over US$11bn in 2005 through formal channels and an estimated unrecorded amount of a further US$3bn. These remittances are set to grow further in 2006. This leaves a small but meaningful current account surplus that keeps the pressure intact for PHP gains except in times of crisis.

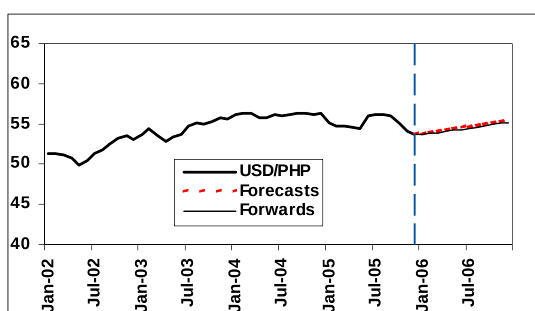
2006 will be characterised by a significant tightening of policy. The 2% rise in VAT is expected to be implemented in February, following on the removal of key exemptions late in 2005. Interest rates are also rising to combat the fallout from oil and other cost push pressures. Together these have various impacts on the market fundamentals. First, rate differentials will remain positive and should actually start to grow from Q2 onwards as the Fed rate tops out. Secondly, growth should slow, keeping imports constrained but putting pressure on capital flows and most worryingly raising questions of political sustainability. Thirdly, a sharply lower fiscal deficit should see foreign debt financing reduced.

The main risks indeed remain political. Already weakened after the elections scandal, President Arroyo will need to push through the tight fiscal policy and at least generate some reform momentum. Resistance that sees her back down or if agitators took to the streets again, would see a further loss of market confidence. Exports are less sensitive to the global economic outlook, but financing requirements imply any rise in global risk aversion would negatively impact Philippines assets.

The BSP maintains little control over the PHP. The central bank builds reserves slowly during periods of strength but has not, and is not likely to try to halt the appreciation pressure. Their presence though has been enough to help keep the USD/PHP restrained above the psychological 53.80/00 mark – the lower bound we suspect for much of the first quarter and even longer in 2006. The central bank still lacks the credibility to resist any sudden PHP losses, although the continued reserve accumulation implies they are actually in a much stronger position than the markets gives them credit for. The 56.50 mark is a level at which they would resist the USD from making strong headway. Periods of sudden sharp losses certainly can't be ruled out but barring such incidents we suspect that PHP's weakness will only slowly re-emerge. The lingering PHP's strength and high inflation rate would meanwhile lead to a slow loss of competitiveness. We see the USD/PHP rising to 55.50 by the year-end, with some risks to the upside.

	Forecasts	Forwards
Q1 06	54.00	53.90
Q2 06	54.50	54.30
Q4 06	55.50	55.17

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/MYR

The MYR has failed to impress since the de-peg on 22 July. In early December however, the USD/MYR began to edge lower again with pressure coming from hedge funds' USD sales. Our view remains for the USD/MYR to head lower in 2006, led by solid current account flows. Our estimates suggest that the risk of further capital outflows is small.

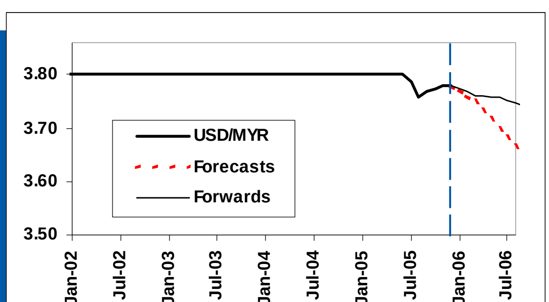
In 2006, we expect exports and imports to grow by 10% and 9% respectively, leading to a trade surplus of US$30bn and current account surplus of at least US$15bn. This should underpin the MYR in 2006. Also, we think exporters may have been holding back their dollar receipts rather than remitting the money in H2 2005. They only have a six-month window to do so according to the BNM's FX regulations. Taking the export receipts for August as a starting point, this means that sometime in Q1 2006, the deadline for remitting exporter earnings should begin to kick in. These flows should nudge the MYR to appreciate.

The risk of outflows related to further disappointment on the MYR is obviously a concern to be addressed. From the portfolio inflows data, we estimated that the size of the speculative capital inflows that came in solely to reap gains from a stronger MYR probably stands around US$11bn as of end-June (data available till end-June). According to the data on foreign holdings of MYR bonds (available until end-Q3 05), foreigners actually sold US$1bn in Q3 2005 and cut their total positions to US$3.5bn. It is reasonable to assume that foreigners also sold a material amount of Malaysian equities in that period. Accordingly, we estimate that the speculative money in Malaysia as of end-Q3 2005 should have been around US$9bn, down from the US$11bn seen as the end of Q2 2005. Following that, October and November alone saw the reserves falling by a further US$7bn. Our guess would be that exporters didn't repatriate most of their export receipts in this quarter. This implies that most of the US$7bn fall in reserves should be due to outflows in the portfolio investment, FDI and other investment categories of the BoP. As net FDI is usually positive, we think the fall in reserves might represent "other investment" outflows and "portfolio capital" outflows.

It is hard to guess what the "other investment" outflows were in Oct and Nov as these figures are historically very volatile. However, unless these outflows were unusually large, the price action in the equity and bond markets suggest that a significant part of the S$7bn drop in reserves might represent outflows of hot money from Malaysia. The Malaysian stock index KLSE, dropped 4.7% in October and November from end-Sept levels, while the 5 year bond yields rose 50bps to 3.8%. Anecdotal evidence also pointed to foreign investors selling out of these markets. As such, these estimates suggest that a major part of the hot money is probably flushed out of Malaysia. This in turn means that the risk from outflows is not that much going forward, especially as the market players position for a renewed USD decline in 2006 while expecting the Fed rates to peak in mid-2006.

	Forecasts	Forwards
Q1 06	3.7500	3.7620
Q2 06	3.7000	3.7570
Q4 06	3.6000	3.7260

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



The other key determinant in the MYR's direction is the degree of BNM's tolerance to MYR appreciation. The BNM is a very interventionist central bank. However, they have suggested in their policy statement following the de-peg that the stability of the exchange rate against regional countries has become increasingly important. We think the BNM's intervention in months following the de-peg are not indicative of its intervention style. In the initial weeks in July and early-August, the priority for the central bank was to ensure stability so that corporations could prepare and protect themselves from FX volatility (especially as the BNM seemingly didn't prepare the companies in advance). Following that the BNM has hardly intervened in a big way except to sell dollars and prevent the USD/MYR from rising. As such, we think all this argues for renewed appreciation pressure for the MYR in 2006 and that the BNM should be more tolerant of the pair declining to 3.60 by the end of 2006.

USD/IDR

Indonesian assets and the IDR have struggled to price in some of the recent positives, such as the brave decision to work towards eliminating fuel subsidies. But to be fair, risks have remained high, particularly on the inflation and growth fronts. But with new, more reliable and credible economic leaders in place, we should see some of these risks gradually priced out over the next 12 months, especially in H2 2006, in our opinion.

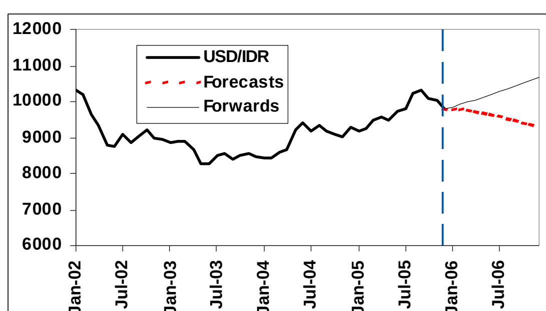
As expected, Boediono and Sri Mulyani Indrawati were respectively named to replace the ineffective Abu Rizal Barkie and Jusuf Anwar as the Coordinating Minister for the Economy and Fin Min. Boediono was the BI Deputy Governor in charge of monetary policy after the financial crisis hit Indonesia in 1997-98. Although he served under both Presidents Suharto and Habibie, he is not known to have any affiliations to any political party and has a reputation for integrity. Given his strong links with the central bank and the Finance Ministry given his Fin Min appointment under the last Administration, Boediono is obviously a better choice than his controversial predecessor, whose commercial links with former despot Suharto remain strong. With no government experience, Bakrie's and indeed Jusuf Anwar's appointments as Chief Economic Min and Fin Min were clearly compromised moves and looked ill fated from the beginning. Together with Sri Mulyani, a respected and prominent economist with previous stints at the IMF, the economic team has certainly been strengthened by the changes made.

These appointments are another step at soothing the IDR's crisis of confidence. The current stability should see improvements in flows too, with the BOP likely to be more reflective of the trade and current accounts going forward. While the headline non-oil exports growth numbers were hampered by the large base effect in September and October, these should rebound comfortably into 2006, helped somewhat by the weak IDR but more importantly by the strong GFCF over the last 7 quarters which should provide enough buffer for non-oil output to remain strong. We expect a check on the large US$3.5bn outflows in Q3, potentially seeing inflows of circa US$1bn in Q4 barring large errors and omissions.

But there is little Boediono and Sri Mulyani can do to pull GDP growth numbers significantly higher for now. We expect less than impressive economic growth numbers to be a drag on the IDR in the next 3-6 months. Private consumption and domestic investment - the key drivers to growth in recent quarters – are likely to be significantly suppressed by the 275bps hike in interest rates since October. We expect the 2005 growth numbers to fall slightly short of the 5.5% forecast at 5.2% with more disappointments likely in H1 2006. But the pressure on growth has somewhat been mitigated by the modest rate hike on 6 December, which to us signals a lower than expected peak in interest rates than initially anticipated, other things remaining equal. We look for interest rates to reach a peak at 13.5% in Q1 2006 before easing. Private consumption and investment should therefore rebound in H2 2006 although growth of 6.2% assumed for the budget calculations will remain out of reach. We are looking for 2006 growth to come in at 5.0-5.5%, which will in turn see the deficit rise to at least 1.2% of GDP. The government will also look to extend the debt moratorium tied to the 2004 tsunami. Still, with the deficit not likely to exceed 1.5% of GDP, the impact of the wider deficit is likely to only be limited to the sovereign bond market going forward. We look for the a gradual appreciation in the IDR to 9650 by Q2 2006 before accelerating to end the year at 9300 as both inflation and interest rates ease back to circa 10% at the end 2006 with more room for further easing in 2007. The global liquidity situation is however a major caveat as the high yielding currency may lose some of its sheen if global rates accelerate.

	Forecasts	Forwards
Q1 06	9750	9985
Q2 06	9650	10195
Q4 06	9300	10670

Forecasts for end of each quarter
Forward Rates as of 5th December, 2005



USD/TWD

Taiwan has seen its massive current account surplus slowly whittled away as cyclically strong commodity prices and rising domestic demand outpaced moderate export growth. This should partly reverse in the year ahead. That the electronics cycle is looking increasingly firm and that China should continue to suck up local goods will be instrumental in this current account revival.

There however remain concerns that continued hollowing out has hurt Taiwan structurally, with 40% of export orders now satisfied by production from the mainland. Nevertheless, after reaching a low in middle of 2005, we expect the trade account to return to meaningful surpluses through 2006, with exports growing plus-12%. For a massive net creditor like Taiwan, one would also expect to see some benefits from higher global rates, but seemingly these are being partly recycled abroad rather than repatriated, notably with the CBC's holdings. Service receipts meanwhile took a hit in 2005, but again should revive somewhat into 2006. After a current account surplus of US$9bn in 2005, we see as much as US$18bn in 2006.

Inward financial flows have been excellent sporadically through the last 12 months, notably into the local stock market. These are highly susceptible to changes in the global equity and risk environment. While these are expected to be decent overall, they could very well be patchy again in 2006 just as it was in Q4 2005. Decent local growth that should average 4%, and the pickup in the IT sector should also help. For now of course interest rates are diverging, but the CBC has hinted that it favours moving to 25bps per quarter - either in one or two separate meetings per quarter. This implies differentials with the US will narrow again from Q2 onwards. Speculative flows could at times also accelerate, as we saw in the past two years, when the CNY comes under pressure. Cross straits relations always offer a risk in this regard but international factors driving liquidity and risk appear much more important. To a large extent then, it appears that the TWD will be driven by the global rates and growth environment.

The CBC's FX policy has been to resist moves either way, and they have successfully kept the USD/TWD in a 12% range in the post-crisis period. There are though some suggestions that the authorities have adjusted away from targeting a flat rate against the USD. The CBC governor made a statement to this affect in late October and through 2005 the TWD actually traded with an effective exchange rate focus. This implies that the USD/TWD will track the USD/CNY and the USD/JPY closely, both of which, in our view, will be positive for the local unit.

Overall flows are unlikely to reach the sizes seen in recent years, and may well be patchy, but should nevertheless overall be net positive towards the local unit. This should keep the directional bias downwards on USD/TWD. The size of moves in 2005 though look unlikely to be repeated. A range of 32.00 to 34.00, with a bias towards the lower end, looks more likely in 2006.

	Forecasts	Forwards
Q1 06	33.30	33.26
Q2 06	33.20	33.00
Q4 06	33.00	32.50

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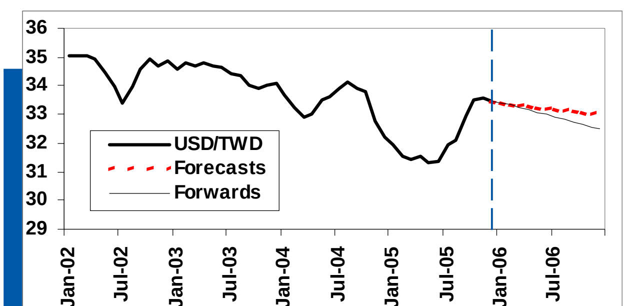

USD/CNY

Pressure for and actual CNY appreciation are likely to be key themes in the global FX markets in the year ahead. We see the pace of appreciation in the CNY accelerating to 3-5% from 1.33% currently.

The U.S. Administration has kept up mild but insistent pressure in public for further appreciation, accepting that more visible action could be counterproductive. Behind closed doors however we can be sure that the issue is being pushed harder. The U.S. even successfully brought the IMF into the fray at the December G7 meeting. Congress moreover has held out on action only on repeated assurances that more will be done. Both the Chinese and the US governments seem set on avoiding protectionist pressures, and the game seems to be doing as little as they can get away with. Key dates here will be the end of Q1 when U.S. Senators Schumer and Graham have threatened to bring their bill back onto the floor, and April, when we get the next US Treasury report on FX manipulation that has threatened action unless further CNY appreciation is forthcoming.

Signs of misalignment have only grown. The July revaluation seemingly took off some of the speculative froth, albeit only temporarily, as the trade and current account surpluses have been soaring. The latter may hit as much as US$150bn in 2005, meaning it may just squeeze into first place past Japan as the world's largest net saver. The strong USD will help avert some of this pressure, although importantly it will not affect the bilateral balance that is key to the political action. A revival in economic growth will also have an impact on trade balances as imports start to accelerate strongly again after slowing in late 2004 through to mid-2005. All sectors indeed now seem to be firing; consumption is rising rapidly, while investment money supply, and industrial production are again re-accelerating. Serious imbalances still exist within the local economy, notably the problem of over investment, and tightening measures will have to be introduced, most probably still through administrative means. The opening of the banking sector in December will be a key event, and reforms through the year will focus on recapitalising, cleaning-up and listing the state owned banks. Capital account liberalisation will continue.

Since the 21 July revaluation, USD/CNY has been trading with an effective NEER focus; with the basket composed of, we calculate, 98% USD, 1% EUR and 1% JPY, with 1.333% p.a. appreciation trend. USD/CNY has never moved meaningfully away from this predicted level. From the Chinese perspective, the next logical reform is to allow more daily fluctuations around this target level as this would help slowly build trading expertise within the local banking system. Certainly key reforms like the introduction of forwards, the liberalising of inter-bank rates, and the January introduction of market makers gives them the opportunity to adjust the regime. Given the political pressure, they will probably also have to accelerate the pace of appreciation. We have heard talk of a possible further 1% revaluation, but simply increasing the trend adjustment is simpler. US allegations are that the CNY is somewhere between 20-30% undervalued (in a survey of the literature we found estimates of 0-40%, with a mean of 16% after adjusting for the July move). A move to a sustained 3-5% appreciation rate may be enough to keep the pressure at bay. Any reform is likely to come through the existing framework that already allows daily moves of up to 0.3%. Note meanwhile that with the small NEER policy in place, USD/CNY moves will be influenced by those in the USD/majors. This implies we could see accelerated gains in H2 when we expect the USD to weaken.

	Forecasts	Forwards
Q1 06	8.0200	7.9800
Q2 06	7.9600	7.9000
Q4 06	7.8400	7.7500

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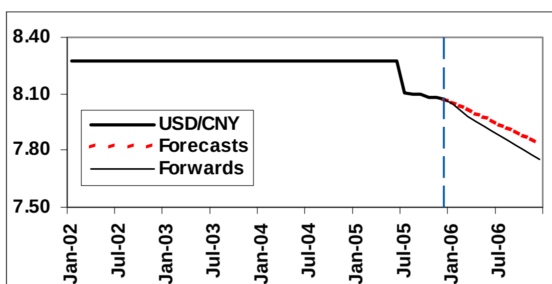

USD/HKD

The HKD's new forex regime withstood the CNY revaluation in July and through to the end of 2005 came under any no intense speculative pressure. We expect the HKD regime to remain unchanged for the next 12 months. But with the market still pricing in further changes in the pace of CNY appreciation, if not the CNY regime itself, coupled with strong domestic asset prices, there is little reason to expect the USD/HKD to deviate significantly from the weakest end of the 7.75-7.85 range.

Hong Kong's growth story over the last couple of years has been a happy one, driven not least by the two-year head start granted to the territory prior to the opening of the mainland markets to the rest of the world under the Closer Economic Partnership Agreement (CEPA). The CEPA, signed in 2003, has been instrumental in paving the way for the 8 consecutive quarters of seasonally adjusted sequential growth in Hong Kong that have averaged 7.9% p.a. While this will be harder to sustain over the next four, growth is not about to fall drastically either given the resilience of the Chinese and U.S. economies. We look for growth to ease slightly from 7.5% in 2005 to 6.5-7.0% in 2006.

The strong economic growth has reduced the burden on government spending to generate growth and boosted the cyclical component of government revenue. These eased the government's battle to rein in the budget deficit in the FY2005/06 to the extent that a fiscal surplus could actually be seen for the first time since 1997/98, a positive for the local currency. While this is obviously welcomed, it does not totally eradicate the niggling concern that the government budget remains structurally unsound. The tax base has remained exceedingly narrow - direct taxes accounted for more than 50% of the total revenue in FY2004/05. The long-awaited GST should still be implemented to widen the tax base. Although not likely in 2006, our estimates suggests that GDP growth of 4% or less would drag HK back into a fiscal deficit unless the GST is put in place.

But quite how the HKD would react to a CNY appreciation that takes the mainland currency to a stronger level than the HKD's peg band of 7.75-7.85 is still not immediately clear. While the only other logical monetary policy regime for the HK economy, which doesn't depend on price competitiveness, is to be linked to the CNY, it seems premature for such a move to materialize anytime soon. For one, the Chinese forex regime is still in a state of flux. Most importantly, the CNY is still not fully freely tradable. China's financial institutions are also still too under-developed, while hedging facilities are still evolving.

	Forecasts	Forwards
Q1 06	7.7500	7.7500
Q2 06	7.7600	7.7440
Q4 06	7.7600	7.7310

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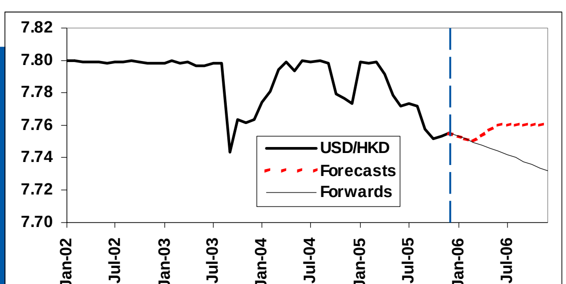

In the short-run, CNY speculation and IPO flows could see the USD/HKD heavy while the fwds maintain a close eye on the USD/CNY NDFs. But HK interest rates are catching up to US rates as demand for HKD funds begins to accelerate – the November 25bps Fed rate hike triggered a 50bps hike in HK commercial bank prime rates. The domestic property and stock markets have been absorbing some of these domestic funds while consumer credit has also been rising. Over a multi-month horizon after the large IPOs are fully priced in, this is likely to mean a rightmove in the USD/HKD fwds back towards par particularly if the Spot TT remains close to the 7.75-strongest end of the HKD band. And while the budget is back into the black and the economy strong, the former still seems cyclical while the latter heavily dependent on economic activities in China. This would mean that in the long-run, a premium in local rates over US rates may still be warranted if the Chinese economy falters. Such risks remain although they seem a distant possibility for now.

USD/INR

India's growth prospects for 2006 seem favourable but this could ironically be the INR's bugbear throughout the year as the trade deficit expands far more than the expected foreign equity investment inflows. In the face of the large current account deficit, the central bank is also expected to be keen to absorb reversible capital inflows, even at the expense of the BoP.

We expect continued trade liberalisation and strong global growth to keep exports growing at a very strong 23% rate in 2006. With this, India's economic growth should remain strong at around 7.5%. Strong investment expenditure as well as growing consumer preference for imported goods means that import growth would outpace the strong export growth. We expect imports to grow at 29% and the trade deficit to widen to a whopping US$60bn in 2006. However, the invisibles portion of the current account should bridge a large part of the gap, with the trend of Indians travelling abroad the only exception. As India remains by far the most favoured off-shoring destinations, we expect continued strong expansion in the services exports and net services receipts to rise to US$20bn in 2006. Also, the rising US rates will not halt the remittances from Indians living abroad. This is because part of this money is for consumption by families back home and the other part for investments in Indian property seen as necessary by most Indians for future accommodations or financial assets, which continue to be attractive relative to savings rate. All considered, we expect the overall current account deficit to be smaller than the trade deficit, albeit still at a sizeable US$18bn in the coming year.

The financial account picture is expected to remain positive in 2006. We forecast foreign portfolio investment inflows of at least US$6bn in 2006, notwithstanding the US$8bn seen in the last two years. Two factors are important here. First, the economic growth and corporate earnings are expected to remain strong in 2006, with little signs of decelerating from what was seen in 2005. Second, the number of FII's registered with the Securities Exchange Board of India (SEBI) rose to 806 on Nov 3 from 685 at the end of March, an increase of 18%. The RBI noted in its latest economic review that the FIIs now come from a much larger number of countries than before. This means the FII investor base has broadened. The FDI flows should also grow moderately, even if it remains well below potential. However as other interest sensitive capital slows, including loans, the capital account surplus is expected to narrow to US$21bn.

Theoretically, this means that every quarter we have large current account deficits of around US$3-5bn and large capital account surpluses of US$4-6bn. The equation though would change significantly if the RBI's discretionary reserve accumulation needs were taken into account. The RBI's reserves accumulation policy is based on the size of the risk-adjusted capital flows as well as liquidity risks from outflows. Hence, while the BoP seems in balance, absorption of speculative or reversible capital flows by the RBI should put the overall flows in a deficit. Indeed, we expect that the BoP should then record a deficit of circa US$2bn every month.

	Forecasts	Forwards
Q1 06	46.30	46.53
Q2 06	47.00	46.66
Q4 06	47.50	46.93

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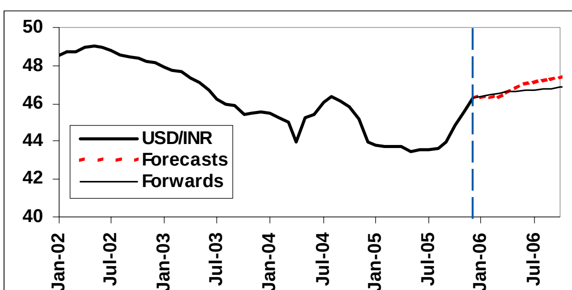
On aggregate, we expect the INR to face intermittent pressure to weaken on a trade-weighted basis in 2006. We expect the USD/INR to first trade sideways in Q1 and end the first quarter at 46.30. The INR is then expected to weaken sharply to 47 by end-Q2 06 - marking possibly the worse quarter for the INR in 2006 – following which we expect more modest USD/INR upside (though largely due to the sharp and generalised USD weakness) to 47.30 and 47.50 respectively.



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