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Global FX Strategy

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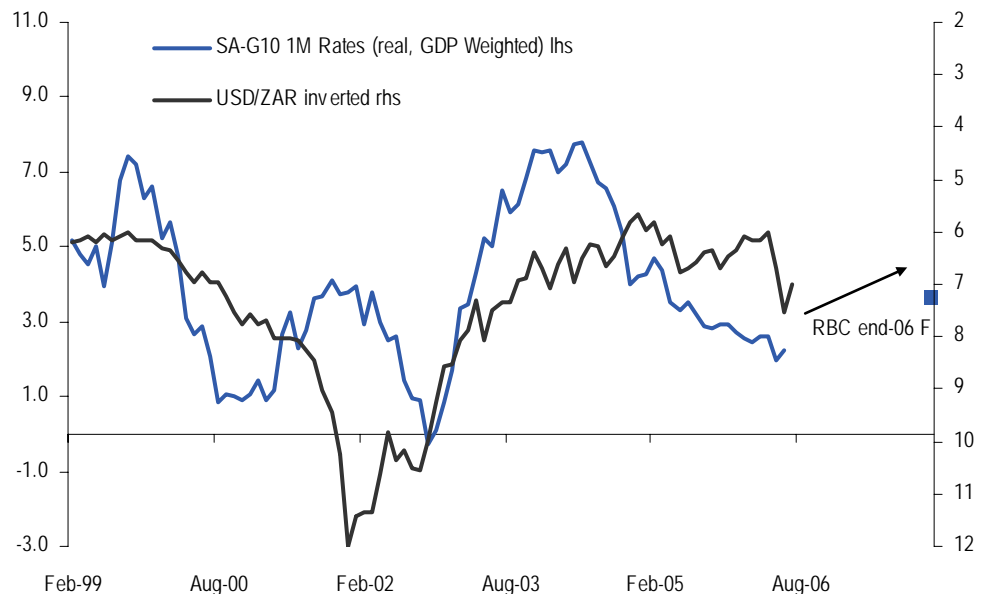
Currency Report Card

- In the first half of 2006, the DXY Index fell 8% and was the third worst performing currency of 11 major and peripheral commodity currencies, despite the Fed raising rates by 75bp to 5.25% and the USD becoming the fourth highest yielding currency among these markets. The USD is failing to capitalise on rising US rates. RBC expects Fed funds rates will peak at 5.5% this year, which is almost fully discounted by the Fed funds futures. Interest rate markets having almost fully discounted our expectations of further rate hikes by the ECB (to 3.25%) and the BoJ (to 0.5%, with the first hike on 14 July) and the potential for “safe haven flows” back into the US are limited, especially since the USD was the second worst performing currency on a risk-adjusted basis. Even if Fed funds rates were to peak at 6% nominal and real global rates will stay extremely low. We retain our 1.32-year target.
- Safe haven trading rules: buy current account surplus currencies and sell current account deficit currencies are breaking down as markets turn risk seeking. RBC’s Risk Aversion Thermometer has fallen to -1.9pt, the first time it has shifted risk seeking since April.
- We recommended selling USD/ZAR at 7.1250 on 3 July with a target of 6.65 and stop loss at 7.18. Our bullish ZAR view is premised on an expected widening in South African-G10 interest rate differentials, gold prices to rally to U\$800/oz over the next 12-months, a rebound in global equities (US equities up 6% over the next 6 months) and renewed risk appetite.

Forecast Revisions

- USD/ZAR: revised down to 6.65 end-Q3 (from 6.90) and left end-Q4 unchanged at 6.5
- EUR/HUF: revised up to 270 at end-Q3 (from 258) and 267 at end-Q4 (from 263)
- USD/MXN: revised up to 11.2 at end-Q3 (from 11.1) and to 11.3 at end-Q4 (from 11.2)
- USD/CLP: revised up to 545 at end-Q3 (from 540) and to 560 at end-Q4 (from 555)

Expected widening in S.A.-G10 Real Interest Rate trigger to sell USD/ZAR



Source: RBC Capital Markets, Bloomberg

Table of Contents

FX Focus in July: USD Returns Lag Rising US Interest Rate Carry	3
Majors	
US Dollar	5
Euro	6
Japanese Yen	7
Sterling	8
Swiss Franc	9
Scandis	
Swedish Krona	10
Norwegian Krone	11
Commodity Currencies	
Canadian Dollar	12
Australian Dollar	13
New Zealand Dollar	14
South African Rand	15
Central Europe	
Polish Zloty	16
Hungarian Forint	17
Czech Koruna	18
East-Asia	
Chinese Yuan	19
Hong Kong Dollar	20
Singaporean Dollar	21
South Korea Won	22
Latin America	
Mexican Peso	23
Brazilian Real	24
Chilean Peso	25
Forecasts	
Forecasts	26
EUR Crosses	26
Yen Crosses	27
CAD Crosses	27

USD Returns Lag Rising US Interest Rate Carry

Monica Fan

The DXY Index is down 8% in the 6 months to 30 June, despite the USD having climbed further up the ranks of high yielding currencies. The 75bp increase in Fed funds rate to 5.25% in the first half of this year, has made US short rates the highest among the major markets, notwithstanding those in peripheral commodity currencies such as AUD, NZD and ZAR with official rates at 5.75%, 7.25% and 7.50%, respectively. The FOMC's retention of a tightening bias has renewed some investors' USD bullishness on the premise that a peak in Fed funds rates of 6% has yet to be discounted by Fed funds futures (currently implied rates of 5.5%) and the resulting reduction in global liquidity, which would be compounded by an initial 25bp rate hike by the BoJ on 14 July, would trigger "safe haven" inflows back into the USD.

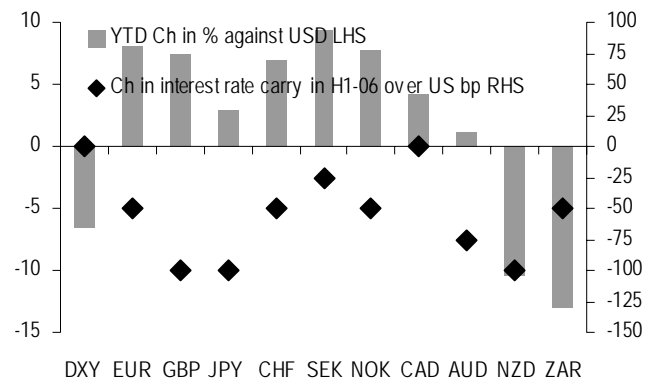
However, the widening yield advantage of the USD over the major currencies has been a poor predictor of the USD's performance against the major currencies. Figure 1 shows that the DXY Index was down 8% in H1 and the third worst performing currency of the 11 currencies shown, after a 13% loss on the ZAR and 10.5% loss on NZD. The strongest performer against the USD in the first half of this year was the SEK, which appreciated by 9.4% (US-Swedish rates widening 25bp in favour of a stronger USD), followed by 8% gain in the EUR and NOK (as relative rates rose 50bp in favour of the USD) and the GBP which was up 7.5% (despite US rates having moved 100bp above the UK).

Moreover, on a risk-adjusted basis, the DXY Index was the second worst performer (-0.5%) after the NZD (-1.2%) for the 12-months to 30 June. Figure 2 shows the annualised risk-adjusted returns of these currencies (estimated by the annualised excess return on a currency assuming the risk-free rate is the Fed funds rate, divided by the annual volatility of returns). Note on this basis, the Yen was the fourth worst performing currency after the ZAR, AUD and DXY. At the opposite end of the spectrum, was the CAD, which offered the highest risk adjusted returns, followed by the SEK and EUR.

Going forward, there are reasons to believe that the USD will not rally on further Fed hikes, even if Fed funds peak at 6% in mid-2007 as anticipated by the most bullish US economic forecasts (4 out of 20) surveyed by Reuters on 30 June. RBC economists are amongst the large minority (8 out of 20) forecasting a 5.5% peak in Fed funds rate this year.

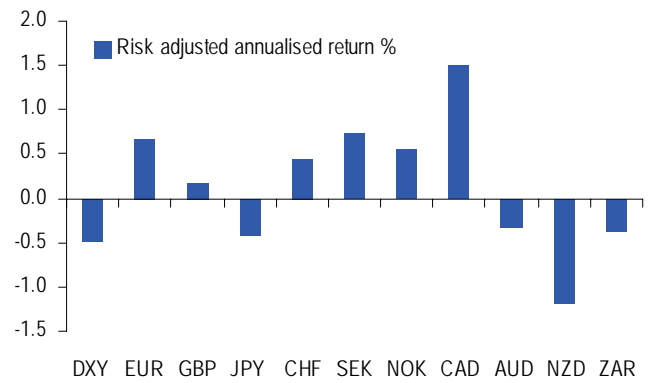
First, the interest rate market has already discounted most, if not all of the rate hikes forecast by our economists for the US and other major markets. Figure 2 shows the change in the USD's carry over the major currencies in H2, implied in interest rate futures. All, if not more, of the rate hikes expected by RBC economists have already been discounted. For example, one

1. DXY is down 8% in H1 despite increased carry



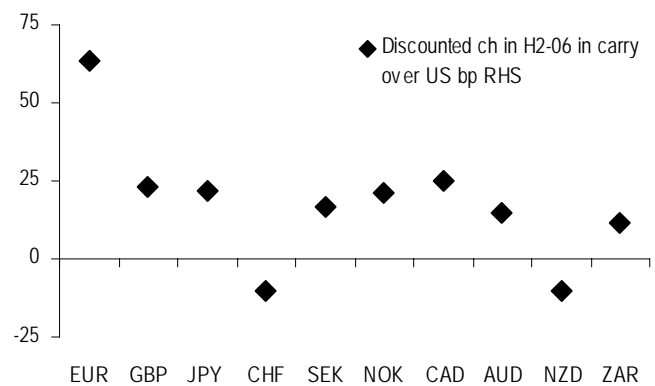
Source: RBC Capital Markets, Bloomberg

2. Low yielders were better "value" on risk adjusted basis



Source: RBC Capital Markets, Bloomberg

3. Changes in H2 USD's carry almost fully discounted



Source: RBC Capital Markets, Bloomberg

25bp rate hike by Q4 has been discounted in short sterling futures, contrary to RBC economists' anticipation that UK base rates will stay at 4.5% for the rest of 2006. Secondly, the start of the BoJ tightening cycle, most likely on 14 July, is unlikely to significantly reduce global liquidity.

Interest rate markets have already fully discounted a 25bp hike in Q3 and 60% chance of another 25bp in Q4. All of the monetary tightening discounted in H2 in the rates markets implies that year-end nominal and real G7 real rates will rise only very modestly. They imply nominal rates would rise from 3.5% to 4% and real rates from 0.8% to 1.9% (see Figure 4). Even if the Fed's funds rate were to rise to 6% by the end of this year, real rates in the G7 area would be still be very low at 2.1%. Moreover, RBC's Risk Aversion Thermometer has fallen to -1.9pt, and has moved into risk seeking territory for the first time since 26 April. There is little reason to expect a "flight to quality" will drive investors back into USD-denominated assets, rather than euros, particularly given the relatively poor risk-adjusted return on the USD so far this year. We continue to target an appreciation in EUR/USD to 1.32 by year-end.

In our April *Currency Report Card*, we discussed the consistent sell-off in major and emerging market currencies with current account deficits in March. This had been partly triggered by the downgrading of Iceland's long-term debt outlook from stable to negative on 22 February and exaggerated fears that further global monetary tightening by the ECB and Fed would significantly reduce global liquidity. Since then, the Fed and ECB have each raised rates by a further 50bp and 25bp, respectively, but the correlation between currencies' performance on a trade weighted basis and the status of their current account deficit has become far less clear cut.

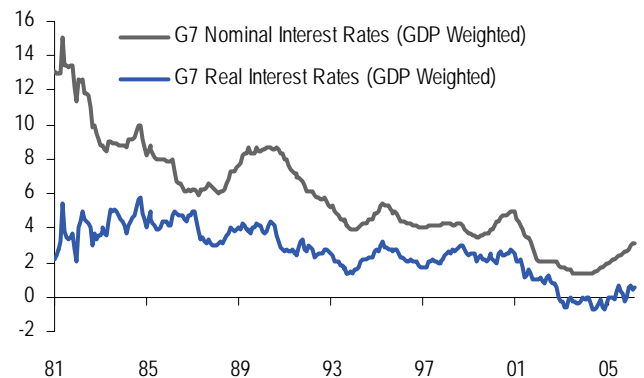
Figure 5 highlights that in June, declines in the trade weighted indices of ISK, NZD, HUF and ZAR could only partly be attributed to their large and burgeoning current account deficits. The South African trade weighted index fell 5.4% in June, significantly more than the 0.6% decline in the Australian trade weighted index, while the US trade weighted index in fact rose by 1.2%. This is despite South Africa's current account deficit (5% of GDP 4 quarter sum) being lower than that of Australia (6.2%) and the US (6.3%). Part of this, of course, reflects the higher liquidity risk premium of the ZAR.

FX Implications: Safe haven trading rules breaking down

But it also highlights that "safe haven trading rules" that involve: selling currencies with current account deficits and buying currencies with current account surpluses, are breaking down as risk appetite recovers. This is reinforced by the minimal broad based contagion from the 21% collapse in the TRY from 9 May to 21 June and the ISK since 21 February, across all emerging market currencies. As risk appetite picks up, investors are increasingly discriminatory about the domestic fundamentals and political factors underpinning currencies saddled with current account deficits.

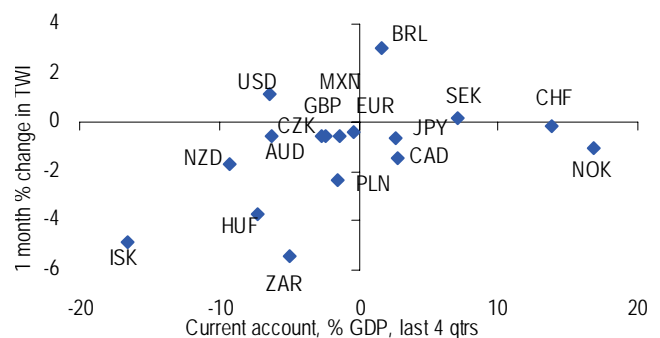
The sell-off of the TRY was triggered partly by the unwinding of carry trades, fears of stagflation in Turkey (with inflation running at 10.1%), uncertainty regarding Turkey's social security reforms and EU accession negotiations, and the drop in investor confidence in response to the Central Bank of Turkey's emergency rate hikes. Aside from similar sell-offs in the ZAR, PLN, HUF and CLP, which again reflected country specific factors, other emerging market currencies performed far better on average.

4. Risk appetite is picking up and global liquidity is ample



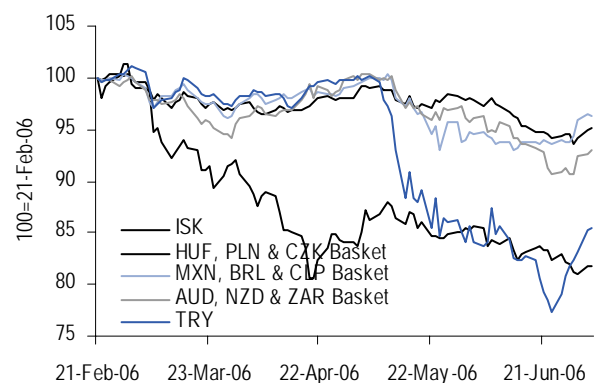
Source: RBC Capital Markets, Bloomberg

5. Only select current account deficits currencies underperformed in June



Source: RBC Capital Markets, Bloomberg

6. Low contagion from ISK and TRY to regional currencies



Source: RBC Capital Markets, Bloomberg

US Dollar

Adam Cole

1 – 3 Month Outlook

The extreme FX market reaction to the Fed's more-dovish-than-expected statement accompanying the June 29 rate hike underlines USD's vulnerability once the support of rising rate expectations is kicked away. DXY fell 1.8% in the immediate wake of the FOMC while the yield on December 2006 Eurodollar futures fell 10bp as the Fed said future tightening would be dependent on incoming growth and inflation data.

Even after the move lower in rate expectations, however, markets still attach a 65% probability to an August 8 hike (Figure 1). Given the Fed's stated dependence on incoming data, this overstates the near term risk of higher rates. Although RBC economists expect one more 25bp hike in the current US rate cycle, the Fed is expected to pause at both the August 8 and September 20 meetings. This suggests further near term USD downside risk.

6 – 12 Month Outlook

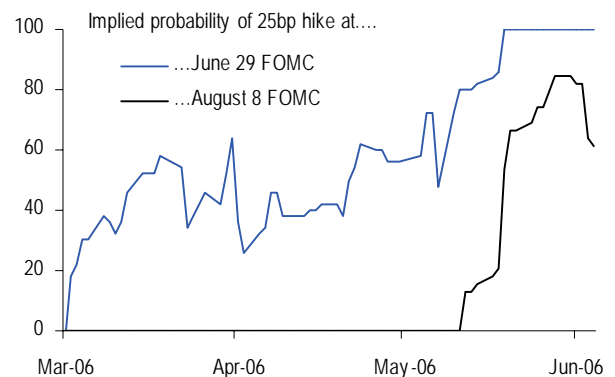
Also notable in the context of rate expectations, however, is the failure of USD to benefit significantly as the markets moved to *price in* the June hike. During the period between March and May, when the implied probability of a June 29 hike moved up from zero to 100% (see figure 1), DXY actually fell almost 8%. The asymmetry of USD's response to changing rate expectations probably reflects the changing motivation for rate hikes and the growing evidence that the more interest rate sensitive parts of the economy are already slowing. The US rate environment is moving from one where the Fed is hiking *because of* strong growth to one where it is hiking *despite* slowing growth. Figure 2 highlights the changing growth/inflation mix apparent in 2006. Growth expectations (proxied by the ISM survey) have slowed over the last six months, while long term break even inflation has risen from 2.6% to 2.8%. Against a background where the Fed either stops hiking, or keeps hiking, but into a slowing economy, we continue to look broadly based USD losses. Technically, with the long-term valuations unwinding from overbought levels, resistance at 89.17 and 92.50 in DXY is expected to attract selling interest for a re-test of support at 83.72. A monthly close below here would target the quadruple bottom at 80.27.

Indicators

	Current (Previous) *
Official cash rate	5.25% (5.0%)
Trend interest rates (10yr average)	4.20%
Bias in interest rate market	Rising
Core PCE Inflation %Y/Y May (Apr)	2.1% (2.1%)
Inflation target	Price stability
Budget balance % GDP FY04 (FY03)	-4.9% (-4.6%)
Budget balance target % GDP	-
GDP Growth %Y/Y Q1 (Q4)	3.7% (3.2%)
Trend GDP %/y	3-3.5%
Purchasing Power Parity Value	-
Spot	-
PPP Valuation	-
Current account balance % GDP Q1 (Q4)	-6.4% (-6.3%)
Trend current account balance % GDP	-3.7%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

* Current is latest month, quarter or year

1. Market still over-pricing August FOMC hike?



Source: RBC Capital Markets, Bloomberg

2. Inflation expectations rise, growth expectations fall



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
EUR/USD	1.21	1.28	1.31	1.32	1.30	1.28	1.26	1.25
USD/JPY	117.5	114.5	110.0	107.0	105.0	106.0	105.0	105.0
USD/CAD	1.17	1.11	1.15	1.17	1.19	1.21	1.24	1.24

Euro

Adam Cole

1 – 3 Month Outlook

Although EUR lost 0.9% against USD in June, it gained against all other G10 currencies as ECB rate hike expectations continued to rise. The yield on Dec 2006 Euribor futures rose 15bp in the month, ending at 3.61% and implying the market now fully discounts two further ECB hikes and is close to discounting a third. The rise in rate hike expectations reflects consistently positive economic news. Our economic surprise index, which measures the balance of upside vs downside surprises relative to consensus in the activity indicators for the Eurozone and the main member states, is shown in Figure 1. The smoother 12 week moving “window” has been at or above zero consistently for the last year, which is by far the longest run of positive surprises since we started collecting data seven years ago.

So long as the economic news points to growth at trend or above (2-2¼% pa), the ECB is likely to remain concerned about the possible second round effects of higher energy prices and rhetoric is likely to remain hawkish. However, with interest rate markets already priced for a significant step up in the pace of ECB tightening, the EUR/USD gains we anticipate from here largely reflect USD weakness, with EUR falling moderately on most crosses.

6 – 12 Month Outlook

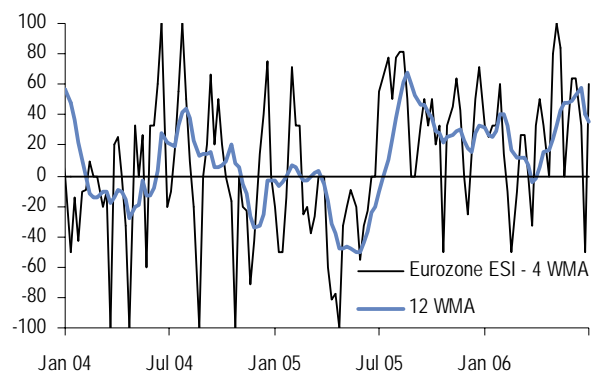
In the longer term, however, it is not clear that higher ECB rates will be a significant support for EUR. Figure 2 shows that, over the last five years, the correlation between EUR/USD and the yield on the second generic Euribor contract has generally been negative. Higher rates have historically been associated with a lower EUR, in contrast to US rates, which fit the more conventional rule of higher rates pushing USD up against EUR. Possibly the perverse effect of ECB rates on the EUR reflects the dominance of bonds in the Eurozone’s capital flows. On a 12 month view, we expected EUR/USD to be close to current spot of 1.28. Technically, With the long-term valuations at oversold levels, support at 1.2348 is expected to attract long-term buying pressure for an attempt to exceed resistance at 1.2989.

Indicators

	Current (Previous) *
Official cash rate	2.75% (2.50%)
Trend interest rates 10y average	4.1%
Bias in interest rate market	Rising
HICP Inflation %Y/Y Jun (May)	2.5% (2.5%)
Inflation target	Close to but less than 2.0%
Budget balance % GDP FY04 (FY03)	-2.8% (-3.0%)
Budget balance target % GDP	3% of GDP-Unless special circumstances
GDP Growth %Y/Y Q1 (Q4)	1.9% (1.7%)
Trend GDP %y/y	2.2%
Purchasing Power Parity May (Apr)	1.1733 (1.1711)
EUR/USD end-June	1.2785
PPP Valuation	EUR/USD is overvalued
Current account % GDP Q1 (Q4)	0.0% (0.2%)
Trend current account balance % GDP	0.1%
Moody's Foreign Currency Rating	Aaa (Germany)
Outlook	Stable

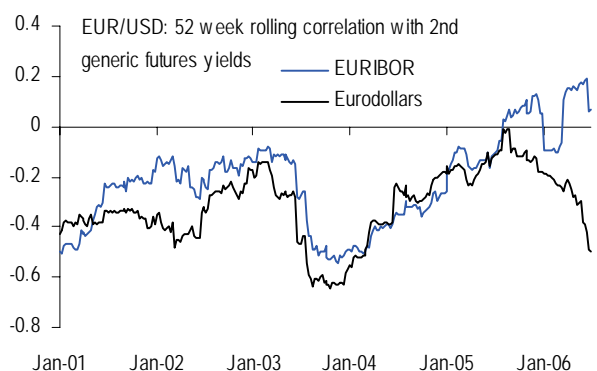
* Current is latest month, quarter or year

1. EZ news-flow still positive



Source: RBC Capital Markets, Bloomberg

2. Euribor vs EUR/USD relationship “normalising”



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
EUR/USD	1.21	1.28	1.31	1.32	1.30	1.28	1.26	1.25
EUR/JPY	142.6	146.3	143.0	141.2	136.5	135.7	132.3	131.3
EUR/CAD	1.42	1.42	1.51	1.54	1.55	1.55	1.56	1.55

Japanese Yen

Adam Cole

1 – 3 Month Outlook

Despite mounting evidence of strengthening economic recovery and a growing consensus that the BoJ will raise interest rates at the July 13-14 policy board meeting, JPY continues to trade poorly, losing against all G10 currencies except NZD through the course of June. The primary cause of JPY weakness is diminishing demand for Japanese equities by foreign investors. Through the first three weeks of June, overseas investors sold JPY0.8trn of Japanese stocks and for the calendar quarter to date, net sales were JPY1.2trn. This compares to net purchases of JPY4.1trn in Q1 and is the first sustained net selling since 2002. Rather than investors taking a bearish view on the Japanese economy, this almost certainly reflects the Japanese market's highly cyclical nature. The TOPIX index has a beta of 1.19 relative to the MSCI global index (five year of weekly data in first differences). If global equity markets continue to stabilise, JPY selling pressure should abate. Possibly, uncertainty regarding repercussions from BoJ governor Fukui's investment in the Murakami fund is also undermining JPY. Recent opinion polls have shown little public support for Fukui. An Asahi poll on June 27 suggested 67% of the public thought Fukui should resign immediately. Although we ultimately expect Fukui to survive, uncertainty will hang over JPY until such time that the BoJ actually hike rates, which we anticipate on July 14. Thereafter we expect USD/JPY to resume trending down. Technically, support is located at 113.41 in USD/JPY.

6 – 12 Month Outlook

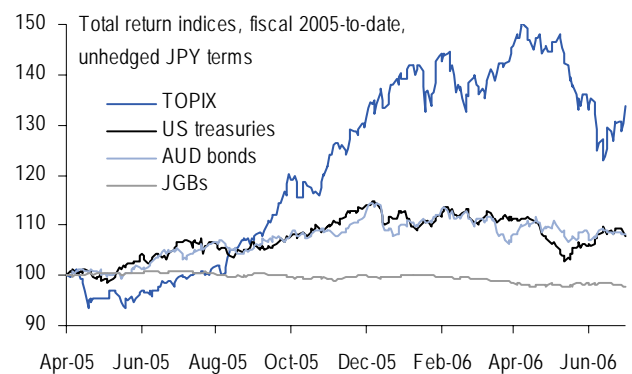
Longer term, we expect renewed interest in Japanese equities from overseas investors to support JPY. According to Reuters' monthly asset allocation poll, US investors' weighting in Japanese equities fell to a nine month low in June and at 6.5% is well below the 10.0% weight seen as recently as February. European and UK investors have also reduced exposure to Japanese stocks, though less abruptly than US investors. Ongoing weak demand for overseas bonds by Japanese investors (net purchases of just JPY2.2trn FY-to-date compared to JPY7.6trn in the same period in FY2005) adds to the medium term case for JPY out-performance. Technically, a move below monthly support at 112.42 would target 108.80.

Indicators

	Current (Previous) *
Official cash rate	0% since 2001
Trend interest rates 10y average	0.15%
Bias in interest rate market	Rising
CPI Inflation %Y/Y May (Apr)	0.6% (0.5%)
Inflation target	
Budget balance % GDP FY04 (FY03)	-6.9% (-8.2%)
Budget balance target % GDP	Primary budget surplus by 2010
GDP Growth %Y/Y Q1 (Q4)	3.5% (4.0%)
Trend GDP %Y/Y	1.2%
Purchasing Power Parity Value May (Apr)	93.22 (93.23)
USD/JPY end-Jun	114.47
PPP Valuation	USD/JPY is overvalued
Current a/c balance % GDP Q2 (Q1)	4.1% (3.9%)
Trend current account balance % GDP	2.9%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

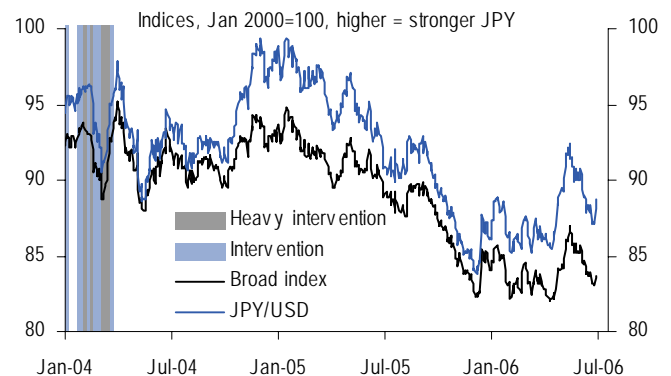
* Current is latest month, quarter or year

1. Japanese investors losing money in overseas bonds



Source: RBC Capital Markets, Bloomberg

2. JPY is weaker than it looks



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/JPY	117.5	114.5	110.0	107.0	105.0	106.0	105.0	105.0
EUR/JPY	142.6	146.3	143.0	141.2	136.5	135.7	132.3	131.3
CAD/JPY	100.68	102.76	95.65	91.45	88.24	87.60	84.68	84.68

Sterling

Adam Cole

1 – 3 Month Outlook

GBP performed poorly through June, falling 1.9% against USD and 0.9% against EUR. Diminishing prospects of a near term MPC rate hikes were the main driver for GBP underperformance. In the second half of June, the yield on September short sterling fell 13bp to 4.79% and the futures strip now attaches only a 50% probability to a August 3 rate hike – down from 100% in mid-June.

The latest activity indicators, however, suggest markets may be premature in pricing out the risk of a near term rate hike. In particular, upwards revisions to Q4 and Q1 GDP (released June 30) now put growth above trend for two consecutive quarters (0.7% q/q compared to trend of 0.6%). As Figure 1 shows, GDP growth relative to trend has, for most of the last five years, been an extremely good guide to MPC policy, with rates trending to rise when growth is above trend and fall when it is below. Although the historical relationship would have suggested more aggressive BoE easing over the last 12 months, the MPC's failure to act probably reflects some scepticism on the quality of the output data, with surveys consistently pointing to stronger growth than hard data. Along with consistently strong housing market indicators, the Q1 GDP data suggest the risk of a near term rate hike has risen significantly which should offer some short term support to GBP. Technically, GBP/USD targets 1.8557 in the short term.

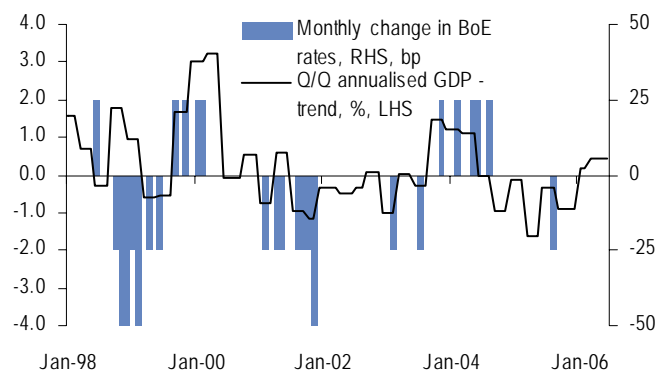
6 – 12 Month Outlook

Longer term, GBP will also be a key beneficiary of an expected rebound in global equity markets. GBP is one of the key winners in rising equity environments (see *Currency Report Card*, 5 June 2006), probably reflecting the UK's high market capitalisation/GDP ratio (second highest in the G10) and large foreign ownership share (33% of LSE market capitalisation). The UK would also be a key beneficiary of on-going strength in global M&A activity and our medium term view remains that GBP will rise against a generally weak USD and out-perform on the crosses. On a 12 month view we target GBP/USD at 1.88 and EUR/GBP at 0.6840. Technically an attempt to test resistance at 1.9076 is possible, with secondary resistance located at 1.9325.

Indicators	
	Current (Previous) *
Official cash rate	4.5% (4.5%)
Trend interest rates 10y average	5.5%
Bias in interest rate market	Stable
CPI Inflation %Y/Y May (Apr)	2.2% (2.0%)
Inflation target (HICP)	2.0%
Budget balance % GDP FY04 (FY03)	-3.0% (-3.4%)
Budget balance target % GDP	Balanced current budget over the cycle
GDP Growth %Y/Y Q1 (Q4)	2.4% (2.2%)
Trend GDP %Y/Y	2.5%
Purchasing Power Parity Value May (Apr)	1.6351 (1.6332)
GBP/USD end-Jun	1.8469
PPP Valuation	GBP/USD is overvalued
Current a/c balance % GDP Q1 (Q4)	-2.4% (-2.2%)
Trend current account balance % GDP	-1.6%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

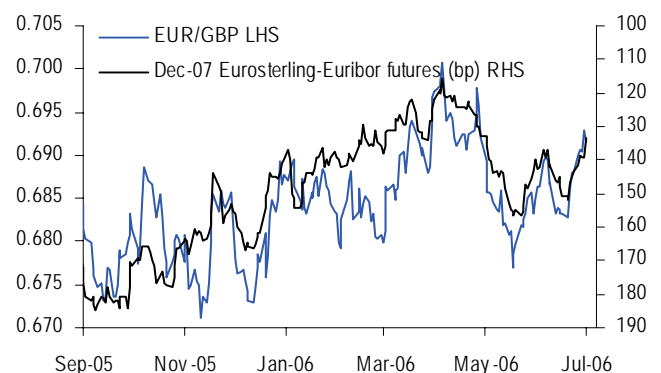
* Current is latest month, quarter or year

1. Activity starting to signal tighter policy...



Source: RBC Capital Markets, Bloomberg

2. ...and GBP still primarily a rate story



Source: RBC Capital Markets, Bloomberg

Forecasts	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
GBP/USD	1.74	1.85	1.89	1.90	1.90	1.88	1.86	1.85
EUR/GBP	0.70	0.69	0.69	0.69	0.68	0.68	0.68	0.68
GBP/JPY	204.3	211.4	207.9	203.3	199.5	199.3	195.3	194.3
GBP/CAD	2.03	2.06	2.17	2.22	2.26	2.27	2.31	2.29

Swiss Franc

T.J. Marta

1 – 3 Month Outlook

EUR/CHF strengthened towards the end of the month at 1.5654 after having fallen as low as 1.5496. The weakness in EUR/CHF had stemmed from stronger-than-expected Swiss GDP, CPI, PMI and a decline in the unemployment rate. However, EUR/CHF firmed towards the upper end of its trading range after the SNB raised rates by an expected 25bp to 1.50% and reiterated its intention to gradually increase rates. Despite the SNB rate hike, the Euribor-Euroswiss 3 month spread for Dec-06 futures has widened to 150bp, suggesting EUR/CHF should trade to 1.5850 (see Figure 1). Furthermore, the decline in RBC's Risk Aversion Thermometer has also moved lower into risk seeking territory (see Figure 2), which should allow EUR/CHF to trade more closely with interest rates. However, with technical valuations approaching overbought levels, resistance between 1.5706 and 1.5747 could cause the cross to stall and consolidate before moving above 1.58. Additionally, any increased risk aversion due to geopolitical tensions regarding Iran, North Korea and Gaza could cause temporary retracements.

6 – 12 Month Outlook

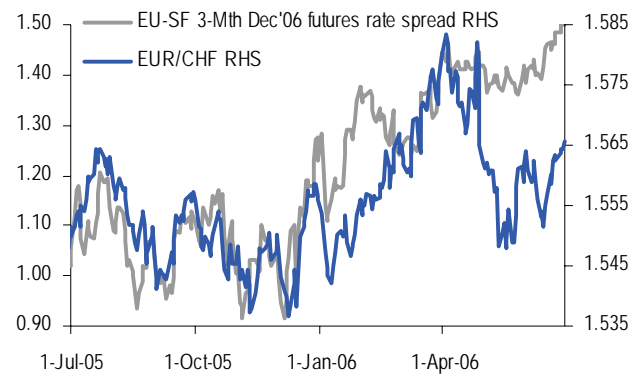
Low trend growth in Switzerland (we estimate 1.5%) and a relatively small output gap (-1.0% of trend GDP according to the OECD) suggest "neutral" interest rates in Switzerland are significantly lower than all G10 countries except Japan (2.5% compared to a G10 average 4.7%). The implied yield on Jun-07 Euroswiss futures has risen to 2.49%, suggesting the market will need to move to price in future restrictive monetary policy for further CHF gains. However, with annual inflation at 1.6%, well below the SNB's target ceiling of less than 2.0%, the spread is likely to widen further and augurs for a stronger EUR/CHF. In the absence of a significant rise in risk aversion, we expect EUR/CHF will drift higher over the next 12 months (target 1.59).

Indicators

	Current (Previous) *
Official cash rate	1.00-2.00% (0.75-1.75%)
Trend interest rates 10y average	1.70%
Bias in interest rate market	Rising
CPI Inflation %Y/Y Jun (May)	1.6% (1.4%)
Inflation target	less than 2.0%
Budget balance % GDP FY04 (FY03)	-2.5% (-1.9%)
Budget balance target % GDP	Balanced over the business cycle
GDP Growth %Y/Y Q1 (Q4)	3.5% (2.7%)
Trend GDP %Y/Y	1.58%
EUR Purchasing Power Parity Value May (Apr)	1.4398 (1.4412)
EUR/CHF end-Jun	1.5654
PPP Valuation	EUR/CHF is overvalued
Current a/c balance % GDP Q2 (Q1)	13.8% (13.7%)
Trend current account balance % GDP	10.2%
Moody's Foreign Currency Rating	Aaa

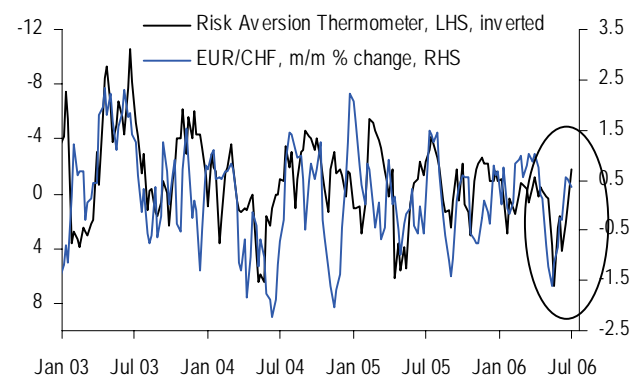
* Current is latest month, quarter or year

1. Expected yield spread favors stronger EUR/CHF



Source: Bloomberg

2. Risk aversion has abated – taking weight off EUR/CHF



Source: RBC Capital Markets

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CHF	1.30	1.22	1.21	1.20	1.22	1.24	1.26	1.27
EUR/CHF	1.58	1.57	1.58	1.59	1.59	1.59	1.59	1.59
CHF/JPY	90.2	93.5	91.2	88.8	85.8	85.3	83.2	82.5
CAD/CHF	1.12	1.10	1.05	1.03	1.03	1.03	1.02	1.03

Swedish Krona

Monica Fan

1 – 3 Month Outlook

EUR/SEK traded as low as 9.16 on 5 June but failed to extend its decline and traded back to a high of 9.30 on 20 June, despite a hawkish Statement accompanying the Riksbank's 25bp rate hike to 2.25% that day. Part of EUR/SEK's resilience may be seasonal. There has been a seasonal rally in EUR/SEK in June and July, primarily due to domestic SEK buyers squaring up their books for the northern summer, over the past six years. Over this period, EUR/SEK has rallied in June (on average by 0.5%) and July (average rises of 1.0%). This seasonality has, however, been difficult to trade in recent years. Technically, resistance at 9.2984 and 9.3688 is expected to contain rallies in EUR/SEK for a move to support at 9.2040 (which is near our fundamental fair-valuation of 9.20). A close below this level would target secondary support at 9.1519.

Rallies in EUR/SEK towards 9.30 are attractive opportunities to establish short EUR/SEK positions as the Riksbank is likely to raise rates more aggressively than is discounted in the FRAs. The implied rate on 12M FRAs of 3.68%, is at the low end of the Riksbank's June *Inflation Report* estimate of neutral Swedish rates of 3.5%-5%. Headline and core CPI in April of 1.6%/y is already above Riksbank's forecast for year-average headline and core CPI of 1.6% and 1.3%, respectively.

6 – 12 Month Outlook

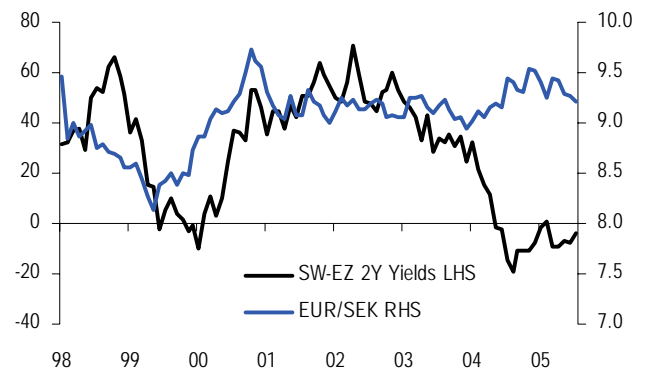
Although the risks to EUR/SEK remain biased to the downside from faster Swedish rate hikes and strengthening Swedish exports to the euro area in tandem with the euro area recovery, there is a risk that greater portfolio outflows from Sweden will prevent EUR/SEK falling as much as it would otherwise "fundamentally" warranted. Large FDI outflows from Sweden in 2005 (SEK94bn) contributed to the SEK's underperformance against all the major currencies last year, and although these have been offset by SEK45bn of FDI inflows in the first quarter of this year, these have been partly offset by SEK100bn portfolio outflows in Q1. Trends in portfolio and bond inflows, which have dominated the impact of short rate spreads in 2005 (see Figure 2), make the SEK vulnerable to underperformance in the rest of 2006.

Indicators

	Current (Previous) *
Official cash rate	2.25% (2.0%)
Trend interest rates 10y average	4.5%
Bias in interest rate market	Rising
CPI Inflation %Y/Y May (Apr)	1.6% (1.5%)
Inflation target (UND1X)	2.0%
Budget balance % GDP FY04 (FY03)	0.3% (0.5%)
Budget balance target % GDP	Cyclical average surplus of 2%
GDP Growth %Y/Y Q1 (Q4)	3.9% (3.1%)
Trend GDP %Y/Y	2.5%
EUR Purchasing Power Parity Value May (Apr)	8.4072 (8.4194)
EUR/SEK end-Jun	9.2106
Valuation	EUR/SEK is overvalued
Current account balance % GDP Q1 (Q4)	7.1% (6.5%)
Trend current account balance % GDP	6.8%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

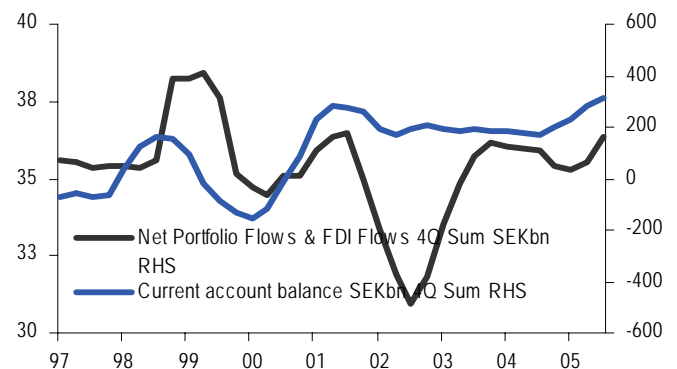
* Current is latest month, quarter or year

1. Interest rates point to a lower EUR/SEK



Source: RBC Capital Markets, Bloomberg

2. ... but trend outflows are supporting EUR/SEK



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/SEK	7.77	7.20	6.79	6.52	6.46	6.56	6.59	6.64
EUR/SEK	9.43	9.21	8.90	8.60	8.40	8.40	8.30	8.30
NOK/SEK	1.19	1.16	1.17	1.16	1.14	1.12	1.09	1.06
CAD/SEK	6.66	6.47	5.91	5.57	5.43	5.42	5.31	5.35

Norwegian Krone

Monica Fan

1 – 3 Month Outlook

EUR/NOK firmed from 7.75 to as high as 7.9741 in June. EUR/NOK gains were capped by oil prices staying above US\$70/b and a mixed June *Inflation Report* accompanying the Norges Bank's widely anticipated decision to keep interest rates at 2.75% on 29 June. But lower than-expected May Norwegian CPI inflation and rising euro area interest rate expectations fuelled by hawkish ECB rhetoric flagging a potential 50bp hike in August limited the sell-off in EUR/NOK. After the Norges Bank had accelerated the pace of tightening from once every quarter, to once every two months with its May hike, it was widely expected that rates would remain unchanged last month. The Norges Bank retained its stance that rates would rise in "small, not too frequent steps", and we expect the Norges Bank will next raise rates in August to 3% (which has been fully discounted into FRAs). Although core CPI-ATE moderated to 0.7%/y in May to below the Norges Bank's 1.0% forecast, headline CPI inflation of 2.7%/y remained above the Norges Bank's target of 2.5%, and mainland GDP growth remains above trend at 3.5%/y. Although Norges Bank revised down near term inflation forecasts, it also noted that domestic demand driven inflation pressures are picking up even though imported goods price inflation continues to moderate. Capacity utilisation is above normal and the unemployment rate fell to a new five year low in June (2.6%). Although petroleum prices have peaked, they remain elevated, and this will increase transfers to the Government Pension Fund and make fiscal policy easier than it would otherwise be in 2007. Persistently high oil prices will keep EUR/NOK under modest downward pressure over the next 3 months, especially as the risks are that interest rate futures have overestimated (underestimated) the magnitude and speed of the ECB (Norges Bank) tightening cycle this year.

6 – 12 Month Outlook

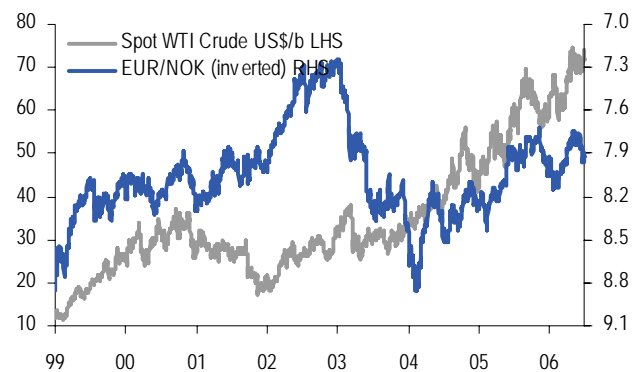
We are modestly bearish EUR/NOK in the next 6 months, with our fair-value estimate of EUR/NOK currently at 7.88 and implied rates on 3M FRAs of 3.3% in the middle of the 2.75-3.75% range projected for November by the Norges Bank. Technically, there is a double bottom in EUR/NOK at 7.7615 and a descending channel base at 7.5666.

Indicators

	Current (Previous) *
Official cash rate	2.75% (2.5%)
Trend interest rates 10y average	5.00%
Bias in interest rate market	Rising
CPI (ex energy and taxes) %Y/Y May (Apr)	0.7% (0.8%)
Inflation target %	2.5%
Budget balance % GDP FY04 (FY03)	6.6% (8.3%)
Budget balance target % GDP	Structural, non-oil deficit < 4%
GDP Growth %Y/Y Q1 (Q4)	2.7% (2.4%)
Trend GDP %Y/Y	3.4%
EUR Purchasing Power Parity: May (Apr)	8.04 (8.07)
EUR/NOK end-Jun	7.9573
Valuation	EUR/NOK is under-valued
Current account balance % GDP Q4 (Q3)	16.8% (15.2%)
Trend current account balance % GDP	10.4%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

* Current is latest month, quarter or year

1. EUR/NOK underperforms oil as risk aversion abates



Source: RBC Capital Markets, Bloomberg

2. EUR/NOK is close to fair value and PPP



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/NOK	6.55	6.22	5.80	5.61	5.69	5.86	6.03	6.24
EUR/NOK	7.95	7.96	7.60	7.40	7.40	7.50	7.60	7.80
NOK/SEK	1.19	1.16	1.17	1.16	1.14	1.12	1.09	1.06
CAD/NOK	5.61	5.59	5.04	4.79	4.78	4.84	4.86	5.03

Canadian Dollar

T.J. Marta

1 – 3 Month Outlook

USD/CAD traded higher during June, testing our quarter-end forecast of 1.13 late in the month. A 9.4% drop in RBC's C\$ Base Metals Index (CBMI) fully supported the rally, although it has stabilized in recent sessions. The move was further supported, initially at least, by a drop in the price of oil to below \$69/bl. USD/CAD remains firmly locked in a 1.0975-1.1273 range as the rally ahead of the FOMC meeting was offset by strong Canadian CPI, retail sales and employment numbers, as well as a FOMC statement that proved more dovish than expected. During the summer months, we expect further evidence of slowing in the U.S. economy. Additionally, Chinese policymakers will ramp up their efforts - and eventually succeed - in slowing the Chinese economy, which would support our base metals analysts' call for further downward adjustment in base metals prices (see Figure 1). Oil will likely remain supported in the near term by geopolitical fears (Nigeria, Venezuela, Iran) as well as concerns regarding hurricanes. However, with OECD oil stocks near record levels and economic slowdowns in the U.S. and China, the fundamental picture for oil, barring open hostilities in Iran, will likely cause oil to begin to trade lower towards September.

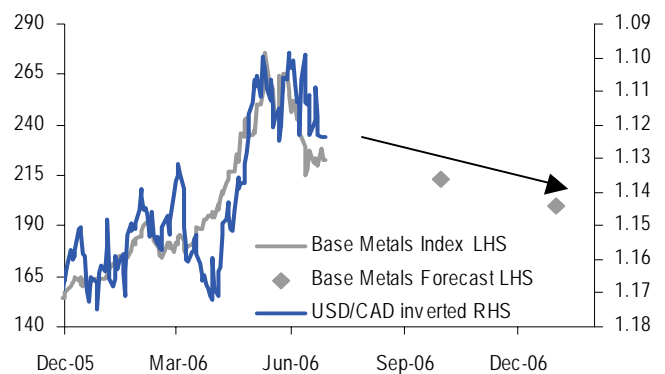
6 – 12 Month Outlook

As the reality of a slowdown in the U.S. economy filters through to Canadian exports in the second half of 2006, we expect USD/CAD will break above its recent trading range, and continue appreciating through 2007 as U.S. GDP growth cools towards 2.5%q/q,saar. USD/CAD will also derive support from a decline in oil below \$60/b. Capping USD/CAD gains will be a stabilization of base metal prices once the "froth" is removed from the market, along with sporadic M&A activity into Canada as foreign entities attempt to gain access to the country's commodities. Three major risks to our 12-months USD/CAD forecast of 1.21 are (1) the U.S. economy fails to slowdown, (2) the global economy, and more specifically China, continues to expand at current levels despite a mild slowdown in the US, (3) despite a U.S. and Chinese slowdown, oil prices continue to increase as geopolitical risks rise.

Indicators	
	Current (Previous) *
Official cash rate	4.25% (4.00%)
Trend interest rates 10y average	4.00%
Bias in interest rate market	Rising
Core CPI Inflation %Y/Y May (Apr)	1.8%(1.6%)
CPI Inflation target range %Y/Y	1-3%
Budget balance % GDP FY04 (FY03)	1.3% (0.6%)
Budget balance target % GDP	Balanced over the business cycle
GDP Growth %Y/Y Q1 (Q4)	3.8% (2.6%)
Trend GDP %Y/Y	3.3%
Purchasing Power Parity Value May (Apr)	1.3543 (1.3548)
USD/CAD end-Jun	1.1140
PPP Valuation	USD/CAD is undervalued
Current account balance % GDP Q1 (Q4)	3.0% (3.7%)
Trend current account balance % GDP	2.00%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

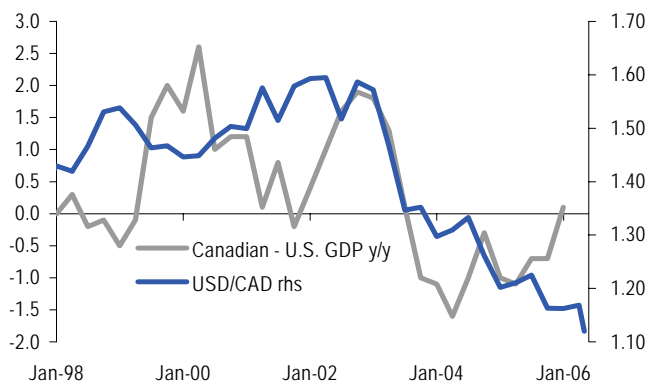
* Current is latest month, quarter or year

1. Further "froth" to be removed from base metals prices



Source: RBC Capital Markets, Bloomberg

2. Relative slowing of US GDP growth supports USD/CAD



Source: RBC Capital Markets, Bloomberg

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CAD	1.167	1.114	1.150	1.170	1.190	1.210	1.240	1.240
EUR/CAD	1.417	1.424	1.495	1.544	1.547	1.549	1.562	1.550
CAD/JPY	100.7	102.8	95.7	91.5	88.2	87.6	84.7	84.7

Australian Dollar

Sue Trinh

1 – 3 Month Outlook

The AUD has weakened through most of June in line with the broad based USD strength over this period. However, the March low of 0.7016 was never seriously tested, with the low in June posted at 0.7271. Amid the data deluge of the past month, the key numbers have surprised on the upside and largely justify the RBA's May rate hike. For instance, April retail sales surged 1.4% m/m with gains across all categories including the more discretionary sectors. Spending remains fuelled by debt with the RBA's credit aggregates data showing another strong 1.1% gain in May. Credit growth has been 1% or higher for each of the last 8 months with y/y lending running at 14.1%, strengthening from a little over 13% last October (Figure 1). Business investment edged higher in Q1 (+0.6%) and this followed several robust quarters (including a notable upward revision to Q4 to +13.0% from an already strong +9.2%). Investment spending plans for the rest of this financial year are extremely strong, although some moderation is anticipated in 2006-07 from the second estimate in the latest CAPEX survey. With tax cuts from the recent Federal Budget due to come into effect on July 5, the risk of a rate hike at the August meeting is high, with inflation high, unemployment at generational lows and skill shortages intense. The bank bill strip currently has this priced with 50% probability, so there is room to move in the AUD (Figure 2), especially should the July 26 release of Q2 CPI come in poor, keeping the AUD bid.

6 – 12 Month Outlook

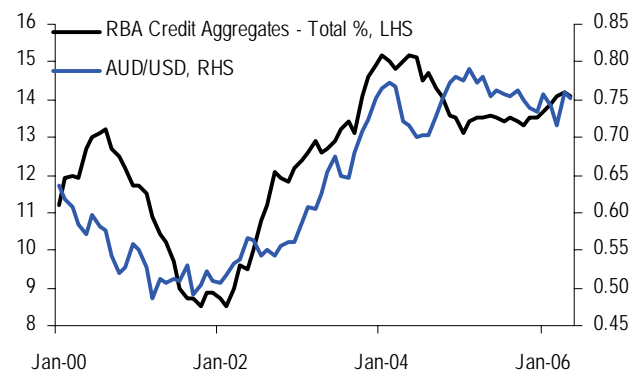
Over the next 6-12 months, we see limited weakness for the AUD beyond the March lows. The domestic economy is much firmer than it was in Q1, while the USD's expected weakness through the next 6-12 months will also prop up the AUD. We continue to look for a steady, orderly decline in AUD/USD through 2006 H2 as the rate of appreciation in base metals prices slows. However, a rapid fall in the AUD is not anticipated. We look for AUD to trade at 0.73 at the end of the year and 0.71 at the end of Q2 2007. We favour expressing a bullish AUD view vis a vis the NZD, forecasting AUD/NZD to 1.24 by year end and 1.2670 by mid 2007.

Indicators

	Current (Previous) *
Official cash rate	5.75% (5.75%)
Trend interest rates 10yr average	5.5%
Bias in interest rate market	Flat
CPI Inflation %Y/Y Q1 (Q4)	3.0% (2.8%)
Inflation target	2.0-3.0%
Budget balance % GDP FY04 (FY03)	0.7% (1.2%)
Budget balance target % GDP	Balanced over the business cycle
GDP Growth %Y/Y Q4 (Q3)	3.1% (2.9%)
Trend GDP %Y/Y	3.70%
Purchasing Power Parity Value Q1 (Q4)	0.6695 (0.6652)
AUD/USD end June	0.7525
Valuation	AUD/USD is overvalued
Current account balance % GDP Q4 (Q3)	-5.6% (-6.4%)
Trend current account balance % GDP	4.4%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

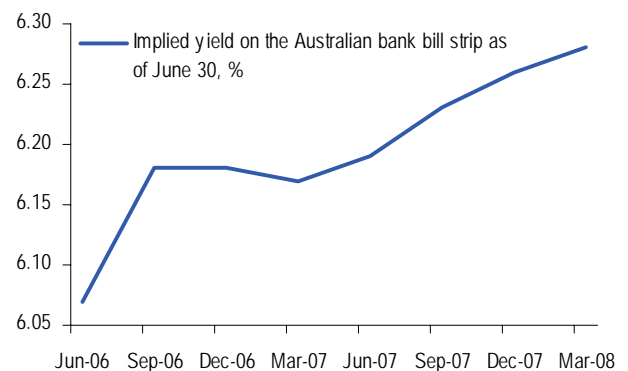
* Current is latest month, quarter or year

1. Implied yields on Australian bank bills tick higher



Source: RBC Capital Markets, RBA, Bloomberg

2. August hike 50% priced, with room to move



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
AUD/USD	0.72	0.74	0.74	0.73	0.72	0.71	0.71	0.70
EUR/AUD	1.69	1.72	1.76	1.81	1.81	1.80	1.77	1.79
AUD/JPY	84.2	85.0	81.4	78.1	75.6	75.3	74.6	73.5
AUD/CAD	0.84	0.83	0.85	0.85	0.86	0.86	0.88	0.87

New Zealand Dollar

Sue Trinh

1 – 3 Month Outlook

The RBNZ remains hawkish. Cash rates have remained unchanged at 7.25% thus far in 2006 after 200bp of tightening in 2004 and 2005 with the last 25bp hike in December 2005. In the June Monetary Policy Statement, the Bank repeated the key message from the April OCR Review that there is "no scope for an easing of the OCR this year". The inflation outlook, especially in the near term, has deteriorated further by more than they expected and this largely reflects the impact of higher oil prices and a weaker NZD. We note that neither factor is likely to disappear anytime soon and this suggests that the risks to inflation will remain for some time, if not intensify further. This will keep the RBNZ sidelined for some time and RBC do not expect the RBNZ to begin an easing cycle until Q1 next year, with the bulk of the easing cycle likely to take place in 2007-08. We expect that this will go some way to underpin the NZD's downside, and fears of a recession in NZ that dominated earlier in the year are receding fast, with the recent NBNZ Business confidence survey's own activity expectations measure nudging higher, with a net 17% of businesses expecting conditions to improve over the coming year, up from a net 10% in May. While such a reading continues to point to subdued growth over the year ahead of 1.5%-2.0%, it hardly suggests recession. Technically, 0.5920 is key support.

6 – 12 Month Outlook

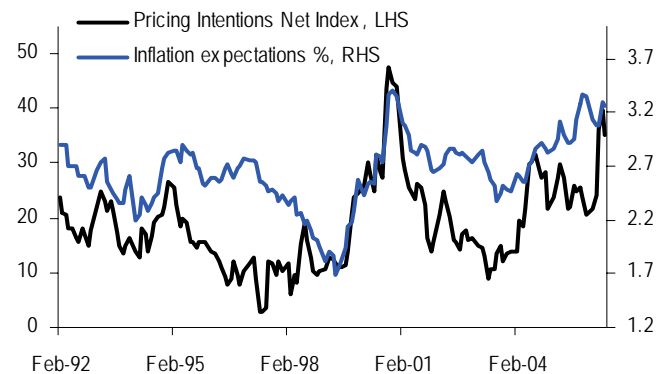
Over the next 6-12 months, the NZD is expected to weaken steadily – to 0.57 at the end of Q1 2007, and 0.56 at the end of Q2 2007. A particularly bearish development for the NZD is evident in the recent trends in the uridashi market. Not only is Japanese demand waning, with total issuance halving (JPY terms) since January, but new NZ\$ issuance is starting to fall behind replacement rates. Given the NZD's high correlation with net uridashi/eurokiwi issuance, and NZ's strong dependence on uridashi flows to fund its record current account deficit of 9.3% of GDP in Q1 (we estimate that uridashis funded 93.8% of this), the increasing maturity schedule of uridashis and eurokiwis will be bearish NZD (Figure 2), with most of the weakness expected in 2007, where the monthly average redemption is NZ\$1.4bn, compared to the monthly average of NZ\$0.85bn for the rest of 2006.

Indicators

	Current (Previous) *
Official cash rate	7.25% (7.25%)
Trend interest rates 10yr average	6.30%
Bias in interest rate market	Falling
CPI Inflation %Y/Y Q1 (Q4)	3.3% (3.2%)
Inflation target	1.0-3.0%
Budget balance % GDP FY04 (FY03)	3.0% (2.3%)
Budget balance target % GDP	Balanced over the business cycle
GDP Growth %Y/Y Q1 (Q4)	4.1% (3.8%)
Trend GDP %Y/Y	3.2%
Purchasing Power Parity Value Q1 (Q4)	0.5961 (0.5906)
NZD/USD end-Jun	0.6372
Valuation	NZD/USD is over-valued
Current account balance % GDP Q4 (Q3)	-9.3% (-8.9%)
Trend current account balance % GDP	-5.20%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

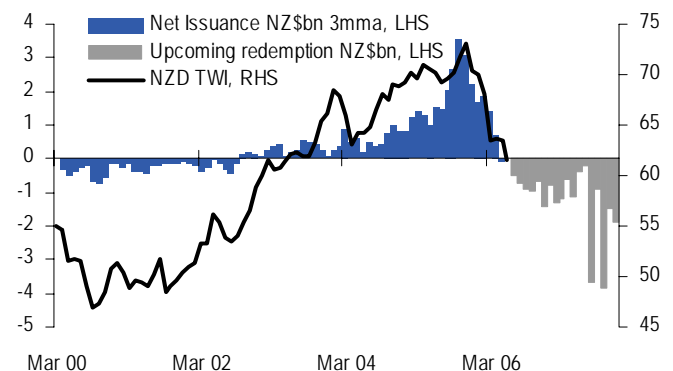
* Current is latest month, quarter or year

1. Inflation is still a problem for the RBNZ



Source: RBC Capital Markets, Bloomberg

2. Net NZ\$ offshore issuance running into negative



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
NZD/USD	0.62	0.61	0.61	0.59	0.57	0.56	0.55	0.54
EUR/NZD	1.97	2.10	2.13	2.24	2.28	2.29	2.29	2.31
NZD/JPY	72.4	69.7	67.1	63.1	59.9	59.4	57.8	56.7
NZD/CAD	0.72	0.68	0.70	0.69	0.68	0.68	0.68	0.67

South African Rand

Tania Kotsos

1 – 3 Month Outlook

The ZAR slumped by as much as 14% in June with USD/ZAR trading as high as 7.5350 (highest since January 2004). While we were long standing ZAR bears in H1, the *extent* of the sell-off reflects more the spike in risk aversion and the adjustment to global inflation risks and higher interest rates which saw the ZAR used as a proxy for global emerging markets, than it does domestic fundamentals. ZAR is oversold on fundamentals and we suggest buying ZAR against CHF and USD with a target of 5.50 (spot 5.80) and 6.65 (spot 7.12) respectively. RBC forecasts gold prices will rally back to US\$700/oz this year and to US\$800/oz in the next 12 months. Although the correlation (based on wk-on-wk % changes) between USD/ZAR and gold has fallen to just 45% from a high of 90% in March 2005, we expect this relationship to strengthen in H2. RBC's USD/ZAR fair value regression model suggests current fair value is 6.75 while the June rally saw spot move above the upper band (+2 standard deviations above fair value) for the first time in the model's history since January 2000 (see Figure 1). RBC's economists expect the Fed to pause in August and hike once more by 25bp to 5.5% in Q4. With Fed Fund futures still pricing in a 65% chance of an August rate hike despite the less hawkish FOMC statement (June 29), the further unwinding of Fed rate hike expectations is bullish for equity markets near term. Given the ZAR's pro-cyclical nature and near 60% correlation (based on wk-on-wk % changes) with MSCI World, a rebound in global equities is bullish ZAR.

6 – 12 Month Outlook

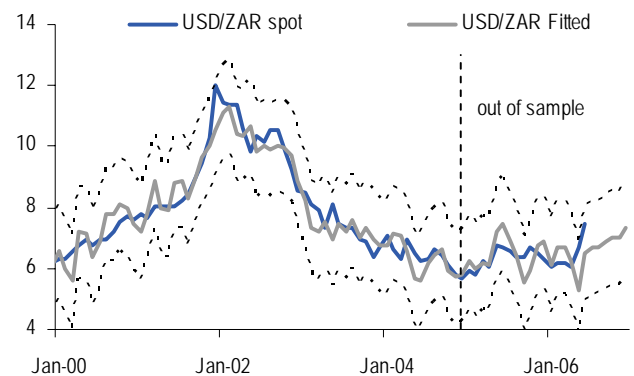
We retain our bearish USD/ZAR view through H2 and Q1 2007 as we expect SA-G10 real interest rate differentials (see Figure 2) to widen from 2.7% currently to ~3.3% based on our view that the SARB will hike rates by 50bp to 8% on August 3 and by another 100bp through 2007 and that the Fed will *cut* rates by 25bp in Q4 2007. Seasonality analysis shows USD/ZAR depreciates in November and similarly that gold prices appreciate in August through to November. The caveat to our bearish ZAR view is two-fold: US inflation risks force the Fed to hike rates to 6% and / or the SA record wide current account deficit (6.4% of GDP in Q1) deteriorates further – neither of which we expect to materialise at this stage.

Indicators

	Current (Previous) *
Official cash rate Jun (May)	7.50% (7.00%)
Trend interest rates (average since 1998)	11.32%
Bias in interest rate market	Higher
CPIX Inflation %Y/Y May (Apr)	4.1% (3.7%)
CPIX Inflation target	3.0-6.0%
Annual Budget balance % GDP FY05/06 (04/05)	-0.5% (-1.6%)
Budget balance target % GDP	Non-official 3.0% of GDP ceiling
GDP Growth %Y/Y Q1 (Q4)	4.2% (3.2%)
Trend GDP %Y/Y	3.2%
Purchasing Power Parity Value May (Apr)	7.1527 (7.1448)
USD/ZAR end-Jun	7.1640
Valuation	USD/ZAR is at fair value
Current account balance % GDP Q1 (Q4)	-4.8% (-4.2%)
Trend current account balance % GDP	-1.3%
Moody's Foreign Currency Rating	Baa1
Outlook	Stable

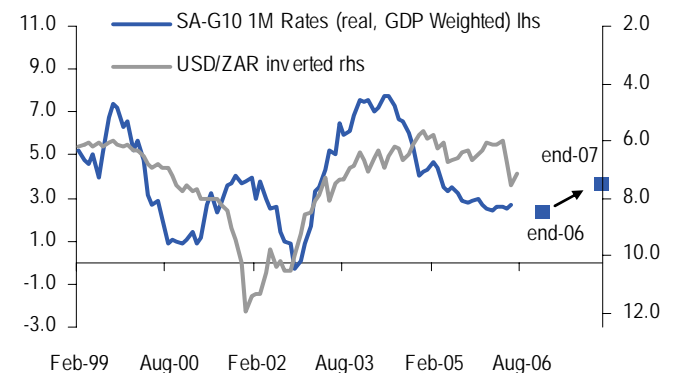
* Current is latest month, quarter or year

1. Fair-value at 6.75 – USD/ZAR “overbought”



Source: Bloomberg; RBC Capital Markets

2. S.A.-G10 1-month rate differential versus USD/ZAR



Source: Datastream; RBC Capital Markets

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/ZAR	6.15	7.16	6.65	6.50	6.45	6.30	6.20	6.50
EUR/ZAR	7.47	9.16	8.65	8.58	8.39	8.06	7.81	8.13
ZAR/JPY	19.1	16.0	16.5	16.5	16.3	16.8	16.9	16.2
GBP/ZAR	10.70	13.23	12.57	12.35	12.26	11.84	11.53	12.03

Polish Zloty

Tania Kotsos

1 – 3 Month Outlook

EUR/PLN rallied as much as 5% in June to a high of 4.1335 as the market adjusted its global rate expectations (particularly US) upwards. The 14% slump in copper prices in June and 21% fall in Polish copper giant KGHM saw the MSCI Poland index, which has a 45% correlation with EUR/PLN (based on wk-on-wk % changes), fall as much as 8% in June. Polish equities also *underperformed* Central European and eurozone equities, which partly explains PLN's underperformance relative to HUF and CZK through most of June. While our fair value regression model suggests that the EUR/PLN rally above 4.10 was warranted by the fall in Polish equities, the 0.6% rise in Polish 10-year yields and contagion from Hungary, we forecast EUR/PLN to depreciate to 3.90 in the next 1-3 months. Fed Fund futures are likely to unwind the 65% chance of the 25bp Fed rate hike priced in for August and any rebound in global or domestic equities in Q3 is bullish PLN given its pro-cyclical nature. Equities aside, Polish fundamentals remain very strong. The dismissal of FinMin Gilowska may have created a medium-term uncertainty given her replacement's (Wojciechowski) lack of political weight but it does remove the near term doubt associated with her resignation.

6 – 12 Month Outlook

PLN stands out as the fundamental winner in the region given the trend improvement in Poland's current account deficit to 1.7% of GDP (4Q rolling average) and combined portfolio and FDI flows of 6.5% of GDP. This makes PLN less vulnerable than for instance HUF to fears over the withdrawal of global liquidity going forward. Political uncertainty is never far from investors' minds but the worst is behind us (for now) and the ruling PiS government is at least showing the political will to keep on track for euro adoption in 2010. The next challenge comes in September when the 2007 budget is sent to parliament for approval. The two caveats to our bullish PLN view are 1) markets move to aggressively price in 6.0% Fed Funds and 2) a protracted fall in copper prices cause Polish equities (and so PLN) to fall further given copper giants KGHM's 15% weighting in the index. Having said this, despite the recent slump and volatility in copper, it remains the top performing commodity, up 61% year-to-date.

Forecasts

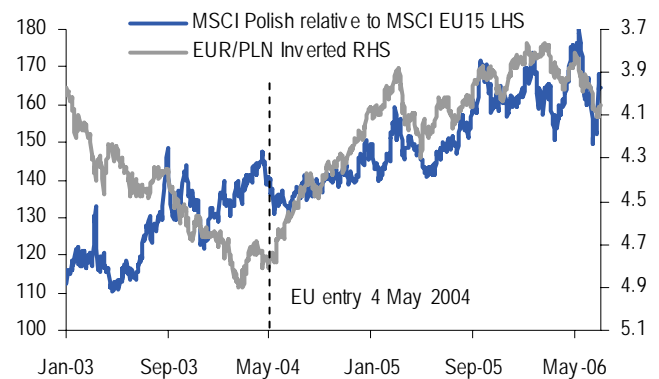
	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/PLN	3.232	3.184	2.977	2.902	2.923	3.047	3.135	3.200
EUR/PLN	3.923	4.070	3.900	3.830	3.800	3.900	3.950	4.000
PLN/HUF	67.33	69.57	69.23	69.71	69.74	67.18	67.09	66.25
PLN/CZK	7.259	7.010	7.210	7.311	7.342	7.179	7.114	7.088

Indicators

	Current (Previous) *
Official cash rate Jun (May)	4.00% (4.00%)
Trend interest rates (average since 1998)	10.75%
Bias in interest rate market	Higher
CPI Inflation %Y/Y May (Apr)	0.9% (0.7%)
Headline Inflation target	2.5% (+/- 1%)
Annual Budget balance % GDP 2005 (2004)	-5.6% (-4.5%)
Budget balance target % GDP	Below 3.0% of GDP in 2007
GDP Growth %Y/Y Q1 (Q3)	5.2% (4.2%)
Trend GDP %Y/Y	4.3%
EUR Purchasing Power Parity Value May (Apr)	4.4748 (4.4659)
EUR/PLN end-June	4.0695
EUR/PLN Valuation	EUR/PLN is undervalued
Current account balance % GDP Q1 (Q4)	-1.7% (-2.0%)
Trend current account balance % GDP	-3.0%
Moody's Foreign Currency Rating	A2
Outlook	Stable

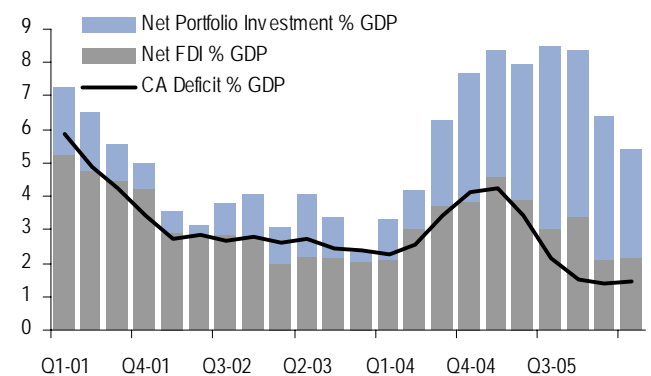
* Current is latest month, quarter or year

1. Polish relative MSCI equity performance vs EUR/PLN



Source: Bloomberg; RBC Capital Markets

2. Poland's external position bearish for EUR/PLN



Source: Datastream; RBC Capital Markets

Hungarian Forint

Tania Kotsos

1 – 3 Month Outlook

EUR/HUF rallied to a new record high of 285.15 on June 30, breaching the mid-point of its 30%-wide trading band of 282.36. Although EUR/HUF is overbought at current spot of 280.35 we have revised *up* our forecasts to 270 (from 258) by end-Q3. High-yielding currencies should rebound in the next 3 months as RBC's *Yield Appetite Thermometer* rose for the first time in 6 months in June albeit still near historic lows. Similarly, our Risk Aversion Thermometer has slipped into risk *seeking* mode for the first time since April 26. Hungary has the highest interest rates at 6.25% and the worst current account deficit at 7% of GDP (4Q rolling average) in CEE3, which suggests a return of yield and risk appetite is most bullish for the HUF. We expect the NBH to hike rates by 75bp in H2 to 7.0%. The government's new 2006-2010 programme leaves much to be desired in terms of structural reforms but nevertheless the pledge to cut the deficit to 3.0-3.5% of GDP in 2008 from an upward revise 8% in 2005 and the immediate introduction of VAT tax hikes should limit console investors. The sell-off in HUF has not been as *sharply* reflected in other Hungarian assets. Hungarian-German 10-year yield spreads have only widened 20bp since the beginning of the year while Hungary's BUX index may have erased most of the year's gains but is still up 3.5% year-to-date. This compares to the 10.2% rally in EUR/HUF over the same period and we expect part of the speculative rally in EUR/HUF to unwind in H2.

6 – 12 Month Outlook

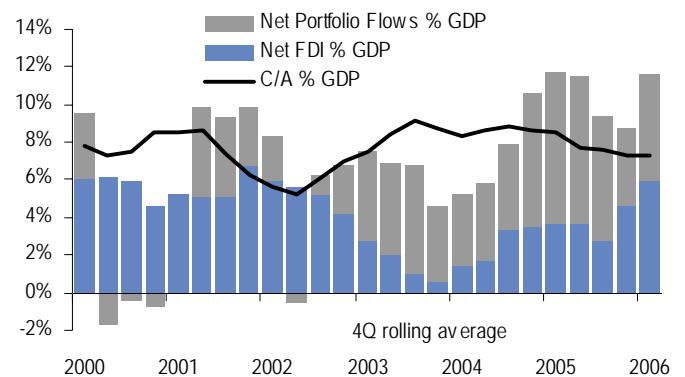
The longer term picture depends on the fiscal front. The 2006 upward revised 8% of GDP target (prior 6.1%) itself is likely to be overshoot and increases the risk of another downgrade from ratings agencies in H2. The days of buying emerging market assets indiscriminately are over given the tightening in global liquidity conditions witnessed so far this year with G7 real rates forecast to rise to 1.7% by end-2006 from 0.9% currently and a period of *negative* real rates from 2003 to 2004. Although we expect EUR/HUF to depreciate from current overbought levels, downside should be limited to around 265. Our analysis shows HUF is a counter cyclical currency, suggesting higher U.S. 10-year yields and a rebound in global equities is generally a negative background for HUF. Having said this, EUR/HUF has significantly overshoot levels warranted by the rise in US yields.

Indicators

	Current (Previous) *
Official cash rate Jun (May)	6.25% (6.00%)
Trend interest rates (average since 1997)	15.4%
Bias in interest rate market	Higher
CPI Inflation %/Y/Y May (Apr)	2.8% (2.3%)
Inflation target	3% medium term target
Annual Budget balance % GDP 2005 (2004)	-6.1% (-5.3%)
Budget balance target % GDP	3.0-3.5% in 2008
GDP Growth %/Y/Y Q1 (Q4)	4.6% (4.3%)
Trend GDP %/Y/Y	4.2%
EUR Purchasing Power Parity Value May (Apr)	308.50 (306.36)
EUR/HUF end-June	283.21
EUR/HUF Valuation	EUR/HUF is undervalued
Current account balance % GDP Q1 (Q4)	-7.4% (-7.5%)
Trend current account balance % GDP	-7.6%
Moody's Foreign Currency Rating	A1
Outlook	Negative

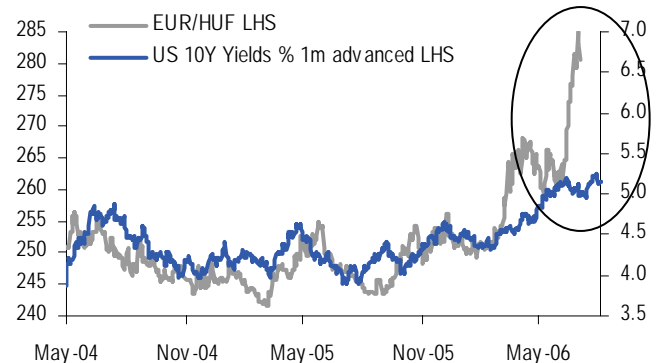
* Current is latest month, quarter or year

1. Hungary's balance of payments



Source: RBC Capital Markets; Bloomberg

2. Higher U.S. 10Y yields limits EUR/HUF downside



Source: Datastream; RBC Capital Markets

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/HUF	217.6	221.5	206.1	202.3	203.8	204.7	210.3	212.0
EUR/HUF	264.1	283.2	270.0	267.0	265.0	262.0	265.0	265.0
PLN/HUF	67.33	69.57	69.23	69.71	69.74	67.18	67.09	66.25
CZK/HUF	9.276	9.924	9.602	9.536	9.498	9.357	9.431	9.347

Czech Koruna

Tania Kotsos

1 – 3 Month Outlook

RBC retains its moderately bullish CZK view despite the EUR/CZK rally to a high of 28.5820 on June 21 on contagion from elsewhere in CEE as well as political uncertainty. CZK is the world's second best performing currency, up 11% against the USD and 2.5% against EUR year-to-date. EUR/CZK should depreciate to 28.12 in the next 3 months thanks to strong FDI flows (7.5% of GDP, 4Q ma), record high GDP growth (7.4% Q1), a healthy trade surplus since January 2005, the trend improvement in the current account deficit (2.6% of GDP, 4Q ma) and a budget surplus of CK7.6bn in the period January-June. While the widening in the *negative* CZK-EUR rate differential to 75bp has not been a driver of EUR/CZK this year, our forecast that the CNB should *hike* rates by 25bp to 2.25% as early as August, supports our bullish CZK view. Moreover, the end may be in sight for political uncertainty as outgoing PM Paroubek said the Social Democrats (CSSD) would support a Civic Democrats (ODS) led coalition under certain conditions, suggesting policy orientation should stick to a pro-euro path. This is a welcome change to the prospect of early elections as the leftist and centre-right parties hold 100 seats each in the 200-seat parliament. ODS chief Topolánek has said the CSSD would be offered the house chairmanship on the condition they support the new government. Nevertheless, Paroubek and Topolánek remain divided on the ODS proposal for a flat tax rate and the privatisation of public services and the pension system.

6 – 12 Month Outlook

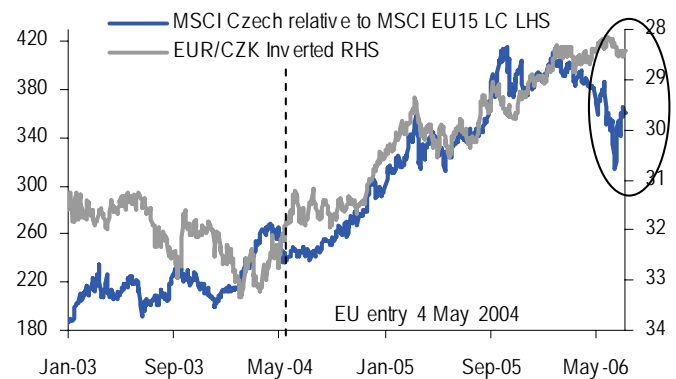
We highlight two fundamental risks to our bearish EUR/CZK view through the remainder of the year. First, a protracted political deadlock as the new cabinet must be approved by a simple majority of the lower house of parliament. If after three straight votes of confidence the new cabinet is not elected, the President must call for new elections within 60 days. So far the first vote to elect a speaker of parliament has failed with the next on July 7. The second risk is the CZK's vulnerability to a dry up in FDI flows (record US\$11bn in 2005), which have in fact fallen for three straight quarters to just 2.5% of GDP in Q1 but this has not (yet) been reflected in the 4-quarter rolling average figure given the huge 17.8% FDI seen in Q2 last year. This risk is exacerbated by portfolio *outflows* for four straight quarters.

Indicators

	Current (Previous) *
Official cash rate Jun (May)	2.00% (2.00%)
Trend interest rates (average since 1995)	6.40%
Bias in interest rate market	Higher
CPI Inflation %Y/Y May (Apr)	3.1% (2.8%)
Headline Inflation target	3% point target
Annual Budget balance % GDP 2005 (2004)	-2.6% (-3.0%)
Budget balance target % GDP	Below 3% of GDP in 2008
GDP Growth %Y/Y Q1 (Q4)	7.4% (6.9%)
Trend GDP %Y/Y	2.8%
EUR Purchasing Power Parity Value May (Apr)	35.977 (35.91)
EUR/CZK end-June	28.5260
EUR/CZK Valuation	EUR/CZK is undervalued
Current account balance % GDP Q1 (Q2)	-2.6% (-2.0%)
Trend current account balance % GDP	-4.5%
Moody's Foreign Currency Rating	A1
Outlook	Positive

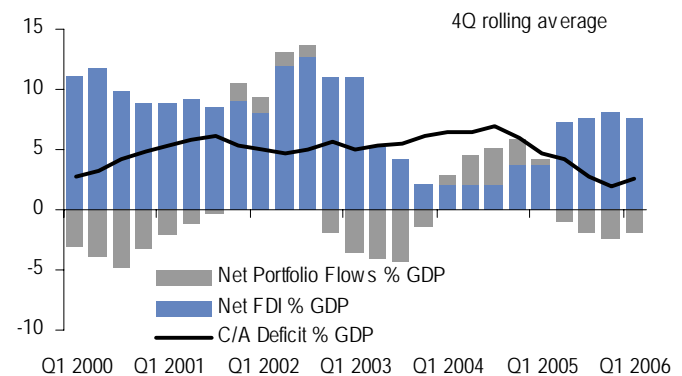
* Current is latest month, quarter or year

1. EUR/CZK "ignores" fall in Czech equities



Source: Bloomberg; RBC Capital Markets

2. FDI flows the cornerstone of CZK strength



Source: Datastream; RBC Capital Markets

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CZK	23.46	22.32	21.47	21.21	21.46	21.88	22.30	22.68
EUR/CZK	28.47	28.53	28.12	28.00	27.90	28.00	28.10	28.35
PLN/CZK	7.259	7.010	7.210	7.311	7.342	7.179	7.114	7.088
CZK/HUF	9.276	9.924	9.602	9.536	9.498	9.357	9.431	9.347

Chinese Yuan

Sue Trinh

1 – 3 Month Outlook

During the month, the People's Bank of China (PBOC) announced that it would raise its required reserve ratio for commercial lenders by 0.5%, to 8.0%, effective from 5 July. The move represents one of a series of measures being taken by the Chinese authorities to slow the growth of investment. Indeed, the investment boom in China shows little sign of abating. Urban fixed asset investment growth accelerated further, to 30.3%/y in January-May (+29.6% in Jan-Apr), and represents 38.95% of GDP for Q1. Meanwhile, real estate investment growth has edged higher after bottoming in February at 17.72%/y to 19.86%/y in April. Against this backdrop, further policy tightening by the PBOC will be needed. However, any rise in the lending rates will again be lagged by that in the savings rates so as to support private consumption (Figure 1). USD/CNY has weakened steadily through the month of June by 0.4% and we expect this trend to continue. Our end Q3 forecast is 7.80.

6 – 12 Month Outlook

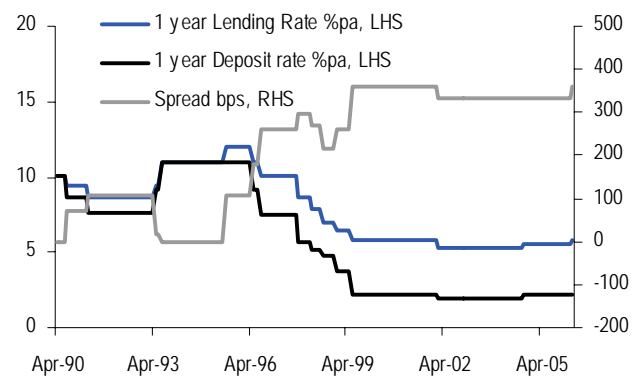
Even as the Chinese authorities have allowed greater flexibility in the CNY, they are using but a fraction of the flexibility that they could use within the current system (+/- 0.3% per day) (Figure 2). PBOC Governor, Zhou Xiaochuan, has reiterated that China will continue to allow the market to play an increasingly important role in determining the CNY exchange rate, but this will be a gradual process. China's monthly trade surplus was again higher than expected in May at US\$13.0bn (consensus: US\$12.0bn). On a 12 month moving sum basis, the trade balance has jumped to a new record high of nearly \$128bn, and underscores the risk of further trade tensions. The PBOC are expected therefore to increase the pace of CNY appreciation in response to expected renewed protectionist pressures in the run up to the US mid-term elections in November. Our end Q4 forecast is for USD/CNY to trade to 7.60, which is slightly more bullish than current Chinese NDFs at 7.86.

Indicators

	Current (Previous) *
Base lending rates 1 yr	5.85% (5.85%)
Trend interest rates 10yr average	7.50%
Bias in interest rate market	Rising
CPI Inflation %Y/Y May (April)	1.4% (1.2%)
Inflation target	-
Budget balance % GDP FY04 (FY03)	-2.3% (-2.8%)
Budget balance target % GDP	-
GDP Growth %Y/Y Q1 (Q4)	10.3% (9.9%)
Trend GDP %Y/Y	9.00%
Purchasing Power Parity Value May (Apr)	7.67 (7.70)
USD/CNY end-June	7.9943
Valuation	USD/CNY is overvalued
Current account balance % GDP CY04 (CY03)	10.1% (4.6%)
Trend current account balance % GDP	2.00%
Moody's Foreign Currency Rating	A2
Outlook	Stable

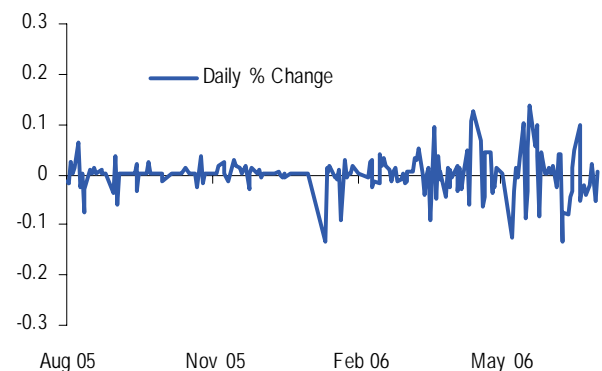
* Current is latest month, quarter or year

1. Further policy tightening ahead, deposit rates to lag



Source: RBC Capital Markets, Bloomberg

2. Flexibility in CNY still just a fraction of that permitted



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CNY	8.02	7.99	7.80	7.60	7.50	7.50	7.30	7.30
EUR/CNY	9.7	10.2	10.1	10.0	9.8	9.6	9.2	9.1
CNY/JPY	14.7	14.3	14.1	14.1	14.0	14.1	14.4	14.4
CAD/CNY	6.87	7.18	6.78	6.50	6.30	6.20	5.89	5.89

Hong Kong Dollar

Sue Trinh

1 – 3 Month Outlook

USD/HKD has moved further away from the lower band of the permitted 7.75-7.85 range through June in line with the broad USD strength over the past month. We envisage no amendments to the currency board in the short term, with the HKMA continuing to downplay possible convergence between the CNY and HKD. Instead, the HKMA have maintained that the peg to the USD will remain in place, with a change only when the CNY becomes fully convertible on the capital account. But spot USD/HKD is likely to remain close to the bottom of the permitted trading band as pressure for a further CNY revaluation intensifies.

6 – 12 Month Outlook

CPI continues to trend higher, while the labour market is also a source of increasing inflationary pressure. The unemployment rate fell below 5% to 4.9% in May for the first time in nearly 5 years (Figure 1) which will also help to sustain consumer confidence and buoy spending, with positive ramifications for the residential construction industry and government property sales despite the restraining impact of rising interest rates.

Despite Hong Kong's exports falling for the first time in four years in May by 0.1%/y (from +9.4%/y), it is still too early to conclude whether a slowdown in Hong Kong's export growth is evident. Much of the decline in May was due to a base effects since textile exports jumped in May 2005 due to anticipation of quotas imposed on China's textiles by the US and EU. Nonetheless, a sharp slowdown in China, while not our central forecast, remains a key risk for Hong Kong (Figure 2), and one worth monitoring.

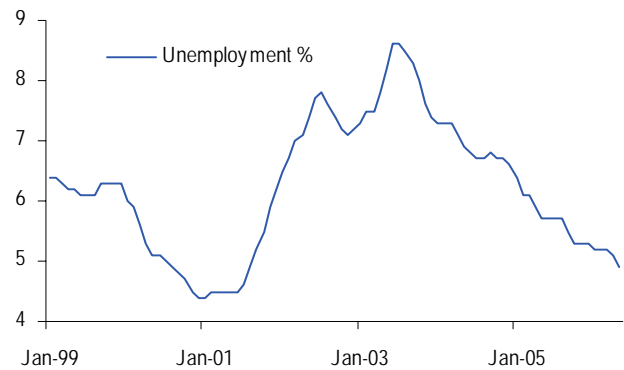
Increased integration between China and Hong Kong and the geographic proximity means Hong Kong has the most to benefit from China's QDIIP (Qualified Domestic Institutional Investors Program) which allows Chinese institutions to invest overseas. In 2007, a small downward adjustment of the central USD/HKD parity, following a year of further USD/CNY depreciation is expected. Our central forecasts continue to reflect this, with a 12 month projection of 7.50.

Indicators

	Current (Previous) *
Cash rate %	As required to peg USD/HKD
Trend interest rates 10yr average	same as the USD
Bias in interest rate market	Rising
CPI Inflation %Y/Y May (April)	2.1% (1.9%)
Inflation target	-
Budget balance % GDP FY04 (FY03)	-4.9% (-3.3%)
Budget balance target % GDP	-
GDP Growth %Y/Y Q1 (Q4)	8.2% (7.5%)
Trend GDP %Y/Y	3.5-4.0%
Purchasing Power Parity Value May (Apr)	6.2274 (6.2522)
USD/HKD end-June	7.7670
Valuation	USD/HKD is overvalued
Current account balance % GDP Q1 (Q4)	11.4% (11.4%)
Trend current account balance % GDP	8.00%
Moody's Foreign Currency Rating	A1
Outlook	Stable

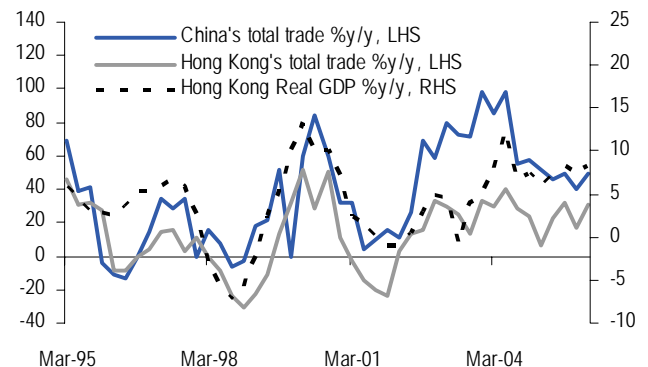
* Current is latest month, quarter or year

1. Labour market increasing source of inflation pressure



Source: RBC Capital Markets, Bloomberg

2. Slowing in China remains a key risk for Hong Kong



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/HKD	7.760	7.767	7.775	7.775	7.600	7.500	7.300	7.300
EUR/HKD	9.420	9.930	10.108	10.263	9.880	9.600	9.198	9.125
HKD/JPY	15.14	14.74	14.15	13.76	13.82	14.13	14.38	14.38
CAD/HKD	9.057	8.652	8.941	9.097	9.044	9.075	9.052	9.052

Singaporean Dollar

Sue Trinh

1 – 3 Month Outlook

USD/SGD has strengthened modestly through June, registering a gain of 2%. We view the move from 9½ year lows in May at 1.5597 as being a correction before resuming the overall downtrend in line with USD/Asia. Industrial data points to a moderation in growth through Q2. For April and May, industrial production rose 6.7%/y. This compares to 20.2%/y in Q1 and 14.5%/y in Q4. There was a slight moderation in electronics to 8.6%/y in May (from 9.0%/y in April). Mitigating this somewhat has been the improvement in the purchasing managers' index. After dropping below 50 to 49.6 in March, the April index improved to 50.4 and the May index came in at 52.3. Non-oil domestic exports have been strong, while in early June, the US Semiconductor Industry Association raised its 2006 forecasts for global chip sales to 9.8% from 7.9% in February. However, with inflation tapering off despite high oil prices (Figure 1), we expect the MAS to maintain its policy of modest and gradual appreciation of the SGD at the October policy meeting. We remain bearish USD/SGD over the next 3 months, and forecast USD/SGD to trade to 1.56 by the end of Q3. We estimate that the SGD is 1.2% expensive to the mid point of the basket range, and see scope for the SGD to weaken against the policy basket.

6 – 12 Month Outlook

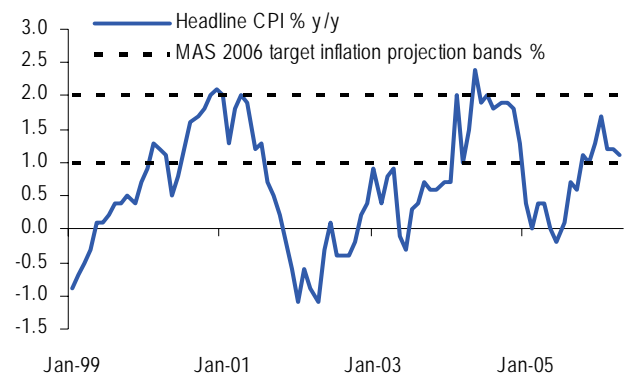
Expected slowing in the US poses a risk to Asia, but with strong growth momentum in China, India, Japan and South Korea supported by growth of domestic demand, the impact of a U.S slowdown on Asian growth should be relatively modest. In any case, it should be noted that Singapore's trade exposure is much more geared to Asia. For the year ended May 2006, 11.26% of Singapore's non-oil exports went to China, while 50.1% went to Asia (including Japan). This contrasts with the US, which only accounted for 16.6% of Singapore exports. As such, Singapore is well positioned to weather the expected slowing in the US in the second half of 2006. We also note that Singapore has steadily increased its dependency on non-electronic exports. Last year, 52% of exports were non-electronics from 48% two years ago. Moreover, greater CNY appreciation will presage a general strengthening trend among Asian currencies. We forecast USD/SGD to trade to 1.56 in Q3 and 1.54 by year end.

Indicators

	Current (Previous) *
Official S\$NEER Target	Modest & gradual appreciation
Trend interest rates 10yr average	-
Bias in interest rate market	-
CPI Inflation %Y/Y April (March)	1.1% (1.2%)
Inflation target	-
Budget balance % GDP FY04 (FY03)	3.7% (5.0%)
Budget balance target % GDP	-
GDP Growth %Y/Y Q1 (Q4)	10.6% (8.7%)
Trend GDP %Y/Y	4.90%
Purchasing Power Parity Value May (Apr)	1.4220 (1.4319)
USD/SGD end-Jun	1.5834
Valuation	USD/SGD is overvalued
Current account balance % GDP Q4 (Q3)	30.8% (29.9%)
Trend current account balance % GDP	15-20%
Moody's Foreign Currency Rating	Aaa
Outlook	Stable

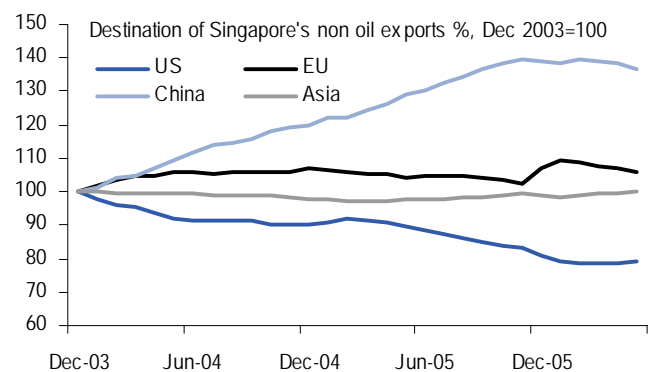
* Current is latest month, quarter or year

1. Benign inflation calls for unchanged MAS policy



Source: RBC Capital Markets, MAS, Bloomberg

2. Importance of US trade has declined



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/SGD	1.62	1.58	1.56	1.54	1.54	1.53	1.53	1.52
EUR/SGD	1.96	2.02	2.03	2.03	2.00	1.96	1.93	1.90
SGD/JPY	72.7	72.3	70.5	69.5	68.2	69.3	68.6	69.1
CAD/SGD	1.38	1.42	1.36	1.32	1.29	1.26	1.23	1.23

South Korea Won

Sue Trinh

1 – 3 Month Outlook

After pausing for three meetings in March, April and May, the BoK hiked rates unexpectedly by 25bps on June 8, taking the overnight call rate to 4.25%. This is the highest since 2003, and the fourth rate increase in 9 months. Even as CPI tracks below the Bank of Korea's 2.5%-3.5% target band, with the core rate at 2.0%/y sa, subsequent stabilisation in the currency and strong house price inflation were behind the Bank of Korea's early June tightening (Figure 1).

Consumer confidence has peaked and has been plummeting since the start of the year. The National Statistics Office's Consumer Sentiment Indicator fell in to 98 in May from 100.6 in April. The weakening in consumer sentiment is also reflected in retail sales, which have also been trending downwards since January, while service sector output is turning lower (Figure 2). Further softening in growth due to the lagged effects of the BoK's tighter monetary regime should be a drag on the KRW. Acting as a slight offset to this is the still healthy state of external demand. After stalling at 3.6%/y in January, Korean exports have recovered strongly to 20.3%/y, despite the appreciation in the KRW over this period. The outlook for the global electronics cycle also looks firm, with the Semiconductor Industry Association upgrading its 2006 forecast for global chip sales to US\$249.6bn, which is up 9.8% from 2005.

6 – 12 Month Outlook

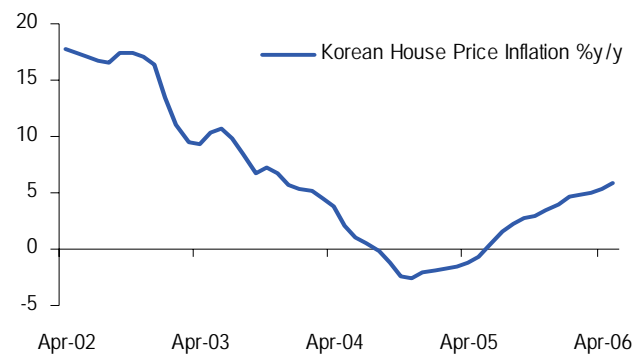
Our core view remains one in which Asia will be a key beneficiary of the next phase of USD weakness, but the KRW's proxy status for bullish Asian plays is over. Further KRW appreciation, especially against other Asian currencies will be restrained by further vigorous intervention by the Bank of Korea. We note that foreign exchange reserves continue to rise, and in May rose to a record high US\$224.7bn (9.02%/y). As such, while we forecast USD/KRW to trade to 920.00 by year-end, KRW should underperform on a cross basis, particularly versus the JPY. We would buy dips in the latter at 8.00 to position for a move in JPY/KRW to 8.35/8.40 by year end.

Indicators

	Current (Previous) *
Official cash rate May (April)	4.25% (4.00%)
Trend interest rates 5yr average	3.85%
Bias in interest rate market	rising
Core CPI Inflation %Y/Y May (April)	2.4% (2.0%)
Inflation target	2-4%
Budget balance % GDP CY04 (CY03)	1.0% (2.8%)
Budget balance target % GDP	-
GDP Growth %Y/Y Q1 (Q4)	6.1% (5.3%)
Trend GDP %Y/Y	5.00%
Purchasing Power Parity Value May (Apr)	1107.2 (1110.8)
USD/KRW end-Jun	948.70
Valuation	USD/KRW is under valued
Current account balance % GDP Q4 (Q3)	0.50% (0.69%)
Trend current account balance % GDP	2.50%
Moody's Foreign Currency Rating	A3
Outlook	Positive

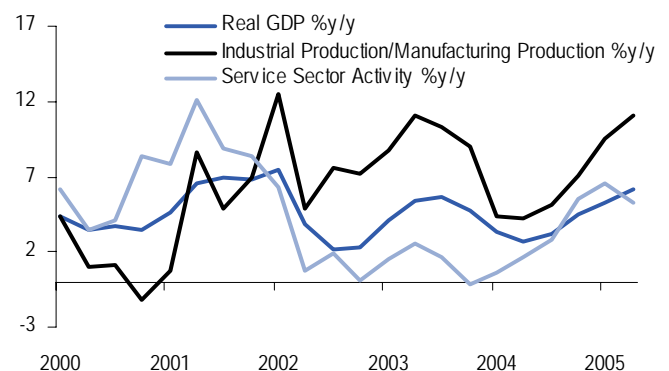
* Current is latest month, quarter or year

1. House price inflation the reason for tighter BoK policy



Source: RBC Capital Markets, Bloomberg

2. But Service sector activity softening



Source: RBC Capital Markets, Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/KRW	971.7	948.7	940.0	920.0	900.0	900.0	890.0	880.0
EUR/KRW	1179.5	1212.9	1222.0	1214.4	1170.0	1152.0	1121.4	1100.0
JPY/KRW	8.269	8.288	8.545	8.598	8.571	8.491	8.476	8.381
CAD/KRW	832.5	851.6	817.4	786.3	756.3	743.8	717.7	709.7

Mexican Peso

Paul Biszko

1 – 3 Month Outlook

The MXN's initial reaction to July 2's presidential election result has been bullish, with USD/MXN selling off 1.7% to 11.15, as the market was positioned for a victory by leftist Lopez Obrador (AMLO), a scenario that does not look very likely at present though still cannot be entirely discounted. With 98% of votes counted, independent polls show the market's preferred right-of-center candidate Calderon (PAN) ahead by a very tight 1.1% margin (36.4% vs. 35.3%). However, AMLO has refused to concede defeat and is already vowing to contest the vote outcome if it still goes against him following a recount, the result of which is due July 6. Our base case scenario is a narrow loss by AMLO, which he contests, requiring the Supreme Court to step in and take a final ruling on the election outcome. As this could take up to 2 months, market uncertainty is likely to remain elevated for weeks / months, posing upside risks to USD/MXN. The key wildcard now is how AMLO will react if he is confirmed as the loser; our view is that he is unlikely to back down and it will be pivotal to see if he calls his supporters to the streets, a potential source of destabilizing social unrest. Aside from lingering political risk, the MXN will not be immune from a potential second wave of global risk-reduction / de-leveraging, given the tightness of the U.S.-Mexico rate differential. We revise higher our USD/MXN forecasts to 11.20 in 06Q3 and 11.30 in Q4.

6 – 12 Month Outlook

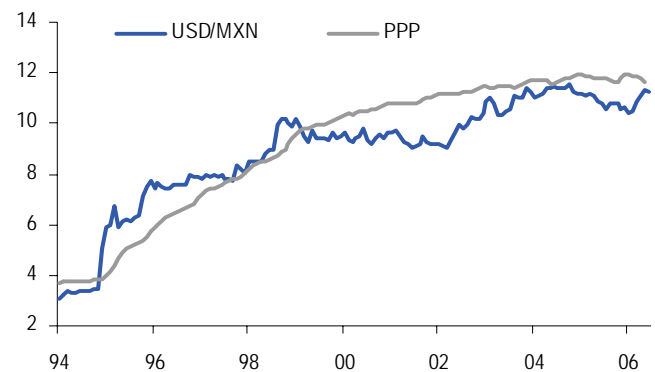
If AMLO is eventually named Mexico's president, concerns over structural reform gridlock, fiscal slippage, central bank independence and a weak peso policy could resurface, posing a medium-term competitiveness challenge for Mexico. However, a radical shift in economic policy is not expected, given a split Congress and the country's strengthened institutional framework and fundamentals. If Calderon is confirmed president, the outlook for structural reform may improve. The economy rebounded strongly in Q1 (5.5%/y), riding a recovery in U.S. import demand. However, with over 85% of its exports going to the US, Mexico is particularly exposed to a sharper-than-expected slowdown in the US. Given a still potentially noisy political transition in Mexico and our expectation that U.S. yields will remain above 5%, USD/MXN is forecast to trend higher towards 11.60 in 2007.

Indicators

	Current (Previous) *
Official cash rate (Overnight funding rate)	7% (7%)
Trend interest rates 7y average	9.4%
Bias in interest rate market	Stable
CPI Inflation %Y/Y May (Apr)	3% (3.2%)
Inflation target	3.0%+/-1%
Budget balance % GDP FY05 (FY04)	-0.1% (-0.3%)
Budget balance target % GDP	-0.1%
GDP Growth %Y/Y 06Q1 (05Q4)	5.5% (2.7%)
Trend GDP %Y/Y	3.6%
Purchasing Power Parity Value May (Apr)	11.6524 (11.7626)
USD/MXN end-June	11.2440
Valuation	USD/MXN is undervalued
Current account balance % GDP FY05 (FY04)	-0.7% (-1.1%)
Trend current account balance % GDP	-2.1%
Moody's Foreign Currency Rating	Baa1
Outlook	Stable

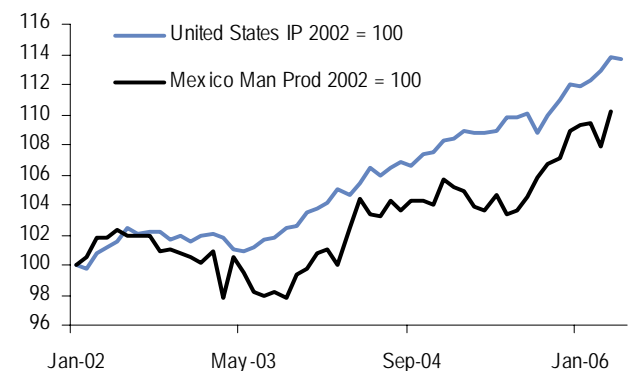
* Current is latest month, quarter or year

Mexican Peso PPP versus the USD



Source: Global Insight and RBC Capital Markets

Mexico manufacturing output vs. U.S. IP



Source: Banxico, U.S. Federal Reserve

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/MXN	10.90	11.24	11.20	11.30	11.38	11.45	11.53	11.60
EUR/MXN	13.23	14.38	14.56	14.92	14.79	14.66	14.52	14.50
MXN/JPY	10.78	10.18	9.82	9.47	9.23	9.26	9.11	9.05
CAD/MXN	9.339	10.093	9.739	9.658	9.559	9.463	9.294	9.355

Brazilian Real

Paul Biszko

1 – 3 Month Outlook

The BRL was the top performing higher-yielding EM currency in June, rallying 4% against USD, partially reversing May's 10% slide. A slew of positive news flow, including a stronger-than-expected 3.4% y/y 06Q1 GDP print, a stable April current account surplus, a new \$1.1 external debt buy-back and a Fitch credit rating upgrade to BB, all helped to underpin the prevailing view that Brazil's fundamentals are still on a stable-to-improving path and the country is better shielded to confront a deeper global risk re-pricing than in 2002. Our view is that so long as the market continues to discriminate between improving / deteriorating EM fundamentals in the face of a sustained negative external backdrop, the BRL is likely to remain relatively resilient thanks to still high double-digit interest rates (even after a forecast 50bp in additional easing this year to 14.75%) and a steady current account surplus and foreign direct investment inflows. Nonetheless, being the EM high-beta proxy, the BRL remains vulnerable to a second wave of indiscriminate investor risk-reduction and / or de-leveraging, possibly triggered by a more hawkish Fed. We retain our call for USD/BRL to rise to the 2.40 to 2.50 range in 2006-H2, as global investor risk appetite continues to gradually wane amid tighter liquidity and local political jitters heighten in the run-up to October's presidential election. Internally, we see risks that the market may begin to question the viability of the status quo being sustained during a probable Lula 2nd term, given a more fractious Congress, uncertainty over who will serve as FinMin and a possibly more adverse external backdrop.

6 – 12 Month Outlook

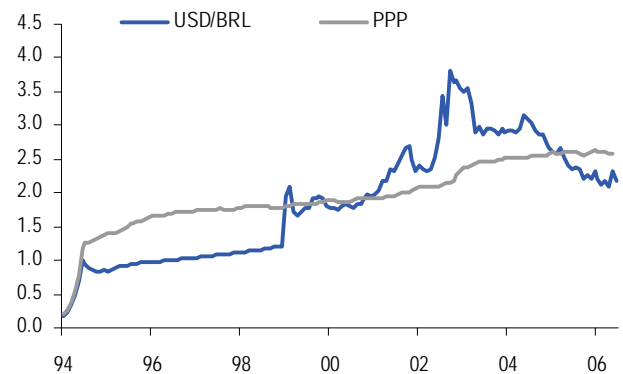
Brazil's solid fundamentals: tight fiscal policy, improving government debt, a current account surplus and a de-leveraged private sector should cap gains in USD/BRL this year. However, Brazil's reliance on volatile external financing makes it particularly vulnerable to rising US interest rates and USD/BRL is expected to rise as US 10-year yields rise to 5.85% by year-end. We expect the back up in U.S. yields will push USD/BRL up into a 2.40-2.50 range, but further gains in USD/BRL are unlikely unless there are Brazil-specific shocks. Presidential elections in October 2006 may increase volatility in Brazilian FX, equity and debt markets in the coming quarters.

Indicators

	Current (Previous) *
Official cash rate (SELIC)	15.25% (15.75%)
Trend interest rates 7y average	20%
Bias in interest rate market	Falling
CPI Inflation (IPCA) %Y/Y May (Apr)	4.2% (4.6%)
Inflation target	4.5%
Budget balance % GDP FY05 (FY04)	-3.3% (-2.7%)
Budget balance target % GDP	-
GDP Growth %Y/Y 06Q1 (05Q4)	3.4% (1.4%)
Trend GDP %Y/Y	2.2%
Purchasing Power Parity Value May (Apr)	2.5829 (2.5923)
USD/BRL end-June	2.1645
Valuation	USD/BRL is undervalued
Current account balance % GDP May (Apr)	1.5% (1.5%)
Trend current account balance % GDP	-2.1%
Moody's Foreign Currency Rating	Ba3
Outlook	Positive

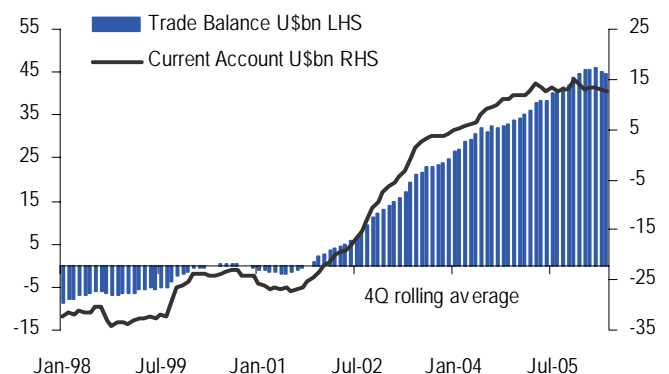
* Current is latest month, quarter or year

Brazilian Real PPP versus the U.S. Dollar



Source: Global Insight and RBC Capital Markets

Brazil's Current Account and Trade Balance



Source: Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/BRL	2.17	2.16	2.40	2.50	2.55	2.60	2.65	2.70
EUR/BRL	2.64	2.77	3.12	3.30	3.32	3.33	3.34	3.38
BRL/JPY	54.1	52.9	45.8	42.8	41.2	40.8	39.6	38.9
CAD/BRL	1.86	1.94	2.09	2.14	2.14	2.15	2.14	2.18

Chilean Peso

Paul Biszko

1 – 3 Month Outlook

A 10% drop in copper prices coupled with broad volatility and weakness in emerging market (EM) currencies pushed USD/CLP over 3.5% higher to 545 in June, making the CLP one of the worst-performing EM currencies aside from HUF, PLN, ZAR and TRY against USD. As we noted last month, the evolution of copper prices will remain the currency's main driver in the near and medium term, as copper now accounts for almost 55% of total exports. RBC is of the view that the current correction in copper is not over yet and forecasts copper prices to decline by another 11% in 2006 to \$2.9 per lb (from the current \$3.25 per lb) followed up by a 14% fall in 2007 to \$2.5 per lb, as global copper demand / supply is re-balanced. Downward trending copper prices are likely to keep USD/CLP moving higher and we have upwardly revised our 06Q3 and Q4 forecasts to 545 and 560, respectively. The BCCh remained on hold in June keeping its overnight target rate stable at 5%, an expected decision after a disappointing +2.8% y/y April economic activity index print. Nonetheless, the BCCh affirmed that its pause decision "doesn't alter the (central bank) governing council's view that, under the most likely scenario, additional increments to the interest rate will be necessary in coming months". This is in line with our expectation of an additional 25bp to 50bp in rate hikes in the remainder of 2006 and a 25bp July rate hike is likely, especially if the Fed hikes in June. If the BCCh does not keep pace with the U.S. Fed, we could see greater pressure on the CLP.

6 – 12 Month Outlook

Chilean GDP decelerated mildly to 5.1%/y/y in Q1 after expanding 6.3% y/y in 2005, the fastest pace in eight years. A continuation in rapid capital investment growth, which averaged 25% y/y in 2005, bodes well for the sustainability of the expansion. Meanwhile, a strong commitment to prudent monetary, fiscal and exchange rate policies coupled with improving debt dynamics will cushion CLP from a downturn in global growth. Chile is the highest rated Latin American sovereign at A/Baa1. Nonetheless, with copper prices expected to decline towards 2007 and U.S. interest rate risks skewed to the upside, USD/CLP is likely to drift higher into a 550-600 range over the next 12 to 18 months.

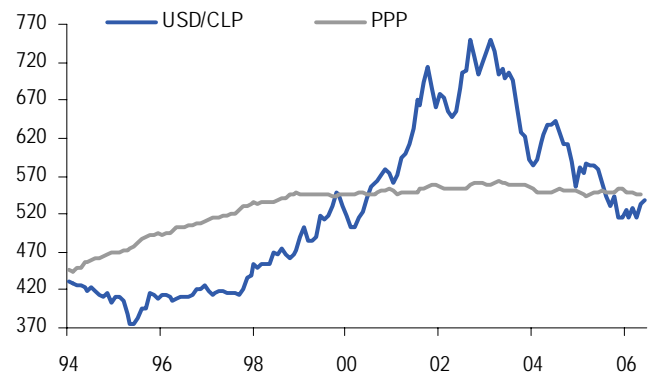


Indicators

	Current (Previous) *
Official cash rate (overnight rate)	5% (5%)
Trend interest rates 5y average	3.4%
Bias in interest rate market	Rising
CPI Inflation %Y/Y May (Apr)	3.7% (3.8%)
Inflation target	2.0%-4.0%
Budget balance % GDP FY05 (FY04)	4.8% (2.2%)
Budget balance target % GDP	1.0%
GDP Growth %Y/Y 06Q1 (05Q4)	5.1% (5.9%)
Trend GDP %Y/Y	4.3%
Purchasing Power Parity Value May (Apr)	545.4 (546.7)
USD/CLP end-June	538.6
Valuation	USD/CLP is undervalued
Current account balance % GDP FY05 (FY04)	-0.3% (1.5%)
Trend current account balance % GDP	-1.7%
Moody's Foreign Currency Rating	Baa1
Outlook	Positive

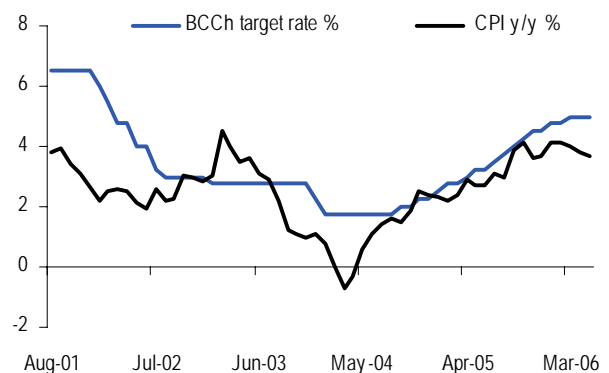
* Current is latest month, quarter or year

1. Chilean Peso PPP versus the USD



Source: Globalinsight and RBC Capital Markets

2. BCCh target rate % versus Chile CPI y/y%



Source: Bloomberg

Forecasts

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CLP	527.0	538.6	545.0	560.0	570.0	580.0	590.0	600.0
EUR/CLP	639.7	688.6	708.5	739.2	741.0	742.4	743.4	750.0
JPY/CLP	54.07	52.89	45.83	42.80	41.18	40.77	39.62	38.89
CAD/CLP	451.5	483.5	473.9	478.6	479.0	479.3	475.8	483.9

Forecasts

Forecasts								
	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
EUR/USD	1.214	1.279	1.310	1.320	1.300	1.280	1.260	1.250
USD/JPY	117.5	114.5	110.0	107.0	105.0	106.0	105.0	105.0
GBP/USD	1.739	1.847	1.890	1.900	1.900	1.880	1.860	1.850
USD/CHF	1.303	1.224	1.206	1.205	1.223	1.242	1.262	1.272
USD/SEK	7.769	7.204	6.794	6.515	6.462	6.563	6.587	6.640
USD/NOK	6.549	6.224	5.802	5.606	5.692	5.859	6.032	6.240
USD/CAD	1.167	1.114	1.150	1.170	1.190	1.210	1.240	1.240
AUD/USD	0.716	0.742	0.740	0.730	0.720	0.710	0.710	0.700
NZD/USD	0.616	0.609	0.610	0.590	0.570	0.560	0.550	0.540
USD/ZAR	6.151	7.164	6.650	6.500	6.450	6.300	6.200	6.500
USD/HUF	217.6	221.5	206.1	202.3	203.8	204.7	210.3	212.0
USD/PLN	3.232	3.184	2.977	2.902	2.923	3.047	3.135	3.200
USD/CZK	23.46	22.32	21.47	21.21	21.46	21.88	22.30	22.68
USD/CNY	8.017	7.994	7.800	7.600	7.500	7.500	7.300	7.300
USD/HKD	7.760	7.767	7.775	7.775	7.600	7.500	7.300	7.300
USD/SGD	1.616	1.583	1.560	1.540	1.540	1.530	1.530	1.520
USD/KRW	971.7	948.7	940.0	920.0	900.0	900.0	890.0	880.0
USD/MXN	10.90	11.24	11.20	11.30	11.38	11.45	11.53	11.60
USD/BRL	2.173	2.165	2.400	2.500	2.550	2.600	2.650	2.700
USD/CLP	527.0	538.6	545.0	560.0	570.0	580.0	590.0	600.0

EUR Crosses

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
EUR/USD	1.214	1.279	1.300	1.320	1.300	1.280	1.260	1.250
EUR/JPY	142.6	146.3	143.0	141.2	136.5	135.7	132.3	131.3
EUR/GBP	0.698	0.692	0.688	0.695	0.684	0.681	0.677	0.676
EUR/CHF	1.581	1.565	1.580	1.590	1.590	1.590	1.590	1.590
EUR/SEK	9.431	9.211	8.900	8.600	8.400	8.400	8.300	8.300
EUR/NOK	7.950	7.957	7.600	7.400	7.400	7.500	7.600	7.800
EUR/CAD	1.417	1.424	1.495	1.544	1.547	1.549	1.562	1.550
EUR/AUD	1.695	1.723	1.757	1.808	1.806	1.803	1.775	1.786
EUR/NZD	1.970	2.099	2.131	2.237	2.281	2.286	2.291	2.315
EUR/ZAR	7.466	9.159	8.645	8.580	8.385	8.064	7.812	8.125
EUR/HUF	264.1	283.2	270.0	267.0	265.0	262.0	265.0	265.0
EUR/PLN	3.923	4.070	3.900	3.830	3.800	3.900	3.950	4.000
EUR/CZK	28.47	28.53	28.12	28.00	27.90	28.00	28.10	28.35
EUR/CNY	9.732	10.221	10.140	10.032	9.750	9.600	9.198	9.125
EUR/HKD	9.420	9.930	10.108	10.263	9.880	9.600	9.198	9.125
EUR/SGD	1.961	2.024	2.028	2.033	2.002	1.958	1.928	1.900
EUR/KRW	1179	1213	1222	1214	1170	1152	1121	1100
EUR/MXN	13.23	14.38	14.56	14.92	14.79	14.66	14.52	14.50
EUR/BRL	2.638	2.767	3.120	3.300	3.315	3.328	3.339	3.375
EUR/CLP	639.7	688.6	708.5	739.2	741.0	742.4	743.4	750.0

Yen Crosses

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/JPY	117.5	114.5	110.0	107.0	105.0	106.0	105.0	105.0
EUR/JPY	142.6	146.3	144.1	141.2	136.5	135.7	132.3	131.3
GBP/JPY	204.3	211.4	207.9	203.3	199.5	199.3	195.3	194.3
CHF/JPY	90.20	93.49	91.20	88.83	85.85	85.33	83.21	82.55
SEK/JPY	15.12	15.89	16.19	16.42	16.25	16.15	15.94	15.81
NOK/JPY	17.94	18.39	18.96	19.09	18.45	18.09	17.41	16.83
CAD/JPY	100.7	102.8	95.7	91.5	88.2	87.6	84.7	84.7
AUD/JPY	84.17	84.96	81.40	78.11	75.60	75.26	74.55	73.50
NZD/JPY	72.42	69.74	67.10	63.13	59.85	59.36	57.75	56.70
ZAR/JPY	19.10	15.98	16.54	16.46	16.28	16.83	16.94	16.15
HUF/JPY	0.540	0.517	0.534	0.529	0.515	0.518	0.499	0.495
PLN/JPY	36.36	35.96	36.95	36.88	35.92	34.79	33.49	32.81
CZK/JPY	5.009	5.129	5.124	5.044	4.892	4.846	4.708	4.630
CNY/JPY	14.66	14.32	14.10	14.08	14.00	14.13	14.38	14.38
HKD/JPY	15.14	14.74	14.15	13.76	13.82	14.13	14.38	14.38
SGD/JPY	72.72	72.29	70.51	69.48	68.18	69.28	68.63	69.08
JPY/KRW	8.269	8.288	8.545	8.598	8.571	8.491	8.476	8.381
MXN/JPY	10.78	10.18	9.82	9.47	9.23	9.26	9.11	9.05
BRL/JPY	54.07	52.89	45.83	42.80	41.18	40.77	39.62	38.89
JPY/CLP	4.485	4.705	4.955	5.234	5.429	5.472	5.619	5.714

CAD Crosses

	2006				2007			
	Q1	Q2	Q3f	Q4f	Q1p	Q2p	Q3p	Q4p
USD/CAD	1.167	1.114	1.150	1.170	1.190	1.210	1.240	1.240
CAD/JPY	100.7	102.8	95.7	91.5	88.2	87.6	84.7	84.7
EUR/CAD	1.417	1.424	1.507	1.544	1.547	1.549	1.562	1.550
GBP/CAD	2.030	2.057	2.174	2.223	2.261	2.275	2.306	2.294
CAD/CHF	1.116	1.099	1.049	1.030	1.028	1.027	1.018	1.026
CAD/SEK	6.656	6.467	5.908	5.569	5.430	5.424	5.312	5.355
CAD/NOK	5.611	5.587	5.045	4.792	4.783	4.842	4.864	5.032
AUD/CAD	0.836	0.827	0.851	0.854	0.857	0.859	0.880	0.868
NZD/CAD	0.719	0.679	0.702	0.690	0.678	0.678	0.682	0.670
CAD/ZAR	5.270	6.431	5.783	5.556	5.420	5.207	5.000	5.242
CAD/HUF	186.4	198.8	179.2	172.9	171.3	169.2	169.6	171.0
CAD/PLN	2.769	2.858	2.589	2.480	2.456	2.518	2.528	2.581
CAD/CZK	20.10	20.03	18.67	18.13	18.03	18.08	17.99	18.29
CAD/CNY	6.869	7.176	6.783	6.496	6.303	6.198	5.887	5.887
CAD/HKD	9.057	8.652	8.941	9.097	9.044	9.075	9.052	9.052
CAD/SGD	1.384	1.421	1.357	1.316	1.294	1.264	1.234	1.226
CAD/KRW	832.5	851.6	817.4	786.3	756.3	743.8	717.7	709.7
CAD/MXN	9.339	10.093	9.739	9.658	9.559	9.463	9.294	9.355
CAD/BRL	1.862	1.943	2.087	2.137	2.143	2.149	2.137	2.177
CAD/CLP	451.5	483.5	473.9	478.6	479.0	479.3	475.8	483.9

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