Weekly Bulletin – 12th March 2007

The rally in the debt markets petered out last week as fears of a US recession subsided and the equity markets managed to regain some composure. In addition, the ECB duly raised its refinancing rate to 3.75%, while the MPC left rates on hold. As both results had been expected, the market was left to wonder whether it had not rather overdone its optimism. A feeling reinforced by President Trichet making it pretty clear that the ECB was minded to increase rates again, probably by the end of June.

Over the last two weeks there has been much discussion of 'the carry trade'. To avoid confusion and in case any readers have been taking extended breaks on the slopes, this trade refers to the borrowing of a low yielding currency – typically JPY or CHF – where 3 month rates trade at around 0.70% or 2.20% respectively, followed by the sale of the low-yielder to buy higher-yielding assets in another currency.

There are three prerequisites for carry trade opportunities: firstly, there must be a significant yield advantage between the borrowed currency and the invested currency; secondly, the borrowed currency must at least be perceived to be depreciating; and thirdly, there must exist an environment of low volatility.

There is a perception, largely put about by the press, that fund managers (of the hedge variety and otherwise) are in the habit of borrowing yen and investing in the Chinese and other equity markets and that that the 9% fall in the Chinese market on 27th February was precipitated by a rise in the value of the yen. Such an explanation is putting the cart before the horse since, on the day, as the Chinese market was hitting its lows, the USD/JPY rate remained virtually unchanged. It was only later in the day that the market started to cover short JPY positions. In fact, cross asset investment accounts for relatively low volumes compared to the truly staggering size of speculative activity contained within the foreign exchange market. Indeed, most of the JPY that has been borrowed has been invested as cash in high yielding currencies such as AUD, NZD and, to a considerable extent, GBP.

Nonetheless, in the current global investment environment, so much gearing is routinely employed that if investors rush for the exit at the same time, their escape route quickly becomes blocked, precipitating market movements which, in the context of the low volatility prevailing until two weeks ago, appear violent. That the yield advantage of borrowing in JPY and investing, for example, in GBP for a full year was recently wiped out in only 7 days, as speculators dived to cover their positions, is testament to this.

To an extent, market perception of the world has changed. High-yielders can no longer be relied on to offer high returns without the risk of capital depreciation. In reality, of course, they never could: speculators simply got away with the carry trade for so long that they became complacent in the face of high risk. Other things being equal, the pound, which has been a notable beneficiary of the market's quest for yield will, in all likelihood, continue to trade in a somewhat weaker fashion in the short to medium term.

Meanwhile the USD has been a beneficiary of the market's recent shenanigans. When unnerved, investors naturally gravitate towards the US treasury market, driving yields lower and the USD higher and the last couple of weeks have been no exception. Arguably, a factor that may contribute to further USD strength is the fact that the market is currently factoring in two 25bps cuts in the Fed funds rate before the end of the year. From Fed members, however, talk remains consistently centred on the threat of inflation and, indeed, the Fed is currently maintaining an official bias towards tightening. Against this background, we must conclude that the market is getting somewhat ahead of itself in its expectation of rate cuts and that there is more chance that it will be disappointed than fully vindicated. We would, therefore, on balance look for further USD strength rather than weakness over the coming months as expectations of lower USD interest rates are unwound.

In contrast, in the eurozone, following last week's 25 bps hike in the ECB's refinancing rate to 3.75%, the market is fully pricing in a further 25bps rise by September, much to the consternation of several French commentators. It will be fascinating to observe over the next six weeks ahead of the French presidential election the extent of the moaning generated by the ECB's continued removal of accommodation in policy. We expect a great deal of complaint about the ECB's independence damaging French industry as a result of an 'overvalued' EUR. Tensions always surface in the eurozone when Germany's economy, as now, is outperforming those of her neighbours.

Economic releases are fairly thin on the ground this week with the latest producer price indices (today), January's trade figures (tomorrow) and the latest labour market data (on Wednesday) being the only items of interest in the domestic calendar. Of these, the labour market figures will be by far the most influential. With the MPC having made fears about second round inflation through increased wage settlements one of the reasons for tightening monetary policy, the average earnings figure will be closely analysed. However, evidence to date would show that their worst fears are unlikely to be proved justified and the market is expecting the headline rate to remain unchanged at 4.0%: not a level to generate much concern, even to the MPC.

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