



## Weekly Bulletin – 10<sup>th</sup> April 2007

Markets waited with bated breath last Thursday for the MPC's base rate announcement, with the market fairly evenly split between those expecting a 25 bps hike and those anticipating no change. The return of a 'no change' decision produced a knee-jerk and very short-lived 40 pip sell-off of the GBP against the USD. The near-end short sterling futures staged only a modest 4 to 5 bp rally, suggesting that the market will now focus on May's meeting, where another 'no-change' decision would come as a considerable surprise with, therefore, the potential for a rather greater adverse impact on sterling.

Interestingly, last Wednesday in Australia, markets had taken exactly the same view after the RBA had also left rates on hold, with participants now looking for a near-certain rate rise in May. The AUD also sold off initially before rallying sharply to close stronger than before the 'no-change' announcement. When it comes to awaiting interest rate rises, it seems that, for the foreign exchange markets on both sides of the world, to travel truly is better than to arrive.

With the MPC's decision out of the way, the London-dominated foreign exchange markets focussed most of their attention on the Easter break. However, the same could not be said for participants in the US market where money and FX markets opened for a half day on Good Friday. Appropriately enough, with Europe on holiday, the US published its employment report, showing that unemployment had fallen by 0.1% to 4.4%, the lowest level since May 2001, and that the non-farm payroll had increased by 180,000 against expectations of a 130,000 increase. This was compounded by a fairly hefty upward revision in last month's figures. The news sent bond yields and short term market interest rates sharply higher, with the December 07 eurodollar contract selling off 14bps. The USD benefited from these higher yields, with the GBP/USD exchange rate dipping to 1.9634 on Friday and 1.9590 yesterday on very thin volumes.

We made the point last month that the market was somewhat ahead of itself in its expectation at the time of two US rate cuts before year end when Federal Reserve members continually state their concern about inflation rather than growth. With core US inflation running at an uncomfortably high 2.4%, last Friday's unemployment data made it significantly less likely that the Fed will cut rates. Indeed, within a month, the market has moved from fully pricing in two 25bps cuts to less than fully pricing in a single cut. With market interest rates tightening sharply, we are somewhat surprised to see the USD continuing to trade so poorly. This morning, for example, despite the tighter US interest rate environment, the London market has bid the GBP/USD

exchange rate back up to just above 1.9700, exactly the same level at which London closed last Thursday.

There is an old adage on the foreign exchanges that one should never believe anything until it is officially denied. With the USD still on the ropes, it was, therefore, somewhat unnerving last week to hear Chinese government economist, He Fan, deny that the Chinese authorities were minded to diversify their USD 1 trillion of reserves out of the USD in anything other than a gradual and cautious manner. While we still stick to our forecast that the USD will strengthen this year, a sudden diversification of Chinese reserves would have the capacity to upset our forecast totally. Indeed, it may be this worry, combined with the ongoing US sub-prime mortgage debacle that is managing to offset the recent more USD positive interest rate climate. Investors with exposure to a weaker USD should be particularly cautious if the GBP/USD exchange rate achieves a daily close above 2.0100 since, above this level, the exchange rate would threaten to explode upwards into a new trading range.

In another holiday-shortened week, the main focus will be on the ECB's meeting on Thursday. Nobody is expecting a change following the rate hike of last month, but will be looking for signs of the ECB preparing the market for another rate increase in either May or June. The economic data emerging from the major eurozone countries continues to be strong with Germany producing stronger than expected industrial production figures last week. There appears to be growing pressure on pricing which is likely to influence the ECB's future inflation forecasts.

While most think it unlikely that Thursday's meeting will be followed by President Trichet warning that 'strong vigilance' is required, which would be taken as a hike next month being a certainty, we suspect that the ECB will do little to upset the growing belief that rates will rise again in June.

This holiday-shortened week sees little in the way of new economic data in the UK with only the BRC sales survey (out tomorrow) and the latest trade figures (released on Thursday) to provide any interest. Again, the market is more likely to be influenced by events on the other side of the Atlantic where the minutes of the last FOMC meeting are released on Wednesday and the latest consumer confidence survey is announced on Friday. Nevertheless, we expect the UK market to be very quiet over this holiday period before returning for the release of a series of influential figures that will probably determine whether there is any chance of the UK avoiding a further rate hike in May.

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