



Weekly Bulletin – 8th May 2007

This week sees a 'holy trinity' of central bank monetary policy-setting committees, with the FOMC and ECB both expected to leave rates on hold – albeit with the ECB widely expected to signal a further increase of 25bps to 4% in June through a requirement for 'severe vigilance' to be maintained on inflationary pressures. In the UK, however, with a Reuters poll of 61 economists showing unanimity in forecasting a rate hike following this week's meeting, it is a question not of whether rates will increase, but by how much.

Market expectations of rate cuts by the Fed have been trimmed back of late as relatively encouraging data has come out of the States. Last Thursday, for instance, the ISM survey revealed a rise in the services index to 56.0 in April from a four year low of 52.4 in March and the USD reached a two month high against the JPY of 120.48, also coming off its all time low of 1.3682 against the EUR, hit on 27th April, to close last week at 1.3589.

Meanwhile, in the eurozone itself, industrial production data for Germany and France, due this week on Tuesday and Thursday respectively, are expected to show the rate of growth of German output increasing from 7.7% to 7.8% year on year between February and March, while that of France is expected to decline from 2.6% to a mere 1%. These numbers starkly outline the current difference in performance between the eurozone's two most significant members and, arguably, reinforce the case for the supposed neo-Thatcherite economic reforms of new President, Nicolas Sarkozy. The 'one size fits all' eurozone interest rate policy is likely to face its toughest test to date over the next few months as the ECB maintains its vigilant stance on inflationary pressures within the eurozone as a whole against a backdrop of sharply divergent economic performances across member states.

We are sometimes asked why markets assume that higher-yielding currencies will depreciate over time against those offering a lower yield, while in the short term, higher interest rates, or merely their anticipation, are usually supportive for a currency. The issue is one of timing. Although, in the long term, currencies tend to revert to an exchange rate at which the purchasing power of one currency in its own country is equivalent to the local purchasing power of another, the so-called Purchasing Power Parity (PPP) theory, the time-lags involved may run to years or even decades.

Furthermore, markets tend to overshoot upwards and downwards. In the meantime, nimble speculators are able to invest in higher-yielders through borrowing lower-yielders until such time as sentiment towards a particular currency changes – very often as a result of a change in

long term, rather than short term, inflationary expectations. In common with many other markets, sentiment on the foreign exchanges tends not to change gradually – which is why we so rarely see the smooth 'glide paths' implied by the forward markets – but, rather, tends to 'tip', leading to sharp reversals in the fortunes of one currency relative to another. Sometimes such reversals are engineered by central banks as was the case with the Plaza and Louvre accords of the 1980's, respectively to devalue and then stabilise the USD: sometimes they are a function of market activity despite the actions of central banks, as was the case with sterling's ejection from the ERM and consequent devaluation in September 1992.

For the moment, sterling is enjoying the benefit of a small, but growing, interest differential, over the USD and is trading some 23% above its estimated PPP exchange rate of around 1.6200, with a consequent, beneficial check on inflation, a 23% overvaluation of GBP/USD being equivalent to somewhat over 1% on the base rate.

Predicting when a market will 'tip', as described above, is notoriously challenging and makes the MPC's job doubly difficult. If the MPC were to tighten to the extent that the property and stock markets started to be adversely affected by higher interest rates, the foreign exchange market would almost certainly decide at some point that further tightening would be negative rather than positive for the pound. The resultant sell-off would unwind the beneficial effect of the pound's trading above the PPP exchange rate, increasing the need for further tightening as the MPC became trapped in a vicious circle. Mervyn King is fond of telling the markets that the next decade is unlikely to be as NICE (comprising Non-Inflationary Continuous Expansion) as the previous one. It is likely to be the foreign exchange market that decides how much of an understatement, if any, that turns out to be.

This week's selection of domestic economic releases, the BRC sales monitor (on Wednesday), March's industrial production and the latest trade figures (both on Thursday) are unlikely to have much of an impact on the MPC's thinking. It would appear to us that the fears of a 0.50% increase are gradually fading with the odds being in favour of the normal 0.25% hike. However, this would simply be taken as a delay, with the market assuming that the MPC will turn the screw again in August, or possibly earlier.

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