



Weekly Bulletin – 22nd January 2007

Just over a year ago, the release of the minutes of the Fed's meeting of 13th December 2005 had temporarily convinced the market that there would be no US rate rises in 2006 beyond 4.5%. In fact, there were three rises beyond this point and we were, therefore, somewhat surprised to see our forecasts of GBP/USD 1.9000 and EUR/USD 1.3000 exceeded, with GBP/USD and EUR/USD closing the year at 1.9588 and 1.3196.

Since the late 1980s, we cannot remember a time when the markets and media have been so closely aligned in their universal USD bearishness. Just before Christmas last year, many commentators were predicting, with total conviction, the inevitable advance of the GBP/USD exchange rate to the mystical level of 2.000. The price action so far this year, however, with the USD weakening sharply on the very first trading day, followed by a raft of short-covering on the back of continued healthy economic data out of the US, showed the extent to which short term speculators had already sold the greenback, and the USD's gyrations in the first three weeks of this year demonstrate the adage that 'nothing moves in a straight line'.

There remain many reasons to expect USD depreciation this year, including: the ongoing US current account deficit (though this may already have peaked); the US public sector deficit – despite President Bush's talk of reducing this to zero; persistent talk of central bank reserve diversification, particularly on the part of China; and finally, the recent sharply higher levels of confidence and activity in Germany, an economy which still exports six times more than China by value. The USD appears to be constantly 'on the ropes' as the markets throw all they can at the beleaguered reserve currency.

In the USD's struggle, however, there is something reminiscent of the 'Rumble in the Jungle', Muhammad Ali's famous 1974 fight versus George Foreman in Zaire, when Ali, having languished on the ropes for a full five rounds and having absorbed the ferocious punches of the hardest hitting boxer of the era – many say of all time – eventually started to fight back in round 6, as if he had just emerged from an afternoon nap, going on to knock out an exhausted Foreman in the eighth. It is entirely possible that, as regards the foreign exchange markets, we are coming to the end of round 5 and that the USD's recovery is about to start. Therefore, we tentatively forecast year end exchange rates for the USD of 1.8000 and 1.2600 against the pound and euro respectively, implying a EUR/GBP rate of 0.7000.

The slight GBP bearishness in our EUR/GBP forecast stems, firstly, from the political risk associated with the anticipated handover of the premiership from Tony Blair to Gordon Brown this summer and, secondly, from Mervyn King's current difficulties with inflation. While we do not doubt for a moment Mr King's mettle when it comes to

tackling inflation (and it is likely that his opinion will count more than ever on the MPC given the recent vindication of his, with hindsight, correct position following his being outvoted when rates were cut to 4.5% in August 2005), we feel that, on balance, the chances of a hard, rather than soft, landing for the UK economy have increased. At some stage this year, the market will focus on the likely impact of recent and future base rate hikes on the real economy and these worries will begin to outweigh the support that sterling currently enjoys as a result of its high yield status.

Moving now to the European scene, of all the reasons to be bearish on the USD, the one that threatens more than the rest to derail our bullish forecasts is the resurgence of Germany's economy. Since the EUR's inception in 1999, Germany has been at a disadvantage against its fellow eurozone members through having joined at a relatively strong exchange rate, in stark contrast to Italy, for example, which joined at an advantageously weak rate. The Germans, however, have stoically – or, possibly, reluctantly – accepted lower real wage growth than any other eurozone members and have succeeded in whittling away the real wage disadvantage from which the economy suffered in the EUR's earliest days. As an aside, it is instructive to note that the Italians have allowed their initial low wage advantage to be squandered as a result of a long period of strong real wage growth.

Now that Germany is competing on a more equal footing in terms of real labour costs, it is perhaps no surprise that the economy is rapidly returning to its natural position of being the powerhouse of Europe. However, for the moment, this resurgence has scarcely been noticed by the markets. This invisibility will not continue forever – Germany created 600,000 jobs last year – and when, eventually, her expansion begins to put pressure on eurozone interest rates, there could be real excitement in the foreign exchange markets with upward pressure on the EUR. Although on balance, this is perhaps more likely to be a story for 2008, there is a reasonable probability that the markets will latch onto it some time later this year, jeopardising our EUR/USD forecast but increasing the chances of EUR strength against the GBP.

This should be a quiet week for the domestic market where the only release of real interest will be the minutes of the latest MPC meeting. How many members voted against the rate hike has been a matter of considerable debate, but it is the rationale as to why the rate hike was needed in January that will prove more influential. Outside the UK, various housing data will be released in the US during the week as well as the latest durable goods orders (on Friday).

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