



Weekly Bulletin – 12th February 2007

Last week saw the foreign exchange market's attention focussed firmly on inflation and interest rates. As expected, both the ECB and MPC held rates unchanged on Thursday, although President Jean-Claude Trichet's use of the phrase 'strong vigilance' in the ECB's monitoring of inflation reinforced the view that eurozone rates will rise next month to 3.75%.

With interest rates either rising or having already risen in most parts of the world, the onus of providing cheap liquidity to the world's markets through the 'carry trade' where a low-yielding currency is first borrowed and then sold for another, higher-yielding unit, has fallen on Switzerland and Japan. Even in these countries, however, there is upward pressure on interest rates. Last Monday, Thomas Jordan, speaking for the Swiss National Bank, implied that the weight of selling through CHF-funded carry trades was artificially depressing the value of the CHF, creating the potential for overheating in the export sector and, with it, the need for higher interest rates.

Meanwhile, the JPY traded somewhat firmer than of late as investors and speculators pondered the agenda of the weekend's G7 meeting of finance ministers and central bankers. However, with regard to carry trades, the participants' post meeting communiqué avoided direct reference to any particular currency, referring only to concern about 'one-way bets'. This was not the forceful statement the markets need to stop selling the JPY and, this morning, EUR/JPY duly hit a new eight year high of 158.71.

With average global interest rates slowly ratcheting higher, there will come a point at which carry trades to fund a range of investments, particularly in emerging markets, will need to be unwound as funding costs rise. It remains to be seen whether this unwinding process will be conducted in an orderly fashion or whether there will be a stampede for the exit (which is what concerns the G7), prompting central bank intervention in the money and foreign exchange markets of the more vulnerable emerging economies. Unfortunately, history provides us with little reason for optimism on this point.

After last month's surprising UK rate rise, all eyes were on last Thursday's MPC meeting. Immediately after the 'no-change' announcement it appeared that sterling was barely going to react as the GBP/USD exchange rate dipped only a fifth of a cent. However, speculators had clearly built up large positions on a stricter stance from the MPC (short sterling futures ended up 5 to 8 bps firmer across the curve on the day) and within 20 minutes the market's disappointment was being reflected on the foreign exchanges, with the GBP/USD rate off nearly a cent. Sterling continued to trade badly into Friday, finishing the week at 1.9480, down from last

Monday's opening of 1.9669, and at 0.6668 against the EUR, compared to 0.6591.

There was speculation that the MPC had seen the Bank of England's Quarterly Inflation report, due for release to lesser mortals this Wednesday, and that the 'no-change' decision reflected the Bank's confidence that inflation was more under control than the markets have recently feared. The counterweight to this argument is that Mervyn King's greatest fear remains the risk of second-round inflationary pressures creeping in through the labour market. Although there is little evidence of this, so far, with most pay deals in this year's pay-round coming in at around the 4% level (very restrained considering RPI is running at 4.4%), the high season for pay-round negotiations does not end until April. Given Mr King's natural caution, it would, therefore, seem unlikely that he has already concluded that he is out of the woods.

Certainly if the Governor were a German central banker, he would have been alarmed by last week's call from Germany's massive steel union, IG Metall, for a 6.5% rise. Although the union will not achieve a settlement at this rate, the opening gambit is a manifestation of Germany's resurgent industrial confidence and increases the chances of eurozone rates breaching the market's current forecast of a 4% peak for this cycle. Other things being equal, this should provide the EUR with some medium term support.

Quite apart from the release of the Bank of England's quarterly Inflation Report, the UK market will be inundated with economic data this week. The latest producer price indices are released today, followed by the latest inflation figures tomorrow. The targeted CPI measure is expected to hold at the current 3% level and the headline measure is expected to be unchanged at 4.4%. Given the concern over wage settlements, the headline number is probably as important as the CPI measure currently. The latest labour market statistics are released on Wednesday with the crucial average earnings number expected to remain at 4.1%. If these forecasts prove to be accurate, the market might be encouraged to stage a small rally but it should beware of the retail sales figures, to be announced on Thursday, which are expected to be strong with the year-on-year sales figure leaping to 5.6%.

This is likely to be another choppy week for the UK market with the pound likely to remain under pressure, particularly against the EUR, while the interest rate market will not only have to absorb an avalanche of domestic information, but may also be influenced by events in the US where Ben Bernanke is making his semi-annual testimony to the Senate.

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