

Tuesday 18th March

## There May Be Trouble Ahead

Sterling once again split the field last week soaring to a high of 2.04 against USD but moving into the 1.29s against EUR. As predicted in my previous update, volatility continued to be a problem with violent swings seen against most crosses.

Once again, data last week was mixed with the overall picture of increasing inflation and falling house prices shining through. Much has been made of the increases in price of manufacturing commodities be they oil, gold, copper or platinum. These saw input producer prices i.e. the price that manufacturers pay rise by nearly 20% moving to a high not seen since 1989. 'Soft' commodities such as wheat, corn and milk also increased last week as the continued demand from China and from industrialists using grains as an alternate fuel source rose.

RICS, also known as the Royal Institute of Chartered Surveyors, published their monthly house price data last week. With a fall of 9.4% from -54.7% to -64.1% further fears of a sharp deterioration in the UK housing market came to the fore. With recent problems in the credit market meaning that even copper-bottomed mortgage holders are being denied remortgaging options by high street banks we may soon see most first time buyers or relatively new mortgagees i.e. those that started the loan in the past 3 years may end up paying more than 1% above the fixed interest rate as they go variable and some who decide to sell up may have to endure negative equity concerns.

As those of you who received our Budget Special will know, Alistair Darling's first Budget was a lesson in torpor. It had little bearing on sterling before, during or after the speech and most media focused on the new heavy tariffs on alcohol, tobacco and Chelsea tractors instead of the downgrading of the government's growth forecast.

The week ahead will see sterling as a reactionary currency given the dearth of hard data. The highlight will be Wednesday's publication of this month's Bank of England minutes with an 8-1 voting record forecast for the hold at 5.25%. The lone dissenter is expected to be David Blanchflower who, given his dovish tendencies, probably voted for a 25bps cut. Any deviation from this towards a more equal split could see sterling weaken once again with no one particular cross to benefit significantly.

## The week ahead

I believe the USD would be better served by getting out of the spotlight but the problem with being the largest economy in the world is that most people will not give you a break. Alongside the Fed interest rate decision we have US producer prices and the Philadelphia Fed index publication which are forecast to contribute further to the humbling of the US economy.

Euro watchers will have to wait until Thursday for focused Eurozone data. 'Flash' PMI figures will be the highlights and although they are estimates of the upcoming definitive data, further expansions are predicted to strengthen the single currency.

| <u>Currency Rates</u> | <u>Low</u>    | <u>High</u>   | <u>Current</u> |
|-----------------------|---------------|---------------|----------------|
| <b>GBPEUR</b>         | <b>1.2788</b> | <b>1.3161</b> | <b>1.2787</b>  |

If the euro was ever looking for corporate sponsorship, I'd vote for Guinness given the single currency's predilection for record breaking. Smashing through barriers against USD and GBP seems to be almost a daily occurrence as the most severe shocks are focused away from the Eurozone. The highs seen against dollar look to push it towards 1.60.

The German ZEW index, a survey on how the German and other economies will fair over the next 6 months, rose to -32 from -39.5 in February easing fears and promoting the chance of so-called 'solid growth'.

|                       |               |               |               |
|-----------------------|---------------|---------------|---------------|
| <b>GBPUSD "Cable"</b> | <b>1.9994</b> | <b>2.0397</b> | <b>2.0178</b> |
|-----------------------|---------------|---------------|---------------|

Where to start? The dollar weakened against most if not all currencies last week as measures aimed at stabilising the US economy did not work and a major Wall St. investment bank was sold for a song after its liquidity position 'deteriorated significantly' almost overnight.

Ben Bernanke and the Fed launched an initiative to allow money market players to use a wider list of assets for collateral against their borrowings. This totalled close to \$300bln but had a negligible effect as traders gave the greenback no let up.

Friday was the day that 'America's Northern Rock' came to pass. Bear Stearns, one of the most visible and well respected Wall St. banks, saw its share price slashed as it was first loaned money by JP Morgan to continue operating and finally taken over for just \$2 a share by the same bank.

Today sees the Fed announce its March rate decision. After cutting the discount rate on Sunday by 25bps to make borrowing from the Fed more palatable, a cut is certain although market expectations vary from 50bps to 125bps. One thing is clear, the US economy so long known as the strongest in the world is tumbling down a very slippery slope.

### Commodity currencies

|               | <u>Low</u>    | <u>High</u>   | <u>Current</u> |
|---------------|---------------|---------------|----------------|
| <b>GBPAUD</b> | <b>2.1321</b> | <b>2.2010</b> | <b>2.1711</b>  |

Strong commodity prices supported AUD over the week although domestic data would normally point to weakening. Domestic demand is forecast to fall and as such consumer confidence fell to the lowest level in 15 years. Banks are also unwilling to be called on whether the RBA will raise rates once again; they currently are 7.25%, the highest in a developed economy.

|              | <u>Low</u>    | <u>High</u>   | <u>Current</u> |
|--------------|---------------|---------------|----------------|
| <b>GBPZD</b> | <b>2.4574</b> | <b>2.5559</b> | <b>2.4924</b>  |

New Zealand is likely to go into a recession. So says a report by BNZ economist Stephen Toplis who believes that with the pronounced slowdown due and with the RBNZ having no room to cut rates it is all but a certainty. Although NZD moved within 0.3 cents of a new post-float record against the USD, it has plunged after the Bear Stearns news broke. Kiwi will continue to be on the ropes if global stock markets continue to fall as carry trade participants head for safety.

|               |               |               |               |
|---------------|---------------|---------------|---------------|
| <b>GBPCAD</b> | <b>1.9824</b> | <b>2.0208</b> | <b>2.0028</b> |
|---------------|---------------|---------------|---------------|

Canadian dollar was one of the main beneficiaries of the huge uptick in oil prices. The increases in the price of gold also helped. Bullish data also supported the loonie as Canada's trade surplus widened to \$3.3bn from \$2.3bn due to higher export prices. CAD however is cursed by geography and given the likelihood of a severe downturn in the US, we foresee Canadian to continue to struggle.

|               |               |               |               |
|---------------|---------------|---------------|---------------|
| <b>GBPZAR</b> | <b>15.636</b> | <b>16.354</b> | <b>16.276</b> |
|---------------|---------------|---------------|---------------|

Friday saw the news that South Africa's mining production fell by 10.7% MoM in February in what is the first clear indicator of the damage that the rolling black outs SA's mining operations have suffered since late January. This compounded Thursday's Business Confidence figures which saw the biggest QoQ fall in 24 years as the index slipped from 67 to 48. Over the next week we expect both the SARB's quarterly report and retail sales data to disappoint and consequently ZAR to weaken.

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Any rates given are interbank and therefore for amounts of £5million and so are not indicative of rates offered by World First for smaller amounts.

## Definitions

**Bull/Bullish:** one who thinks a market, currency or asset will appreciate

**Bear/Bearish:** one who thinks a market, currency or asset will depreciate

**Pip:** the fifth significant figure of a currency price: 1.234**5**

**Big figure:** the third significant figure of a currency price: 1.2**3**45

**Basis point:** a 0.01% unit

**Tightening (Interest Rates):** raising interest rates (loosening is opposite)

**Hawkish:** comments that suggest interest rate tightening i.e. moving higher

**Dovish:** comments that suggest interest rate loosening i.e. moving lower

**MPC:** Monetary Policy Committee, the body that sets UK interest rates

**ECB:** European Central Bank, the body that sets the Eurozone interest rate

**RBA:** Reserve Bank of Australia: the central bank of Australia.

**Cross-Currency Pair Flow:** Where a set of three interlinked rates, e.g. GBPEUR, EURUSD and GBPUSD, move as any combination of two of these rates must produce the third in order to satisfy a condition known as No Arbitrage. If there are movements in two markets, then the third must move deterministically. Also known as triangulation.

**Carry Trade:** Simply put, is the borrowing of money in a low interest economy (Japan) and investing it in a higher yield economy (Australia). This yields a certain profit unless the interest rate differential narrows or the exchange rate moves such that it costs more to buy the currency back.

**Fair Value- Also called financial fair value:** A measure of the theoretical exchange rate using certain Macroeconomic models (such as eCIP).

**Underlying Inflation:** A somewhat academic measure of long-term inflation- removing all the 'interesting' elements like energy and luxury consumption leaving the 'boring' elements like utility bills and food. [Quotes from BoE governor Mervyn King]

**Interest Rate Traction:** Although there is a group of people who announce an interest rate, it has to feed through the economy through some very complex and poorly understood channels. Once rate hikes are having an effect on inflation and long term yields it is said that they are finding traction with the economy.

**Unemployment rate:** The percentage of people who are able and 'willing' to work (i.e. in the labour force) who are not employed.

**Participation rate:** The percentage of the population of working age in the labour force.