

Monday 6th April

Will the MPC cut and start the revival?

Sterling made a better run of things and was allowed some respite as it moved higher against the euro and dollar over the course of last week. Last week we reported on the lack of confidence that the UK economy is suffering; this week the MPC gets an opportunity to make an impression.

Thursday sees the MPC's April decision and the market is pricing in a 70% chance of a cut with a 100% probability of loosening by May. The consensus size is 25bps and is the minimum that the MPC can be seen to do as homeowners brace themselves for 'repayment shock'; the change in mortgage payments as a fixed-term rate ends.

We tend not to hear about the IMF nowadays and if we do it's a case of a sub-Saharan African country having their debt reduced or written off however last week saw comments on the UK housing market. The IMF estimates that the UK housing market is overvalued by up to 30% and as a result a prime candidate for a 'sharp correction'. It is almost certain that prices will fall this year following the well-publicised contraction in mortgage availability. A figure that stands out is that the amount of money lent in the UK for house purchases is down by 40% year on year in February. Not being able to pay for a house normally precludes you from buying the house.

Sterling's solidification can be put down to couple of things. We have mentioned in the past that GBP is closely related to the fortunes of the worldwide financial sector. Last week some banks which have had a real time of it over the past weeks started to recover. HSBC was up 3.6% last week with Goldman Sachs up 6.8% and Barclays 8.8% over the same period. Weaknesses in the European economy, outlined below, also contributed to a move higher in the GBP/EUR cross with further gains likely to crystallize by the end of H1 as Eurozone cuts are priced in for June.

All in all, the picture has shifted in sterling's favour over the past week but not significantly; there is still a conspicuous absence of popping champagne corks. The only real data this week is the MPC announcement; a cut will bring us lower, but those interested in the outcome of sterling would be minded to watch and wait for BRC shop prices and Wednesday's Industrial and Manufacturing production announcements.

The week ahead

The US economy takes a relative backseat this week as focus turns to the UK and EU. Tuesday evening's FOMC minutes obviously have the power to move the dollar however we will wait and see whether the important musings have already been revealed by Bernanke's recent trips to Capitol Hill. Friday's consumer confidence figure will also be worth watching for signs of a recovery.

Apart from Thursday's rate decision it is a very quiet week for European data with only Friday's OECD leading indicators of note.

<u>Currency Rates</u>	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPEUR	1.2526	1.2782	1.2667

The euro showed the first signs of cracking last week as some poor retail sales and consumer confidence data hinted at an economy starting to sweat over credit crunch issues. As so often is the case the German economy was the focus. Some analysts believe that the German economy alone has been underpinning the Eurozone on its own as Portugal, Spain, Ireland and Italy are seeing a greater slowdown economically speaking than the UK. Some of this could be down to the high proportion of German exports bound for Russia, China and the Middle East gorging on petrodollars.

Jean-Claude Trichet and the ECB are expected to hold rates at 4% this Thursday as has become the customary stance in Frankfurt. Euro watchers will look for cracks in Trichet's hawkish armour at the press conference for indications of when a loosening of rates could be become reality.

GBPEUR is expected to head lower in the short term following a potential cut by the Bank of England. Levels around all-time lows are still well within a solid move downwards. However logic dictates that a GBPEUR rate higher than at the time of writing is probable as I believe weakening of European economic fundamentals will move the single currency lower.

GBPUSD "Cable"	1.9728	2.0046	1.9870
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The word recession is bandied around more often nowadays than articles about the environment and Al Gore's crusade to save some elks but when certain commentators start to give it credence the world sits up and listens. Alan Greenspan, commentating in El Pais, believes there is more than a 50% chance of the US economy heading into recession but believes that the 'sharp falls in orders, strong rises in unemployment and intensive weakening of the economy' does not place the world's largest economy in a slowdown yet.

An FT report also highlighted that the US economy is lacking the migrant workforce that it once prided itself on. Intellectual immigrants such as doctors, teachers and IT workers choosing Canada and Europe over the US as dollar salaries mandated home are being eroded by adverse exchange rate movements.

Ben Bernanke painted a sunny picture however before the Senate Banking Committee as he believes that the economy will pickup in H2 as the effects of the drastic rate cuts and tax rebates would stimulate spending and growth without inflationary pressures.

Commodity currencies

	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPAUD	2.1561	2.1904	2.1506

It was again a quiet week on the AUD domestic data sheet as the dollar primarily moved on external factors and comments from the Reserve Bank Governor Stevens. Stevens stated last week that inflation was not out of control but left open the possibility of further interest rate jumps and recently Australian media has focused on the amount of middle class homeowners in dire straits due to the RBA's aggressive rate hiking stance. Future movements will also be predicated on how the global risk outlook picture fairs with carry trade participants waiting in the wings.

	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPNZD	2.4963	2.5515	2.5046

A deteriorating economy hurt kiwi last week as it fell against its main crosses. With NZ analysts looking forward to tomorrow's Quarterly Survey of Business Opinion a bearish pall has been cast as NZ consumer confidence continued to fall between December and March. Main economic constituents are starting to feel the pinch especially the agricultural sector which is dealing with a drought and a lack of competitiveness due to the NZD strength. This may hurt the potential IPO of the world's sixth largest dairy consortium Fonterra which has been discussed for nearly 6 months with no end in sight.

GBPCAD	1.9982	2.0485	1.9995
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Canadian dollar has drifted back towards parity with its US counterpart over the past week as the Canadian economy rebounded; GDP rose 0.4% against a previous reading of -0.7%. We also saw gains as oil rebounded from levels close to \$100 a barrel back to around the \$106 level.

GBPZAR	15.279	16.224	15.503
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Rand sellers were afforded some respite last week as it fought back from its recent doldrums. This was not really down to any major pro-SA data but more based around problems in the UK and US economies and the weakening of sterling and dollar. This week however sees the SARB's rate decision on Thursday; the market is split almost 50:50 on whether we will see a 50bp hike. CPIX is likely to spike through 10% in April however consumer and industrial confidence is plummeting and retail sales have also been negative over the past 3 months. The trade off between inflation and growth will be the subject of discussion for the rest of this year I feel.

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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.