

Monday 28th April

The inflation outlook and a headache for the MPC

Sterling has edged up off the lows after the release of the Bank of England minutes. Closer inspection of the voting revealed that two members, Andrew Sentance and Timothy Besley did not support the cut. This came as a surprise because, with all the recent concern over lending, the credit crunch, the housing market and lower demand, the market's expectation was a unanimous vote in favour of a cut. In fact, even those that supported the rate cut did so with reservations.

So what would be the reason for this trepidation given recent slowing in activity and the need to loosen policy to help stimulate the economy? The answer lies in inflation. The Consumer Price Index (CPI) is forecast to push back over 3% this summer and possibly remain above the Bank of England's upper boundary for at least three months. This may require not one, but two letters of explanation to the Chancellor detailing why the Central Bank has let price pressure push up so high. The reasons for cutting rates are clear and there for everyone to see. You only have to apply for a mortgage to witness the effects of the tighter credit conditions, but the conundrum, and so the headache for the MPC, lies with their inflation targeting emphasis. Unlike the Federal reserve who quickly moved to loosen the economy at the first sign of trouble. The BoE are, on the whole, of the view that long term economic stability results from keeping inflation in check. In this regard, the risks of near-term upside inflation are plentiful; stemming from energy and food prices and the effects of the recent sterling depreciation.

The implications for future policy and the effects on the pound

While activity continues to slow and the housing/ lending market stutters, the pressure will be on the BoE to ease the economy. Nevertheless, the committee cannot possibly cut rates while faced with a CPI figure over 3.0%. So this calls into doubt how many cuts may materialise. Some of the recent sterling strength can be attributed to this reduction in rate cut expectations. On the other hand, the Bank may push to introduce cuts early in a bid to get some influence in, before their hands are all but tied.

We see a tug of war between activity data and inflation statistics. If CPI nudges ahead, then GBP will have further cause for recovery, but another bout of soft data could ease the pound back into the lows.

A short-term sterling recovery is underway and a push above 1.28 in GBPEUR could see the first significant break out of the long-term downtrend we have witnessed since August last year.

The week ahead

There is a whole host of data due out this week. BoE net mortgage lending and approvals, along with the Nationwide house price index, will help further paint a picture of the almost "Dali-like" housing market. While UK Consumer confidence will detail just how much of a pinch the public is feeling.

The Federal Reserve will meet and decide on the policy this month. The FOMC are widely expected to cut rates further to 2.00%.

<u>Currency Rates</u>	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPEUR	1.2416	1.2733	1.2736

In the past few days we have finally seen some Euro weakness. The German business climate index has fallen from 104.8 in March to 102.4 in April, its lowest level since January 2006. The French business sentiment index has dropped from 108 in March to 106 in April, the lowest level since December 2006. Eurozone sentiment indicators are seen as giving a good guide to growth trends. Paired with this, the European commission have made a downward revision of growth forecasts to 1.5% dropping significantly from November's prediction of 2.2% for 2008. On the back of this data it is very difficult to make an argument for higher interest rates, but with inflation at a 16 year high of 3.6% it is equally unlikely that they will look to cut rates in the near future.

GBPUSD "Cable"	1.9675	2.0024	1.9823
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The Dollar strengthened across the board last week as durable-goods orders increased more than forecast last month, revealing that US economy is starting to resist a housing market slump and on Thursday data showed resilience in the labor market. The Fed is still widely expected to cut interest rates tomorrow by 25 basis points to 2%. There is speculation that we are approaching the end of the Fed's interest rate cutting cycle. A report on weak new US home sales in March failed to provide lasting clues on the outlook for interest rates. However, with oil prices staying close to the \$120 a barrel, inflation is a significant worry and now will be just the time for U.S. rate setters to communicate the fact in the speech that follows.

Commodity currencies

	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPAUD	2.0825	2.1430	2.1209

Aussie CPI gave the dollar a shot in the arm last week taking it to a 24 year high against the US dollar; as such as we have seen repricing of interest rate hikes over the next couple of months. It also headed higher as commodity prices continued to surge. Movements higher are predicted in collaboration with a global commodity's boom and will be underpinned by its extraordinarily high yield on value terms.

GBPNZD	2.4655	2.5411	2.5441
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An eventful week saw GBPNZD lose a percent and regain it by the end of Friday's trading. The Kiwi initially rallied in the build-up to the interest rate announcement but fell on the outcome. Although the market was expecting a "no-change" decision the majority were still looking for a hawkish slant and this should have lent support. The Reserve Bank did indeed leave rates on hold at 8.25% but in the end, softened their stance. The statement was a little more dovish than analysts' expectations as the bank cited risks of a slowdown due to economic pressures from abroad, the drought and the strength of the currency. The market, which had positioned long for the announcement, sold off the Kiwi and GBPNZD climbed back to the week's starting position. Going forward, we expect the RBNZ to leave rates on hold for the foreseeable future and both Sterling and Kiwi remain susceptible to any weak economic releases. The momentum going into the weekend lies with the pound and if GBPNZD opens above 2.54 we expect this to continue.

	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPCAD	1.9860	2.0239	2.0048

The highlight in the Canadian week was the RBC's 0.5% cut to 3.00%. Further cuts are forecast throughout the year although none for the near term suggesting a pause before the dovish stance restarts. Its has stayed within touching distance of parity with its US counterpart throughout the week primarily due to the continuing fortune of crude oil. As prices rocketed towards \$120, CAD strengthened although domestic economic fears will continue to weigh over the near term.

GBPZAR	15.035	15.3886	14.9847
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Rand continued to strengthen against sterling last week as inflation data surprised to the upside and rate hikes were priced in for June. CPIX rose 10.1% in March against a consensus view of 9.7%. Food and energy remain to be the major contributors with a proposed 50% hike in electricity prices slated for early June weighing on sentiment as well. Comments from the Reserve Bank's Governor on Friday caused a stir as the possibility of an intra-meeting decision may be undertaken. Tito Mboweni said that "The situation is deteriorating and we can't say we must wait for that (the MPC meeting) date because it is in the calendar. Economic policy can't wait for that date."

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Please feel free to contact me at anytime regarding these briefings, if you have any questions or thoughts on them, or if you are interested in a particular event in the calendar.

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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.