

Tuesday 6th May

Mr Economy? The Doctor will see you now

All in all sterling had a poor week as data continues to weigh despite its competitors giving GBP ample opportunity to move higher. However I'm choosing not to focus on last week but instead this week's Bank of England Quarterly Inflation Report due for release this Wednesday. This health check lays out the Bank of England's expectations for the next quarter and could prove to be the most important given the crossroads at which most analysts believe we are stood in this long trek through the credit crunch. February's inflation forecast is due to be lower than actual figures as domestic energy prices have risen on the back of increases in wholesale gas prices (as mentioned in last week's update titled 'Be wary of markets bearing gifts'); food suppliers raising prices as weather disasters weigh on supply and increases in import prices as sterling continues to flounder.

An obvious increase in the Bank of England's inflation projections is forecast and markets will be looking to see whether this lands above 3%. The significance of this is of course should CPI post at 3% or higher Mervyn King in his capacity as Governor of the Bank of England has to write an open letter to The Chancellor to explain why. This has happened before; most recently in March '07.

The general tone will be hawkish with a strong probability that Mervyn et al tip their hats to only one more rate cut in 08 which would fall in line with our expectations at the beginning of the year. A subsequent uptick in the fortunes of sterling could be expected; a hawkish inflation report with lower inflation figures last time round saw sterling rally higher against the majority of its opponents.

Other data released this week includes a fairly packed Tuesday with everything from CPI and RPI to house price data from the Royal Institute of Chartered Surveyors and the Department of Councils and Local Government. Both inflation measures are forecast to rise while both house price indices are set to fall; a heady cocktail which will probably end with sterling declines

Regardless of its subsequent impact on sterling, this announcement is due to be a fairly downcast appraisal of the health and vitality of the UK economy. Higher inflation going hand in hand with falling growth is the sickly pill the country must swallow and try hard not to choke. Whether the Bank of England has its own Hippocratic oath is doubtful as we are most certainly due some harm.

The week ahead

The ECB will also release its Monthly report with the same inflationary concerns expected. We will also be interested in CPI and GDP figures released Thursday.

Dollar performance will also hinge on its CPI reading, due Wednesday, and consumer confidence figures calculated by the University of Michigan to be released on Friday.

Currency Rates	Low	High	Current
GBPEUR	1.2589	1.2788	1.2664

Consumer spending hurt the single currency last week as evidence of a European slowdown began to raise its head before Trichet and the rest of the ECB gave a particularly hawkish press conference which dragged euro away from the week's lows.

Retail sales fell again in March indicating a year on year decline of 1.6%, a new record. This led analysts to predict a slight possibility of a change to ECB decision as a reaction however Trichet slammed the door on the doves. In his speech he rolled out his greatest hits of anti-inflationary views with a particular focus on wage settlements. He focused also on high fuel and food costs indicating that the Eurozone still faces a 'protracted period' of high inflation. Some analysts are so convinced of Trichet's unwavering commitment to price control that the potential cut priced in for later in the year has been removed and that now none are forecast for the remainder of 08. We will be looking for further confirmation in price data over the next few months.

GBPUSD "Cable"	1.9457	1.9787	1.9583
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Dollar has enjoyed yet another strong week as it moved to 2 month highs against the euro and sterling. US data has continued to help underpin the currency although the recovery remains balanced on a knife-edge.

US PMI moved back into expansionary territory posting a reading of 52.0 against a consensus of 49.6 showing that the service sector was beginning to get off its knees. The jobs markets also showed a bit of steel as the effects of this month's non-farms payrolls continued to help; initial jobless claims only fell by 5,000 jobs but the fall was more important than the amount and dollar bulls increased bets of further strength.

These however are only a few releases and for dollar to continue to strengthen a lot more positive sentiment will be needed. Large potential downside exists should we see falls in the consumer spending arena or if jobs market increases materialise to be nothing more than seasonal.

Commodity currencies

	<u>Low</u>	<u>High</u>	<u>Current</u>
GBPAUD	2.0600	2.1022	2.0742

Increases in gold prices allowed Aussie dollar to strengthen as the commodities boom continued unabated. Gains however were capped by domestic uncertainties as the RBA left rates on hold at 7.25% citing a significant slowdown in demand with markets taking this an indication of interest rate cuts in the near future.

The jobs market continues to thrive in comparison with its Antipodean neighbour as a 24,500 increase in employment was seen in the month of April.

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.