Market Update   22nd July 2010

Irrepressible Eurodollars

The Macro Trader's view:

Short term interest rates in the US have been at virtually zero for a considerable period of time, as the US economy experienced one of its most difficult periods for decades, but combined with a sizeable fiscal stimulus, the patient had shown encouraging signs of recovery during the early months of 2010.

But more recently data has begun to weaken.

At first this didn't seem too big a problem as certain key reports continued to hold up well:

- The housing market showed signs of recovery,
- Non-farm payroll, for several months, reported an improving labour market,
- The ISM manufacturing report showed solid growth in that sector, and
- Businesses began to restock.

But the warning signs were there; the ISM non-manufacturing survey, which reports on the most important part of the economy, had already begun to weaken back in the late 1st quarter. This should have rung alarm bells, but as Fed officials began talking about how and when they would judge it right to begin withdrawing their monetary policy stimulus, traders focused on the positives.

Not until the housing market turned weak again as a buyers tax credit expired, and a recent non-farm payroll report seriously disappoint, did traders start to consider that all was not well.

Now most data releases are flashing amber, as even those that previously proved resilient are losing vigour.

The Fed has now acknowledged the economy faces an uncertain period, and Bernanke has pledged the Fed will take additional policy measures if the recovery weakens from here. So the long rally in the Eurodollar market has received a new lease of life.

The Fed is unlikely to begin tightening policy until well into next year, even if data were to begin improving from now. They would want to see a sustained period of strength that displayed strong signs of being self sustaining.

The recent FOMC minutes saw the Fed reduce its growth forecast going forward, and with inflation expected to stay low, and perhaps too low, as some policy makers fear, the Fed is under no pressure at all to begin a tightening process.

What also makes US policy makers nervous is the Euro zone. The recent crisis there may have come off the boil, but it still simmers and policy makers are unsure of the eventual impact a cooling Euro zone economy would have on the US.

So how far can Eurodollars rally? We think 100.00 is possible in the current environment, unless data suddenly turns stronger.

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