Our Guides - the **Technical Trader's Guide** and the **Macro Trader's Guide** both deal with these and many other markets in much more detail over multiple time- frames. **Key Trades Bulletins** subscribers receive a detailed report on every trade we enter for our Key Trades Portfolio. More details about all these products: CLICK HERE

Market Update 14th January 2011

Sterling and European short rates: which is the better bear market?

The Macro Trader's view:

Inflation is increasingly becoming an issue for traders in many markets. As economic recovery slowly strengthens, fears of deflation, even in the US have given way to worries that inflation may emerge as the next big challenge after a prolonged period of exceptionally low interest rates in the major developed economies.

In the UK the economy has suffered a severe recession and the Bank of England has responded with record low interest rates and quantum easing because of fears of a banking collapse and deflation. In a string of quarterly inflation reports the Bank forecast a near-term spike in inflation, followed by a near collapse in the CPI rate as unemployment and spare capacity were expected to bear down on inflationary forces.

The economy is 2 to 3 quarters into a recovery and inflation has failed to collapse. In fact CPI inflation is now expected to hit 4.0% over the next few months (the MPC's CPI target is 2.0%). Opinion is becoming increasingly divided about how the MPC should respond.

Should the MPC retain their strategy and keep rates low based on the government's austerity program? This program might knock the wind from the recovery's sails with inflation finally collapsing as a result. Or do they take the view that growth will continue, even if only weakly, and that oil prices, commodity prices and food prices will continue to rise? This suggests that interest rates should be raised before inflation becomes too entrenched.

In the Euro zone, the economy has been in recovery mode too, led mainly by Germany and France with the peripheral tail being dragged along behind. Inflation in the Euro zone did

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collapse to very low levels, but has over recent months risen to 2.2%; just above the ECB's 2.0% target.

The main cause of higher Eurozone inflation is as in the UK: rising Oil, food and commodity prices. The ECB seems reasonably relaxed about current inflationary developments, noting the underlying weakness of the money supply and the likely temporary nature of the external forces causing the upward inflationary pressure.

In the Euro zone, the ECB continues to buy large tranches of Euro debt. Unlike the Bank of England and the Fed, the ECB is acting to provide liquidity and isn't creating new central bank reserves or quantum easing. Their actions are necessary to support the economies of Greece, Ireland and other weak economies that had seen their bond yields soar on fears of Sovereign default. This is a factor the ECB has to consider when setting policy.

So the UK and Europe are two economies, both:

- in established economic recovery,
- with different problems going forward, and
- seeing inflation as a potential future problem, albeit with different degrees of severity.

Which Central Bank is likely to hike first, and more important, which market will start to price higher official rates into the yield curve?

Based on all the evidence we think it could be Short Sterling and the Bank of England. If Oil prices continue to rally, driven by a strengthening global recovery, incorporating a US economy in full recovery mode, domestic UK conditions may not be weak enough to offset these external influences, meaning the Bank may have to respond sooner than it might like, to contain inflation and retain credibility.

When could a rate hike happen in the UK? Probably not for several months yet, but traders will be acting ahead of any move as always, indeed Short Sterling is in an advanced topping out process.

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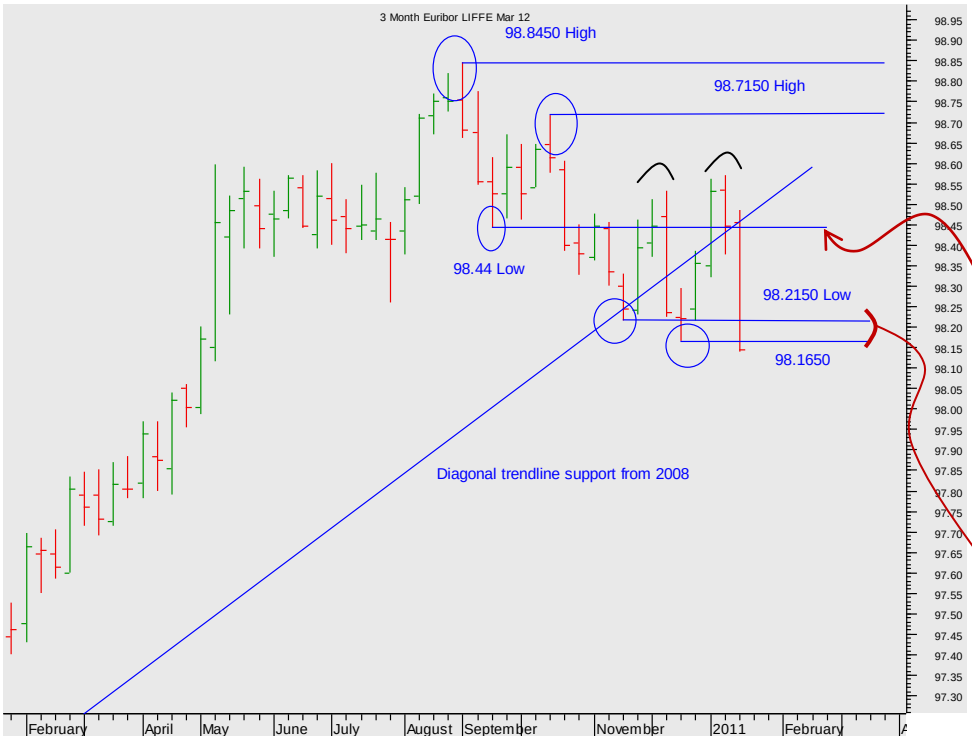
The Technical Trader's view:



WEEKLY EURIBOR CHART

The wild price action of the last few months in the Euribor looks to have been resolved in favour of the bears.

The inability of the market to get back above and hold above the resistance from the Prior Low at 98.44 is clear.

So too is the recent push in the last week beneath the Prior Low Pivots at 98.2150 and 98.1650.

That band should now act as powerful resistance above the market, ratcheting it lower.

The move beneath 98.1650 also marked the final and unambiguous breakdown of the diagonal trendline support.

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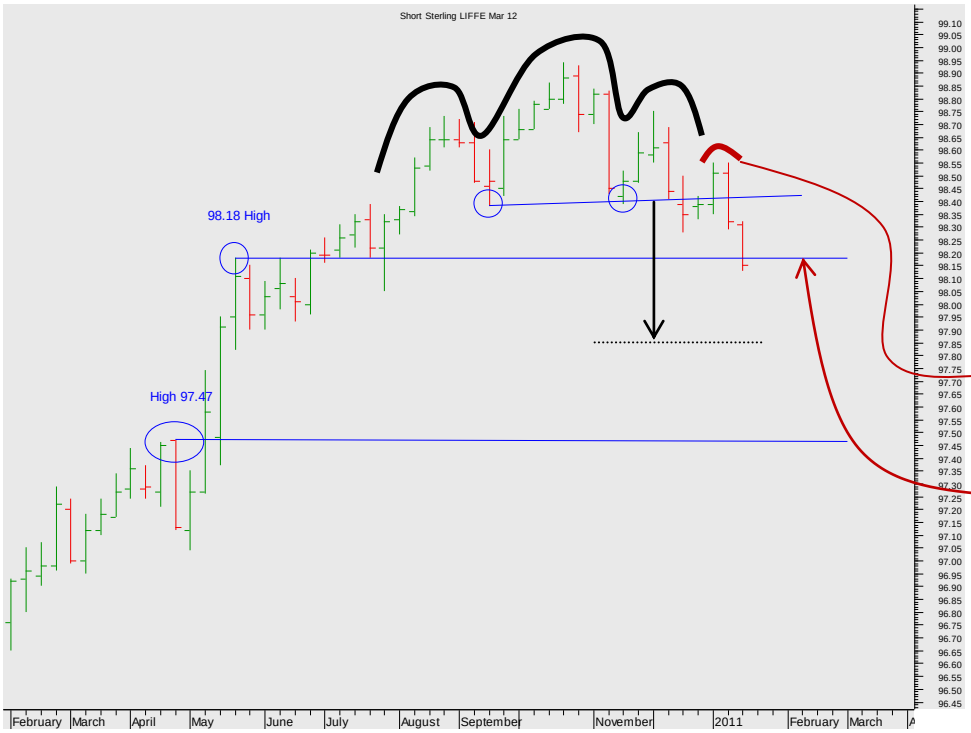

WEEKLY SHORT STERLING CHART

The Short Sterling chart is altogether better structured than the Euribor: a Head and Shoulders top has completed…

And the Neckline has proved to be powerful resistance,

And the horizontal support from Prior Highs (which has been strong in the past) looks likely to be breached.

The minimum move down is as far as 97.85.

Mark Sturdy

John Lewis

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