the technical analyst AWARDS 2011 FINALIST

17th November 2011

Market Update:

UPDATE
Technical
Fundamental

When will pressure on sterling money markets rates end?

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SEVEN DAYS AHEAD

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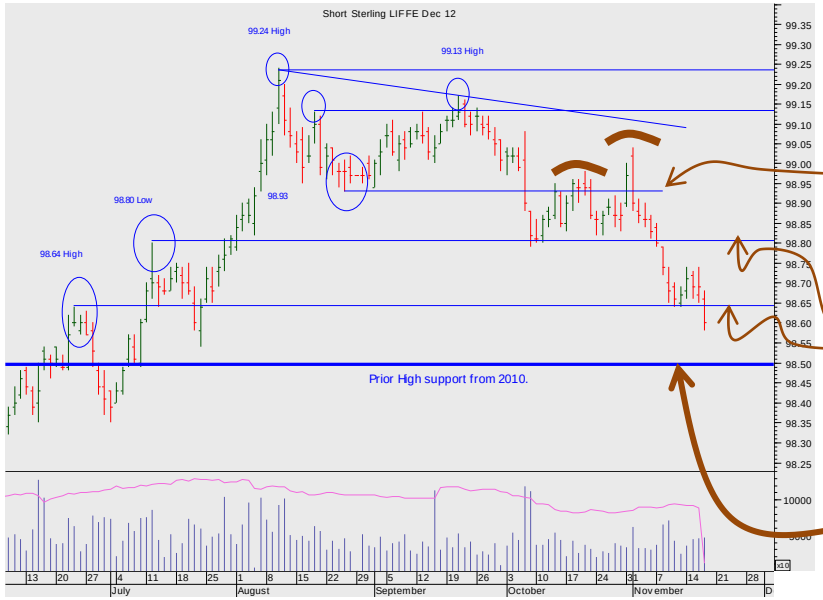
Pressure on sterling money market rates

WEEKLY CHART

The long bull market is well-established. Note the retreat from the top of the channel…

The next significant support looks to be VERY STRONG at the horizontal from the Prior High at 98.49….



DAILY CHART

The detail of the day chart is a clear bear trend from August 2011.

Prior lows in that trend, when tested have been good resistance - suggesting a well-constructed bear market.

And Prior High supports have been solid too – but broken each in turn.

Nonetheless, the substance of the long-standing support from the High at 98.49 may be harder to break.

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FUNDAMENTALS:

With the high drama of the Euro zone Sovereign debt crisis causing traders to switch to and fro from equities to bonds in response to the latest news flow, it is easy to forget about the short end of the market, especially Short Sterling.

While the Gilt has taken up the role of safe-haven trade with yields falling to all-time-lows, Short Sterling has been trading in what appears to be a bearish vein. But surely, with the Euro zone crisis threatening a global recession unless swiftly resolved and the UK economy slowing anyway, due to the UK government's austerity drive, Short Sterling should be enjoying greater support?

Ordinarily in a period of very slow growth that has a realistic chance of evolving into recession, traders would drive short term interest rate markets like Short Sterling higher in anticipation of official interest rate cuts.

But since the Bank of England has already trimmed the Bank rate almost to zero at 0.50%, one could argue that the only way for Short Sterling is down since there is scant room left for a rally, but that conclusion would be wrong.

The UK economy is slowing. The forces bearing down on it are powerful: one is domestic, the public spending cuts, the other is the Euro zone debt crisis.

The Bank of England is worried enough about the likelihood of a new recession to have recently expanded its asset purchase program: "QE". But that's not all, in yesterdays quarterly inflation report the forecasts for both growth and inflation were materially reduced leaving the door open for even more QE.

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FUNDAMENTALS: CONTINUED

Additionally, at a recent MPC meeting policy makers discussed cutting Bank rate from the current level of 0.50%, so Short Sterling isn't trading lower because the economy has turned stronger or the Bank of England is getting ready to change course with hike rates, it is under pressure for technical reasons relating to the ability of Banks to raise funding in the London Inter-Bank money markets.

With the Sovereign debt crisis still unresolved and the banking industry holding Euro zone government bonds issued by troubled countries like, Greece, Ireland, Portugal , Spain and Italy, there is a real fear in the banking community that one or more of the major Banks could fail as a consequence of a sovereign default. Because of this Banks have become increasingly unwilling to lend money to one another for fear they may not get it back.

Since the banks rely mainly on short-term funding and source most of this through inter-bank lending, the scarcity of liquidity in the London money markets is forcing the banks to bid up (pay higher interest rates) to attract the funds they need.

This has the affect of driving up the LIBOR rate which is the London Inter Bank Offered Rate and the bench mark which other interest rates are set against and the rate which Short Sterling ultimately settles against.

So because of the lack of liquidity Short Sterling is moving lower to reflect money market interest rates even though the current economic environment calls for lower interest rates.

The Bank of England is acutely aware of this and makes special liquidity available to the Banks but as happened during the original financial crisis, it has yet to feed through to lower market interest rates allowing Short Sterling to rally. At some point the log jam will ease, but not until the fear of a major Bank going under is removed and that probably requires a resolution of the Euro zone sovereign debt crisis.

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