

## A Fundamental View

Seven Days Ahead 09/02/04

### Short Sterling:

Last week I spoke of the CIP'S releases and the MPC meeting. In the event there were few surprises in the CIP'S data; service sector a little stronger, and the Bank of England's MPC increased rates 25bp as was widely expected. Of all the data out this week the most important will be the B of E quarterly inflation report.

#### March 04

No compelling trade here, the only possibility I see is a settlement trade wherein buy here at 95.78 and hold until expiration on 17<sup>th</sup> March for a max 7 ticks against a libor fix of 4.15%.

As expected the MPC increased the repo rate but with the currency strong and strengthening and the new CPI index showing inflation at 1.3% when the target is 2% the Bank will struggle to justify an aggressive tightening cycle. We will see more of their thinking this Wednesday when the latest quarterly inflation report is released, but there won't be any more rate increases for a few months.

#### March 05

Last week I advised being long of this contract into the MPC meeting and it proved the right trade to have. If still long I would hold with a close stop a head of Wednesday's inflation report. This event has a history of upsetting the market so a close stop will protect profits. If not already long and bullish, then wait for this event to pass as there will be opportunities after. If Bearish one might consider selling here with a close stop as the market has moved up smartly over the week and may be prone to profit taking during Wednesday's Bank of England news conference accompanying the inflation report release.

I still feel there is value in this contract given my previously stated view of where the repo rate will peak in this cycle i.e. 4.5-4.75%. The Industrial production and Manufacturing output data released this morning; still shows weakness and PPI data released at the same time; was more benign than expected and this trend should continue given sterling's strength. Also as rates rise, the housing market and retail sales should cool as an increase of 1 percentage point in the repo rate from 3.5- 4.5% is an increase of 28% in the cost of carrying any given level of debt and we all know how the UK consumer has been on a borrowing binge over the last few years.

## EURO DOLLARS

When I wrote last, I pointed to the release of the two ISM reports and the release of the non-farm payroll report as being the two key events during the week. The ISM data releases saw the manufacturing report come in a little weaker whilst the service report came in noticeably stronger. However the market saved the excitement for the Friday non-farm payroll release. Although the number was in itself stronger than of

late, it was, even allowing for revisions to the previous month, much weaker than the market was looking for and even a drop in the unemployment rate from 5.7 to 5.6 could not stop the market rallying strongly. This report helped balance the Shock to the market caused by the slight but important change in the wording to the statement released by the FOMC the previous week. This week we will hear from Alan Greenspan when he makes two key speeches in the house and then the senate. It is assumed that Mr Greenspan, the Fed chairman will shed some light on the FOMC committee's current thinking.

#### March 04

Much like the front contract in short sterling, I see no obvious trade here. There isn't any real value in an expiration trade.

The Federal Reserve are not going to increase rates in the 1<sup>st</sup> and 2<sup>nd</sup> quarters of this year and unless the economy creates many more jobs each month than recently, not in the 3<sup>rd</sup> quarter either.

#### March 05

My advice last week was to go long this contract into the key non-farm pay roll report and it indeed worked. So if long, my advice is stay long but introduce a close stop just in case Greenspan says something to scare the markets. If Bearish then hold back until the Fed Chairman speaks as his comments later this week will be key. However for choice I think this current rally is good for another 15- 20 ticks and Greenspan's comments could be the trigger.

Given the continuing disappointment in the economies ability to create jobs, and the very low inflation rate it is difficult seeing the Fed tightening policy soon.

### EURIBOR

The ECB meeting passed without a rate cut. Indeed it seemed they were rather hopping for some kind of help via a statement on forex rates from the G7 meeting over this last weekend. A part from the usual platitudes of not liking currency volatility no real help emerged.

#### March 04

As I foretold last week the contract regained its losses caused by the FOMC shock the previous week and if you took my recommendation and went long the market then happiness is yours. That being the case; stay long. If not already long but bullish then don't despair there is more to come so buy now. This contract has further to go. I would suggest another 10 ticks from here.

#### March 05

Here like the front end of the curve the market is bullish. Last week I looked for the contract to advance to 97.34 it did that and more and there is more to come. For those already involved; add on and run a close stop. For those who are bullish and not yet long buy now. I am looking for a move to 97.60. For those who are bearish I would suggest waiting for the French and German GDP releases on Thursday. If they show any unexpected strength then this may be a sell opportunity.

The Euro land economy as said before continues to struggle and the strength of the Euro only makes things worse. The ECB will have to ease policy eventually.

## BONDS

### The Gilt

Although I have no enthusiasm for this contract, its performance over the last week has led me to conclude it may be worth a small buy. So if that's what you do run a close stop. It could reach 109.00 before it runs out of steam. I am going to maintain my stance as a wall flower as far as the Gilt is concerned.

### The Treasury Note (10yr)

Last week I advised selling any rally. The contract rallied I still want to sell it. However if the contract moves above 115.00 I will revisit my view of it but for the moment I think the economic fundamentals i.e. the budget deficit, undermines the attractiveness of this contract.

It is worth noting that this is a presidential election year and the Democrats appear to be producing someone to challenge Bush. If that position solidifies further then start watching the Democrats policies re the deficit. If they favour fiscal rectitude then a Treasury rally may be in the offing as we move through the year.

### The Bund

Having fully regained its composure after the FOMC shock the Bund showed how good a buy it is. I remain bullish, if as suggested you went long last week, then you have been well rewarded. At this level I would propose halving the position and observe. I expect some side ways movement before it resumes its bull run up to 116.00. If not long yet but bullish be patient and wait, you may over the next couple of days get an opportunity at lower levels. If Bearish, then sell here with a close stop, but I really find it hard to short this contract, since with the German economy struggling and the ECB holding the monetary policy reins the only relief is lower long term rates.

## CURRENCIES

After the G7 talks at the weekend the market rightly concluded the only thing to do was sell the Dollar. I remain bearish of the Dollar. My chosen form of expression is to buy cable. Although Buying the Euro will yield good results, it is worth mentioning that Sterling has gained against the Euro. If as I suggested last week, you had bought cable, .then you have enjoyed the rally. I expect the move to continue but after such a strong move I think it right to book some profit and halve the position. If, over the next few days the market stays above 1.85 I would reinstate the full position. If bullish, but not yet long, then I would start to buy small here and look to build a position. I feel the market is so well set that to continue to wait risks completely

missing the boat. If Bearish of this market; I would respectfully suggest you stand aside for the time being. May be if there is Central Bank intervention you will have a chance to sell the market, but not now.

The general picture remains unchanged; the twin deficits continue to weigh on the dollar and until we see strong job creation there will continue to be an element of doubt as to the durability and sustainability of the US economic recovery.