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A FUNDAMENTAL VIEW

7DAYS AHEAD

10-16/05/2004

SHORT END HIT BY CENTRAL BANK MEETING'S

BONDS SELL OFF AFTER US DATA

CURRENCY'S MIXED

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Short Sterling

CALENDAR 03/05-07/05/2004: - ACTUAL

<u>Tuesday</u> CIPS Manufacturing	<u>Thursday</u> CIPS Services. BoE MPC	
55.1	59.00	4.25%

Last week I highlighted the above releases. Both CIPS surveys came in stronger than market expectation and the MPC raised rates by 25 basis points to 4.25% as widely expected. The MPC seemed concerned that inflation would indeed be higher in two years time if they held policy steady. Their rationale was; continuing house price inflation, lack of spare capacity in the economy and higher oil prices. Personally I think they are overly concerned; a disinflationary environment still persists internationally and since the UK is a very open economy these effects will restrain domestic inflation as will the strength of the currency. As for oil, the effects here will not just be higher inflation but slower growth also. The judgement is which of the two will have the most important impact.

CALENDAR 10/05-14/05/2004: - FORECAST

<u>Monday</u> PPI Output sa yr/yr	<u>Tuesday</u> Ind prod & Man Output		<u>Wednesday</u> MPC Qrtly inflation Rprt
1.3%	0.00 mthly	-0.3 mthly	Bearish for rates

This week sees the above releases. Of these, the number which catches my eye is the Quarterly inflation report. The Bank will have to show inflation moving higher if they had failed to act but at the same time they will need to be realistic because CPI is currently at 1.1%, hardly problematic.

Last time I was bullish the front contract but remained neutral the longer dates.

This week I am going neutral the curve. I had reasoned that since so much was already priced in and the change in policy so widely expected, the reaction would be more muted. However in the event the market sold off after the rate announcement and then again on Friday after the non-farm payroll data; I still see 5% as the worst case scenario level of base rates so with June 05 almost pricing in 5.5% that feels excessive.

BULLS will wisely stay sidelined.

BEARS must assess how much further the market can move from here over the near/medium term.

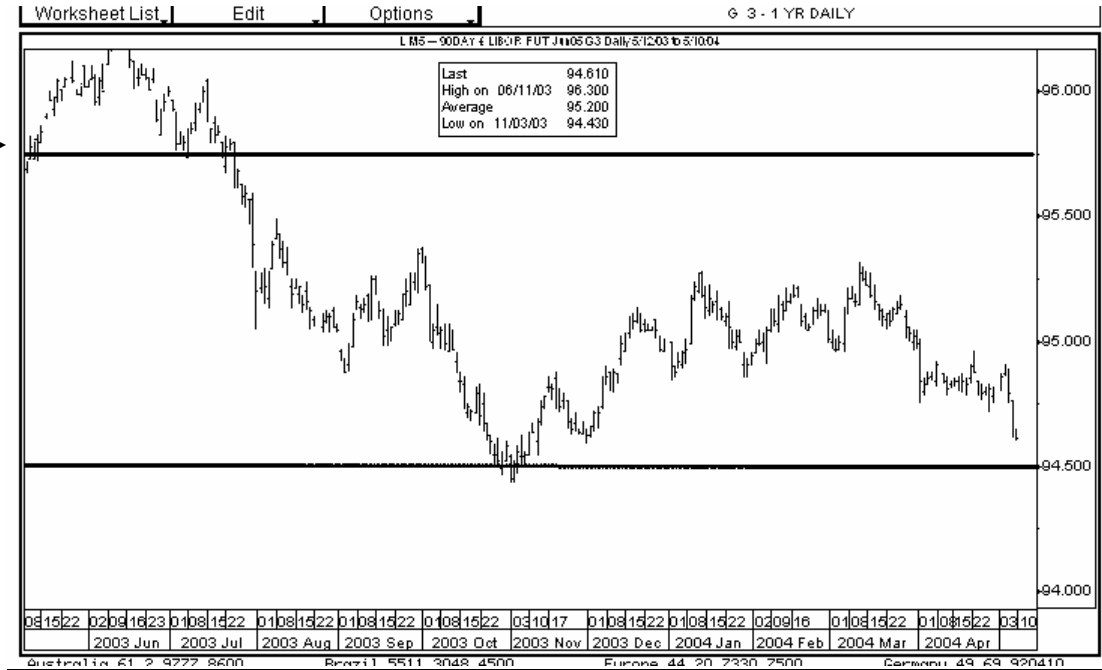
JUNE 04 95.43

Trade recommendation: - I am **Neutral**.

JUNE 05 94.62

Trade recommendation: - I am **Neutral**.

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JUNE 05 SHORT STERLING

Current level of base lending rate.

Market expectation for base rates.

EURO DOLLARS**CALENDAR 03/05-07/05/2004: - ACTUAL**

<u>Monday</u> ISM Manufacturing	<u>Tuesday</u> FEDS FOMC	<u>Wednesday</u> ISM Non- Manufacturing	<u>Friday</u> Non-farm Payroll Unemployment rate
62.4	Unchge/Balanced	68.4	+288k/ 5.6

Last week I was focused on the above releases. The manufacturing survey was broadly in line, the service survey was noticeably stronger, the FOMC as anticipated left policy unchanged whilst tweaking the statement in the direction of higher rates, but Friday's non-farm payroll data was much stronger than market consensus with the report coming in at +288k vs an expected gain of 170k together with upward revision to the previous months data releases. This forced the market materially lower (see chart on next page).

CALENDAR 10/05-14/05/2004: - ACTUAL

<u>Thursday</u> PPI/PPI ex Autos & Retail Sales		<u>Friday</u> CPI, Ind prod/Cap use & U Mich conf		
0.3/0.2	0.2/0.2	0.3 0.2	0.5 & 76.7	96.0

This week I am focused on the above releases, especially retail sales. Will it show a picture of continuing strength thus nudging the Fed close to a rate hike.

Last week I remained neutral the front of the curve but bearish the further out contracts and it proved right with my option strategy showing a 9 tick profit.

This week I am maintaining that stance. With the market now speculating on a June rate increase from the Fed, I think that is a little premature, however another very strong number in June and their hand may be forced. Personally I think they will wait until August.

BULLS should remain sidelined.

BEARS should hold their positions and I again recommend my trade idea in June 05, which is already showing a 9 tick profit.

JUNE 04 98.545

Trade recommendation: - I am **Neutral**.

JUNE 05 96.525

Trade Recommendation: - I am **Bearish**. **SUGESTION** Buy 96.50/96.00 put spread v selling the 97.25/97.50 call spread. Net cost 12.75 ticks. The market has moved along way but when the Fed does move policy has a long way to go to reach neutrality.

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June 05 Euro Dollars

See how the market sold off on Friday. This chart is starting to take on the Characteristics of a double top.

EURIBOR**CALENDAR 03/05-07/05/2004: - ACTUAL**

<u>Wednesday</u>	<u>Thursday</u>	
German Unemployment	German factory Orders	ECB
+23K/ 10.5%	-0.7m/m, 5.2yr/yr	Unchanged

Last week I was focused on the above releases. German unemployment; higher, German factory orders; weaker and the ECB announced their rates decision; unchanged. Given the clear weakness in Euro Land's largest economy, the ECB'S decision is yet again another disappointment.

CALENDAR 10/05-14/05/2004 FORECAST

<u>Wednesday</u>		<u>Thursday</u>			
GE HICP	Fr 1 ST Qtr GDP	GE 1 st Qtr GDP	Fr HICP	Italian Ind prd/Q1GDP	
0.3m/m 1.7 y/y	0.8 Q/Q	0.4 Q/ 0.7y/y	0.3m/ 2.4y	0.4m	0.4Q

This week we are focused on the above data releases which should show just how growth in euro land is shaping up.

Last time I was bullish the curve and was burned, ouch!!! The combination of a BoE rate increase, ECB disappointment and v strong non-farm payroll numbers was simply too much for the market to take.

This week I am going neutral the curve in search of greater clarity.

BULLS should remain unengaged.

BEARS I can't recommend anything here, the market is clearly moving counter to the economic fundamentals.

JUNE 04 97.895

Trade Recommendation: - I am **Neutral**.

JUNE 05 97.06

Trade Recommendation: - I am **Neutral**.

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EURIBOR SPREAD**ERM04/ERM05**

This spread moved violently against us. Such is the scale of the retracement I have concluded it is better to withdraw for the time being. This spread could Move a little further yet.

BONDS

The Gilt 106.04

Trade Recommendation: - I am **Bearish**.

Last time I was bearish the market and it moved violently my way, selling off 1.34 points. If you have been following my advise then you have had a good run.

This week I am holding to my recommendation. As I have said here on many occasions the fundamentals do not look good for UK Government debt. There is a large deficit and the Chancellor will not do anything to correct it this side of a general election. Should the MPC miss handle monetary policy over the next 6-12 months then we could be left with the unhappy mess of large deficits, a slowing economy and higher long term yields.

BULLS should refrain.

BEARS should hold their position for a move on down to 105.00. However run a stop the market has moved a long way.

The US Treasury Note (10 yr) 108.18

Trade recommendation: - I am **Bearish**.

Last time I advised being short of this contract and it moved our way. My target was 108.00 and it came within a whisker of it.

This week I am maintaining my short position for a move to 108.00 and beyond to 106.00 over time.

BULLS should go away and trade something else.

BEARS who took my advice last time are still making money. But as always run a stop. We don't want to give it back. There is more to come but bond markets can have sharp short covering rallies.

The Bund 113.12

Trade Recommendation: - I am **Neutral**.

Last time I was square and so I remain. However the fundamentals in this market argue for the bull case.

BULLS should stand easy for now.

BEARS have had a good run and the market is being dragged lower by the other bond markets. The recent weakness in the currency market doesn't help either. However at some time the local fundamentals will come to the fore and push this contract better, but not yet I fear.

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CURRENCIES

Last time I was long the Dollar against the Euro, neutral Cable and long sterling against the Euro and they moved on balance, my way.

This week I am holding to last weeks recommendations. The Fed, as said last week, changed its wording and held policy. That together with the strong non-farm payroll data served to strengthen the dollar. The impetus came from the view that these events have brought forward the moment the Fed begins increasing interest rates. Sterling is still fundamentally a buy but it has lost its way. We will get a clearer picture this week when the Bank of England releases its latest quarterly inflation report.

Recommendation: - Buy the Dollar against the Euro.

Neutral Cable

Buy Sterling against the Euro.
Eventual target 0.625

GOLD

The market had an unhappy time last week if you are a gold bull, however as I said last week its fortunes are closely tied to that of the US Dollar. The Dollar strengthened last week as the data releases out of the US led the market to conclude policy will be tightened this summer.

I think for the time being this market has had its bull run and we could see an assault on \$340.00 an ounce.

OIL

The oil price made 13 year high's last week and it seems it could go higher yet. The Geopolitical situation is causing volatility in the oil market and as these tensions are unlikely to abate any time soon the market will remain choppy. At the time of writing, the Saudis and Kuwaitis both called for an increase in the opec production ceiling to alleviate the squeeze. This did take the steam out of the market but I wouldn't hold your breath. The whole middle east looks an even bigger mess, politically, than usual and that area still holds the largest chunk of the worlds oil reserves.

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The current chart of Brent oil future.

