

FX Briefing

15 August 2008

Highlights

- Bank of England softens its tone despite rising inflation
- Negative growth in the eurozone
- Strong dollar and global growth worries push commodity prices down

Dollar rally continues

The dollar continued to gain ground against almost all major currencies this week. EUR-USD slipped further to 1.4720. Cable fell a further 7 cents and by the end of the week was only 1.86 – a 21 month low. Since mid-July, the UK currency has lost over 7% versus the dollar. During the course of the week, the dollar firmed against the yen too, rising above 110.

Of all the major currencies, the pound Sterling lost the most ground. This week alone, the UK currency dropped by almost 3%, despite the news on Tuesday that the UK inflation rate had rocketed from 3.8 to a new cycle high of 4.4%. In spite of this, the Bank of England's latest inflation report, published the following day, took a rather dovish tone, which surprised forex market players. Although inflation rates are set to go up even further initially, the UK central bank is expecting inflation to fall to below the 2% target in the next two years as a result of weaker economic growth. The gloomy economic assessment in the BoE's report has fuelled rate cut expectations once more. The market is now expecting the next interest rate cut to take place as early as autumn.

As we had already predicted last week, the weak economic data continued to weigh on the euro this week too. In the second quarter, GDP fell by 0.2% for the first time since the introduction of monetary union. The large countries such as Germany, Italy and, surprisingly, France posted even bigger declines. The GDP data published did not contain any major surprises, but they did

confirm that the eurozone has entered a period of economic weakness.

The weakness is likely to continue, as the prospects for the third quarter do not look any better, given that sentiment indicators and industrial new orders have plummeted. Eurozone production figures also endorse this view. In the second quarter, industrial production declined by 0.6% quarter-on-quarter, and the negative overhang for the third quarter is just as high.

Thus the ECB could, as early as November, have to face the fact that, after two negative quarters, the eurozone has entered a technical recession. Interest rate hike expectations have therefore now vanished completely from the market. If the economic weakness persists, there is more likelihood of rate cut expectations. We are expecting the ECB to react promptly, like the BoE, and to adopt a much less hawkish stance at its next meetings, despite the high inflation rates. We could envisage interest rate cuts towards winter.

The dollar was also supported this week by US inflation data. CPI rose by 0.8% month-on-month, twice as much as had been expected. The core rate also went up surprisingly sharply by 0.3% month-on-month, pushing the annual rate to 2.5%, further above the Fed's comfort zone. This is giving rise to expectations, that the Fed could be forced to raise interest rates, despite the weak US economy, in order to combat heightened inflation risks.

The dollar's strength was also partly responsible for commodity prices falling further this week. For the first time for eight months, gold dropped below \$800 per ounce. In view of increasing concern about global growth and the strong dollar, commodities are becoming less attractive as an alternative investment.

Next week, the focus in the eurozone will be on the first sentiment indicators for August. These are likely to be weaker across the board. As far as the US is concerned, markets will be primarily interested in housing market data.

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Key indicators and important events

Country	Indicator / Event	Release date	Forecast (in % mom/yoy)	Prev. period (in % mom/yoy)	Comments
GE	ZEW economic sent. / Aug	19/8	-68.9	-63.9	
JP	BoJ interest rate decision	19/8	0.50	0.50	
US	Housing starts	19/8	960k	1066k	
JP	BoJ Monthly Report	20/8			
GE	RBS PMI manuf. / Aug	21/8	50.0	50.9	
US	Philadelphia Fed index / Aug	21/8	-18.0	-16.3	
EMU	Industrial new orders / Jun	22/8	-2.0 / -6.7	-3.5 / -1.0	
BE	Business confidence / Aug	22/8	-8.6	-7.6	

Money and foreign exchange market quotations

	Spot vs. EUR	Change vs. EUR	Interbank offered rates		
	15/08/08	in % week-on-week	1 month	3 months	6 months
EUR	-	-	4.48	4.96	5.15
USD	1.4720	2.7	2.47	2.81	3.12
JPY	162.66	2.1	0.61	0.88	0.96
GBP	0.7922	-0.8	5.37	5.76	5.93
CHF	1.6167	0.7	2.26	2.75	2.89
SEK	9.3435	0.5	4.71	5.13	5.37
PLN	3.3350	-1.9	6.25	6.39	6.45
CZK	24.538	-1.3	3.62	3.82	3.85
CAD	1.5710	2.2	3.11	3.33	3.40
AUD	1.7072	-0.6	7.26	7.36	7.37
NZD	2.1125	2.0	8.21	8.29	8.25
SGD	2.0851	1.4	1.32	1.51	1.81
ZAR	11.7371	-1.3	12.50	12.75	12.75

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