FX Briefing

29 May 2009

Highlights

- Treasuries: supply pressure and quality doubts weigh on dollar
- Substantial foreign demand for T-notes at auctions
- ECB set to keep refi rate on hold
- ECB staff to revise down growth and inflation projections

Focus shifts to US government bonds

In the last fortnight, the forex markets' focus has shifted somewhat. Up until about 10 days ago, the dollar's weakness was primarily a sign that international investors' risk appetite was gradually growing in view of the first green shoots of economic improvement and favourable equity markets. The EUR-USD rally from 1.36 to 1.40 in the middle of last week, however, was triggered mainly by sharp falls in Treasury prices. Within a few days, yields on 10-year T-notes climbed from around 3.20% to 3.60%, even peaking at over 3.70%. The yields on equivalent Bunds also rose from around 3.35% to 3.60%.

The interest rate increase corresponds to a certain extent with hopes that an economic recovery is on the way – safety is no longer the number 1 priority. In this case, however, supply side factors played a decisive role. Apparently the yield jump was triggered by the US Treasury's announcement that the following week it was planning to issue over 100bn of 2-, 5- and 7-year T-notes (plus 61bn of 3- and 6-month T-bills). This drew investors' attention to the extraordinarily high level of public borrowing. Then it was announced that S&P had changed Britain's credit rating outlook (up to now AAA) from stable to negative. This intensified investors' worries. A considerable number of market participants also see the "yellow card" given to the UK as a warning to the US to keep an eye on its own credit quality.

The dollar is under pressure because the US government is borrowing abroad on a large scale. At the end of 2008, $3215bn US government bonds, more than half of all privately held US Treasury securities, were in foreign hands. China's holdings alone amounted to well over $700bn. The depreciation of the dollar shows that international investors are becoming less willing to hold existing dollar-denominated debt, let alone increase it.

At the beginning of the week, the leading article in the Financial Times provided some degree of reassurance. It said that, despite critical comments by government spokemen in the last few months, China's official foreign exchange authorities were still buying US government bonds. The last few days' auction results show that about 45 per cent of the $101bn T-notes were bought by indirect bidders (foreigners). Compared with previous years, this is quite a reasonable proportion; it should be borne in mind, however, that the proportion of foreigners interested in the longer maturities was smaller, and that prices, particularly at the long end, had fallen significantly beforehand.

ECB set to keep refi rate unchanged

The ECB governing council's monthly meeting is being held next Thursday. We are expecting the refinancing rate to be kept on hold at 1%. At the beginning of May, the council had kept its options open for further interest rate cuts, but had given no clear indication that rate cuts were

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planned. According to the ECB, the dramatic GDP collapse in the first quarter had been taken into account when rates were lowered to 1%. The economic outlook has not deteriorated significantly since then. The leading indicators are currently signalling that the downswing is slowing, but an economic recovery in the eurozone is still a long way off. However, this is more or less in line with expectations.

We predict that the new ECB staff projections will be adjusted in accordance with the revised view of the ECB council. The staff should reduce its GDP forecast for 2009 significantly to about –4%, but the forecast for 2010 is not likely to be revised at all, or only slightly to just below zero. The inflation forecasts could also be revised down somewhat. The growing output gap is creating a deflationary impetus, which, however, is being partially offset by the expected increases in energy prices (the staff projections derive the expectations from the forward prices). But on the whole we are not expecting the revised ECB staff projections to give any fresh indication as to future policy.

The ECB has announced that on 23 June it will conduct the first long-term refinancing operation with a maturity of one year. Full allotment is planned at the current refi rate. Apparently, the council is considering extending this offer by setting a sort of "interest rate floor". The idea seems to be that the tender could become less attractive if markets are expecting further interest rate cuts. In our view, if such a commitment is made, it will at best be worded in very general terms, given the considerable macroeconomic risks.

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Key indicators and important events

Country	Indicator / Event	Release date	Forecast (in % mom/yoy)	Prev. period (in % mom/yoy)	Comments
World	UN summit	1-3/6			
US	PCE core deflator / Apr	1/6	0.2 / 1.8	0.2 / 1.8	
US	ISM manufacturing / May	1/6	42.0	40.1	
EMU	GDP / Q1	3/6	–2.5 / –4.6	–1.6 / –1.4	
US	Factory orders / Apr	3/6	1.2	–0.9	mom
EWU	ECB monetary pol. decision	4/6	1.00	1.00	
GB	BoE monetary pol. decision	4/6	0.50	0.50	
US	Labour market / May > change non-farm payrolls > unemployment rate	5/6	 –540k 9.2	 –539k 8.9	

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Money and foreign exchange market quotations

	Spot vs. EUR	Change vs. EUR		Interbank offered rates	
	29/05/09	in % week-on-week	1 month	3 months	6 months
EUR	–	–	0.92	1.27	1.48
USD	1.4098	-0.9	0.32	0.66	1.24
JPY	135.09	-2.8	0.24	0.52	0.72
GBP	0.8732	0.7	0.67	1.28	1.49
CHF	1.5135	0.5	0.20	0.40	0.54
SEK	10.6936	-2.0	0.75	0.96	1.28
PLN	4.4712	-1.9	3.96	4.57	4.67
CZK	26.879	-0.7	1.90	2.30	2.50
CAD	1.5534	1.4	0.40	0.70	1.10
AUD	1.7656	1.0	3.21	3.44	3.69
NZD	2.2149	1.9	2.90	3.15	3.39
SGD	2.0353	-1.0	0.31	0.44	0.63
ZAR	11.2023	4.0	8.00	7.85	7.85

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