

FX Briefing

25 February 2011

Highlights

- Fighting in Libya sends investors fleeing to safe havens
- Oil prices soar; long-term effects of Middle East turmoil remain to be seen
- ECB intensifies warning about inflation risks
- Markets await new signals from the Fed

US monetary policy: a change in tone?

Safety was the top priority again this week: the uncertain and clearly dangerous situation in Libya, disruptions in oil production as a result of the unrest, and fears that the political turmoil could spread to other countries (particularly Saudi Arabia) pushed oil prices up significantly. During the course of the week, Brent soared by more than \$12 to around \$115/b, fuelling fears that the global economy could be in danger.

These developments prompted investors to pull out of riskier assets. Equities fell, whereas long-term bonds (with top notch ratings) firmed. In the forex market, the yen and the Swiss franc were the most sought after currencies; the dollar fell to a new record low of 0.9229 against the franc. Emerging market currencies tended to be sold off. As usual, the Australian dollar and the New Zealand dollar were hit by risk-off trades. The latter was also weighed down by the earthquake in Christchurch and concerns about the fiscal burden of the disaster.

The effect of all this on EUR and USD is harder to explain. Up until recently, the unrest in Tunisia and Egypt was still an argument in the dollar's favour, partly because of the greater distance between the US and the Middle East and the fact that the US is less dependent on oil from this region, and partly because of the dollar's role as a financing currency for riskier assets (i.e. carry trades).

This week, however, these arguments have been replaced by monetary policy considerations. It looks very much as though the ECB could pave the way for raising interest rates at its meeting next Thursday. Various ECB representatives, including executive council members Jürgen Stark and Lorenzo Bini Smaghi, have made hawkish comments. Luxembourg central bank governor Yves Mersch was particularly explicit: he was quoted as saying that the ECB may warn of upside inflation risks and could adjust its assessment of economic risks from downside to neutral. Mr Mersch also said that with the economy strengthening and inflation in breach of the target, action would be necessary to rebalance the monetary policy stance. In our view, this is a clear indication that the ECB is planning to raise interest rates in the next few months.

On the back of all these signs, the euro continued to rise during the course of the week. At the end of the week EUR-USD was around 1,38. As far as next week and the ECB governing council's meeting on Thursday are concerned, the interest rate hike intentions have already been priced in. Thus scope for surprises which could strengthen the euro further is limited. Therefore a counter movement in the forex market is more likely.

At the moment, there is a bigger chance of surprises on the US side. Up to now, the Fed has stuck to the monetary policy line decided in December, whereby, given sustained high unemployment and very low inflation rates, maintain-

ing the extremely expansionary monetary stance, including the asset purchase programme, is warranted. But even the Fed is now admitting that in the last few months, the economic recovery has been stronger than expected. This has sparked discussions in the Fed and elsewhere as to how long this policy should continue.

Markets are waiting for a signal that a monetary policy shift by the Fed could be on the cards. Thus a comment made by St Louis Fed president James Bullard last week attracted much attention: he said that it was time to discuss “tapering off” the asset purchase programme. Last autumn, Mr Bullard, a well-known hawk, was the first to advocate QE2 in public. Next week, Ben Bernanke will deliver his semi-annual report on monetary policy to the Congress. That would be a good opportunity to signal a shift in monetary policy stance.

We will not see a radical change in rhetoric, but, if anything, a gradual shift. Together with decent economic data from the US – at the beginning of the month, the ISM survey results and the labour market report will be published – it could support the dollar, however.

What impact the political uncertainties in the Middle East will have on the currency market remains to be seen. The dollar is perhaps more

likely to be seen as a safe haven than the euro (see above). However, it is also unclear to what extent the oil price increase will support the dollar or the euro. Last week, markets seemed to expect the ECB to react more sharply to oil price-related inflation risks, whereas the Fed was seen to be more focused on growth and employment risks. On the other hand, it has often been argued that, as oil is billed in dollars, rising oil prices spark additional demand for the US currency.

However, it cannot simply be assumed that the political developments in the Middle East and North Africa will lead to higher oil prices in the long run. It is rather that the present turmoil is causing production and supply shortfalls, which are pushing oil prices up at the moment. Even if the political situation were to remain unstable, political leaders in the region – whether old or new – are likely to do their utmost to calm people down. And to this end, they will need money, which can only be obtained by selling oil and gas. It is therefore possible that the political turmoil in the region could in the medium term increase oil supply in the market, which would dampen prices. It is striking that the Brent forward market is not pricing in any further price increases at the moment.

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Key indicators and important events

Country	Indicator / Event	Release date	Forecast (in % mom/yoy)	Prev. period (in % mom/yoy)	Comments
US	PCE core deflator / Jan	28/2	0.25 / 1.0	0.0 / 0.7	
GE	Labour market / Feb >absol. change unempl. sa >unemployment rate sa	1/3	-15k 7.4	-13k 7.4	
EMU	HICP flash estimate / Feb	1/3	2.3	2.3	yoy
US	Bernanke's testimony	1-2/3	Fed president testifies on monetary policy and the economy in Senate and House of Representatives		
US	ISM manufacturing / Feb	1/3	60.8	60.8	
US	Fed's Beige Book	2/3			
EMU	ECB interest rate decision	3/3	1.00	1.00	
US	ISM non-manufact. / Feb	3/3	60.0	59.4	
EU	Government leaders meet	4/3			topic: debt crisis
US	Labour market / Feb >absol. change unempl. sa >unemployment rate sa	4/3	125k 9.0	36k 9.0	

Money and foreign exchange market quotations

	Spot vs. EUR	Change vs. EUR	Interbank offered rates		
	25/02/11	in % week-on-week	1 month	3 months	6 months
EUR	-	-	0.82	1.05	1.33
USD	1.3789	-1.7	0.26	0.31	0.46
JPY	112.89	0.1	0.13	0.19	0.35
GBP	0.8568	-2.4	0.61	0.80	1.11
CHF	1.2787	1.0	0.14	0.17	0.24
SEK	8.8210	-1.1	1.96	2.19	2.31
PLN	3.9756	-1.4	3.84	4.17	4.38
CZK	24.488	-0.6	0.85	1.21	1.35
CAD	1.3521	-1.4	1.08	1.21	1.41
AUD	1.3608	-1.5	4.86	4.95	5.15
NZD	1.8378	-3.2	3.13	3.19	3.28
SGD	1.7570	-1.7	0.44	0.56	0.69
ZAR	9.6188	1.2	5.94	5.82	6.50

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