Interest Rate and FX Outlook

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The Federal Funds Futures Market is leaning a little bit in favor of the Federal Open Market Committee (FOMC) lifting the federal funds target rate by 25 bps to 5.50% on August 8—but it's a close call. Last month's congressional testimony from Federal Reserve Chairman Bernanke saw a drastic volte face in US interest rate expectations as Bernanke posited a pullback in US economic growth which will help to moderate inflation pressures in the US. Fed policymakers received a challenging piece of news when it was reported late last month that preliminary Q2 US gross domestic product printed at 2.5%, was below the expectations that foresaw economic growth above 3.0%. At the same time, however, it was reported that the GDP price index grew 3.3%, up from Q1's pace of 3.1%, while the core personal consumption expenditures index climbed 2.9% from 2.0% and the employment cost index expanded to 0.9% from 0.6%. The Fed's perceived comfort zone for core personal consumption expenditures is around 1.7% to 2.0% and the 2.9% print is of concern.

These data are particularly troubling for the Fed because they suggest Bernanke's forward-looking statement about a pullback in inflation remains, well, forward-looking. Crude oil prices —detraction from economic growth in most of the world—continue to result in strong factory gate and retail prices around the world. It may be quite difficult for the FOMC to justify the issue of not raising the interest rates in August, especially with the tailwinds of second quarter price pressures behind them. What about the rest of the world, and how they may relate to foreign exchange?

Eurozone

The euro traded as high as the $1.2770 level on the second-to-last trading day of July, right about the 61.8% retracement of the move from $1.3480 to $1.1640. The weaker-than-expected US Gross Domestic Product (GDP) print was the impetus for a stronger single currency and the pair's ability to remain bid at or above the $1.2559 level in the last week of July—equal to the 50% retracement of the aforementioned range—may bode well for the common currency. Chartists are also quick to point out the fact that the euro has remained bid above the $1.1632 level—the 38.2% retracement of the move from $0.8342 to $1.3666 in 2006. Similarly, the Sri Lankan pair has remained bid above the $1.2409 area—the 23.6% retracement of the same range—since depreciating from the $1.2970 level in May. What about the European Central Bank (ECB)?

Some traders believe the ECB will lift borrowing costs again in early August while others foresee a move higher in September or October. Inflation remains elevated in most of the Euro zone and the ECB has remained relatively on script "vigilant" against inflation. In July, a more vocal ensemble of Euro zone finance ministers threw their tacit support behind another rate hike by the ECB. Business sentiment remains robust in the Euro zone and the strongest economic growth the area has seen in years has been wondering many, if structural inefficiencies in the Euro zone are waning. As the ECB Bank's Governing Council is less-than-transparent with regard to the details of its interest rate deliberations, August's meeting will be a close call. The eventual end of the Fed's rate-tightening cycle and the continuation of ECB rate hikes will narrow the interest rate differential between the US and Euro zone and is likely to precipitate a stronger common currency.

Japan

The US dollar was on the defensive *vis-à-vis* the yen at the end of July as the greenback tested bids around the ¥114.60 level after peaking around the ¥117.85 level. In 2006, the pair has failed to challenge the ¥122.35 level, the 61.8% retracement of the move from ¥135.13 to ¥101.67. Likewise, the ¥119.00 figure remains at a fairly difficult level for the pair with chartists noting that it represents the 38.2% retracement of the move from ¥147.65 to ¥101.30—long-term resistance.

Bank of Japan courageously lifted the overnight unsecured call rate to 0.25% from around 0% in recent weeks and the markets are anticipating another +25 bps move higher in rates by the end of the year with an additional move to 0.75% by the end of the current fiscal year in March 2007.

Great Britain

The British pound has reclaimed some of the ground it lost vis-à-vis the US dollar in 2005 and looks poised to again attack the $1.9000 figure after printing above the $1.8595 level in late July, equal to the 61.8% retracement of the move from $1.9550 to $1.7050. The $1.8960 level presented the pair with difficulty in May, equal to the 76.4% retracement of the move from $1.9550 to $1.7045. Some chartists note the pair remained bid above at the $1.8165 level in July, equal to the 23.6% retracement of the move from $1.3680 to $1.9550.

Bank of England's Monetary Policy Committee (MPC) is unlikely to raise interest rates in August which means that the headline repo rate will have remained anchored at 4.50% since August 2005. Traders, however, believe the MPC has recently become more hawkish and some foresee a monetary tightening to 4.75% by the end of the year.

Reference # 05M-2006-09-01-10