Daily Market Strategy

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Market Strategy

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- **GBP trapped**
- **7-15y gilts exposed to QE pause, steeper curve**

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/$: 1.5892	€/$: 1.3879	$/Y: 91.02
UK 5y sw: 3.13%	US 5y sw: 2.72%	EU 5y sw: 2.63%

Overnight

- A call to ease UK easing (WSJ); says a major benefit could be any added pressure on the government to take tougher action to cut its vast deficit
- Shanghai comp back below 3,000
- US Treasury to sell $81bn in quarterly refunding next week (40bn 3y, 25bn 10y, 16bn 30y)

The BoE arguably faces one of its most daunting policy decisions in recent history today when it must decide whether or not to expand QE and add to the £200bn of asset purchases (Bank rate on hold). With the market overwhelmingly leaning towards a QE pause (64/66 economists), on a pure risk/reward basis, the tactical play must be to position for a rise in QE, or a QE pause but with a dovish MPC statement. Ahead of tomorrow's overriding US NFP report, we see no escape route for GBP from the bearish trap and favour selling GBP/USD rallies, unless equity markets rebound (Shanghai comp slipped back below 3,000 overnight). The cards are stacked differently for gilts and swaps, where a QE pause could leave the government exposed (see WSJ article), and trigger a sell-of in the 7-15y section of the curve where the BoE's holdings are concentrated. This would also favour a bearish steepening of the 2y/10y cash curve, with the spread motoring through 275bp. The risk/reward strategy on a QE increase favours putting on a curve flattener with a 265bp target.

Ahead today:

- UK Bank rate to stay on hold at 0.50%. Our economics team goes against consensus on QE and sees an increase from £200bn to £225bn.
- ECB: no change in rates expected. The situation in Greece, an EU rescue package, and latest assessment of the economy will dominate the press conference.
- US initial claims , productivity and factory orders are all due but are not seen triggering a major knee-jerk market reaction as dealers look ahead to NFP tomorrow. We will also hear for the first time from FOMC member Hoenig since his vote against last week's FOMC statement.

FX:

GBP: unless equities rally on a stronger NFP number tomorrow, we look for GBP/USD to break lower over the next 48 hours and progress towards the October low at 1.5708. Key resistance is situated in the 1.60 and 1.6050 area. The outlook for EUR/GBP is more nuanced by developments in European rate markets and the reaction in Greece and Portugal 10y paper to ECB comments this afternoon with regard to possible intervention and funding of the public deficits. The underperformance of EUR/USD vs GBP/USD this morning is steering EUR/GBP closer to 0.8715 support, and a QE pause would favour a pullback towards 0.8650. GBP/AUD is rangebound in the 1.8050 area (resistance at 1.8142). GBP/CHF is supported at 1.6855.

EUR/USD broke below 1.3900 and 1.3850 in quick succession this morning as peripheral bond spreads widen. This puts 1.3805, 50% Fibo retracement, on the radar ahead of the ECB. A move to 1.35 looms below that, with stronger EU data clearly failing to neutralise increased EUR diversification flows.

Rates: We look for a break out of recent ranges for UK 5y swaps over the next 48 hours, with a lurch higher in yields hanging in the balance if the MPC decides to pause QE and US NFP comes in above consensus. In this context, support and resistance levels can be of less relevance as the risk of being caught off guard by surprise outcomes. The 2y/10y swap curve steepens to 220bp.

	Close	Daily Change %
FX		
EUR/GBP	0.8742	0.01%
GBP/USD	1.5892	-0.51%
EUR/USD	1.3893	-0.52%
USD/JPY	90.980	0.66%
AUD/USD	0.8830	-0.38%
Bonds %		**bp**
US 10Yr	3.705	6.4
EUR 10Yr	3.223	2.8
UK10 Yr	3.915	0.2
UK 5yr Swap	3.128	-0.5
Equities		**%**
S&P500	1097.28	-0.55%
FTSE100	5253.15	-0.57%
Eurostoxx50	2804.61	-0.90%
Shanghai Composite	2995.31	-0.28%
Commodities		**%**
Crude Oil $/bl	76.98	-0.32%
Gold $/oz	1109.8	-0.42%
Copper	297.4	-3.75%
Baltic Dry	2673	-0.67%
Other		
VIX	21.60	0.56%
iTraxx XOVER	443.30	-8.1

Today's Data	Time	Consensus	Previous	Events
BoE -- Rate Decision	12:00	0.50%	0.50%	Fed speaker: Hoenig (19:00)
-- QE Target	12:00	200bn	200bn	
ECB Rate Decision	12:45	1.0%	1.0%	
US Non-Farm Productivity, Q4 prelim	13:30	6.5%	8.1%	
US Unit Labour Costs, Q4 prelim	13:30	-3.4%	-2.5%	
US Initial Claims, Jan-30	13:30	455k	470k	
US Factory Orders, Dec	15:00	0.5%	1.1%	

*All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg , DataStream & CQG

Today's MPC Decision

1. GBP is a SELL

The popular view is that a QE pause would effectively boost GBP. Simply put, the BoE would stop printing money, halting the de-facto devaluation of the currency. The argument for this must be that the BoE does not believe the weak Q1 GDP stats. Survey data suggest the underlying economy is actually expanding at a stronger than 0.1% q/q rate and that eventually the ONS data will catch-up, but currently cannot be relied upon for decision making purposes. The bears argue that the BoE is leaning on a bias to 'pause' on misplaced confidence in the resilience of the economy, and underestimates the risk of a double-dip going into the election (see our Weekly Strategy for more on this). In other words, if the market concludes the BoE is making another policy mistake or if the MPC statement comes with a warning that QE can always be extended if warranted, a knee-jerk rally could rapidly unwind.

QE raised makes GBP a sell on the basis that increasing money supply devalues the currency and risks pushing up inflation. Since the start of QE in March-09, M4 lending has continued to fall on an annual basis, providing little support for the rationale that QE boosts nominal spending though the creation of money. As long as the money in circulation doesn't improve (multiplier effect), there is no upside for spending to accelerate. In other words, the MPC takes its decision tomorrow to increase QE solely on the premise that without a rise in money supply, the economy is not going anywhere but sideways. A QE increase would argue that the BoE thinks the risks of a relapse in activity cannot be underestimated. GBP/USD breaks lower end of the range sub 1.5833, target lowered to 1.57. EUR/GBP spikes through 0.88, target raised to 0.90.

2. GBP is a BUY

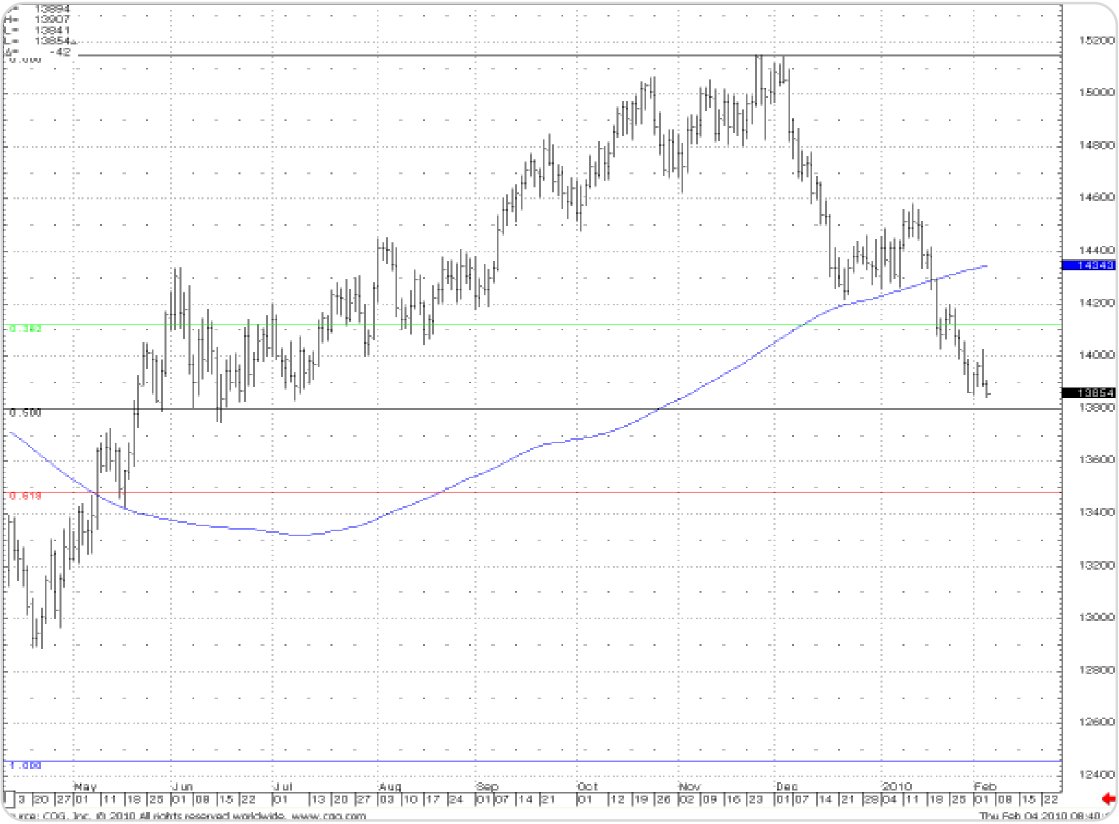
QE paused. The bulls argue that the surge in core CPI is indicative of less spare capacity than originally thought and that the economy is effectively growing faster than official ONS data suggest. This does not appear consistent with governor King's view, but the rationale is that this will put pressure on the BoE to raise rates this year to stop inflation expectations from bedding in (Dec short sterling future discounts 1.50%). With the recovery underway in the US (positive NFP Friday?) and the euro zone also exhibiting resilience in early Q1, the UK stands to benefit from stronger exports. The fact that the Fed has pledged to keep interest rates exceptionally low and optimism that the ECB will stand pat all year support the argument that wider UK/US and UK/EU yield differentials will support GBP. A positive print for US NFP and bounce in stocks supports the long GBP strategy. GBP/USD bounces to 1.6350, EUR/GBP breaks below 0.87 (GBP/EUR through 1.15).

3. Bottom line

The market expects a QE pause (64/66 eco's), but on a risk/reward basis is inclined to sell GBP rallies (cue this morning's price action). For GBP/USD, this corroborates with the sentiment shift since January 18 and the steady decline in 1mth risk reversals from -0.85 to -1.12. For EUR/GBP, the reaction does not simply revolve around a QE pause (Greece, etc). Once the dust settles, much will depend on how gilts react and what this means for UK/EU 2y and 10y spreads. A QE pause would certainly not be viewed as presaging a first rate hike in 2010 (data dependant!), but the market could be inclined to see it that way and push up short dated yields.

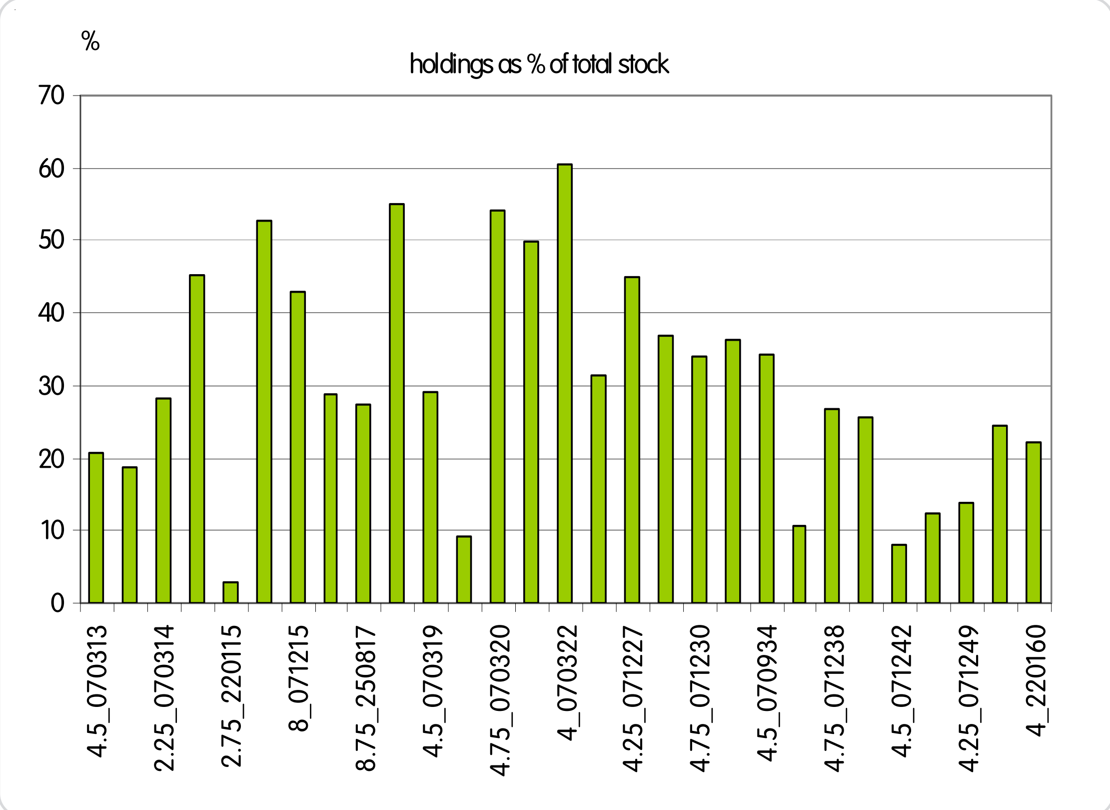
One final point. In the past, so-called 'make or break' data releases and CB decisions have led to nowhere and proved northing more than a damp squib. Whilst we would not underestimate the impact of the MPC decision for sterling and gilts, the devil may not be in the decision itself, but in how the MPC voted and what CPI/GDP projections lead the Bank to its conclusion. This information will not be available until Feb 10th and Feb 17th.

EUR/USD through 1.3850, next support at 1.3805



GBP/USD: target 1.5708 on QE increase

BoE, set to buy more gilts?



Steeper UK curve favoured on QE pause

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EUR/GBP	0.8742	0.01%
GBP/EUR	1.1438	0.00%
GBP/USD	1.5892	-0.51%
GBP/JPY	144.60	0.16%
GBP/CHF	1.6840	-0.06%
GBP/AUD	1.8001	-0.11%
GBP/CAD	1.6888	0.04%
GBP/NZD	2.2622	0.87%
GBP/NOK	9.3315	0.12%
GBP/ZAR	11.9355	-0.04%
GBP/CNY	10.8465	-0.54%

Bonds %		bp
US 10Yr	3.705	6.4
EUR 10Yr	3.223	2.8
UK10 Yr	3.915	0.2

Other		
VIX	21.60	0.56%
iTraxx XOVER	443.30	-8.1
DJ Agriculture Index	59.38	-0.49%

3-mth money		bp
UK	0.616	-
EUR	0.606	-
US	0.249	-

Equities	Close	Daily Change %
S&P500	1097.28	-0.55%
DJIA	10270.55	-0.26%
FTSE100	5253.15	-0.57%
Eurostoxx50	2804.61	-0.90%
Shanghai Composite*	2995.31	-0.28%

*latest price

Commodities		%
Crude Oil $/bl	76.98	-0.32%
Gold $/oz	1109.8	-0.42%
Copper c/lb	297.4	-3.75%
Silver $/oz	16.37	-2.04%
Baltic Dry	2673	-0.67%

Swaps %		bp
US 5yr	2.720	4.2
EUR 5yr	2.622	2.3
UK 5yr	3.128	-0.5

Official Rates %	
UK	0.50
US	0.25
EU	1.00
Japan	0.10