

## Market Insight

### A false start for policy expectations

Over the past few weeks, market participants have been quick to price in monetary policy tightening in response to resurgent stock markets, buoyant macroeconomic indicators and strong sentiment across the developed world. Policy divergence or even policy 'desynchronisation' whereby policy tightening is carried out at different rates, could well be the biggest driver of FX rates over the next 6 months. However, hawkish expectations have proved to be somewhat premature as recovery front-runners – Australia, Norway and New Zealand have been unwilling to indulge market expectations just yet. From a policy perspective, disparities between different regions are getting wider. While the Bank of England considers a form of policy easing in addition to a possible increase in asset purchases beyond £200bn, other central banks such as the Fed, ECB and SNB are tentatively looking to remove stimulus measures. Israel meanwhile has already raised rates at the end of August. For FX traders the focus is usually on the major currencies but policy decisions further afield are having an impact because of the speculative nature of the FX market.

Over the course of this week, investors are anticipating further development in the 'policy disparity' theme – Norges Bank, the Fed, the Bank of Japan and the Bank of England are all due to make references to monetary policy this week either through press conferences or meeting minutes. Hints regarding the development of monetary policy are getting more attention than usual leading to short-term volatility which is likely to continue until more of a consensus is established.

A consequence of diverging monetary policies is the re-emergence of carry trades (borrowing cheaply in a low funding currency and investing in a high yielding currency). Currencies such as the US Dollar and the Japanese Yen are becoming good candidates for such a use because their policy rates are expected to stay suppressed well into 2010.

On top of the mounting pile of themes and influences comes the G20 meeting in Pittsburgh due to commence today. FX is unlikely to be mentioned directly but broader political and economic developments could reshape what market participants expect going forward. The issue of Dollar hegemony, capital market regulation, bank controls and the evolution of stimulus measures are all on the agenda which could lead to all asset classes being affected.

The wide-range of opinions regarding rates of recovery is creating indecision amongst investors and in turn tends to induce knee-jerk reactions as fresh themes develop. A good example of this was last Tuesday's sharp selloff in Sterling pairs purely due to Mervyn King's unwillingness to rule out a reduction in remuneration rates at the Bank of England. Long-term investors are having trouble finding a sense of clarity because of the niggling fear of a false dawn in the recovery, so despite the improving data set and strong comments from prominent central bankers, investors are still tentative when it comes to committing long-term. This has left many asset classes in the control of speculators looking to second guess what the next development will be.



#### Market Research

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