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# Market Insight

## A change of tides, a change of themes

There has been a clear and dramatic change in prevailing themes that are affecting currency markets this year. It is now very dangerous to look too far ahead or with too much assuredness. In the beginning of 2008 interest rate expectations were the main driver of sentiment and price action for most G10 currencies. The ECB was very hawkish in its assessment of future monetary policy in the EU. Inflation was priority number one as savers were lobbying European central bankers to fight inflation as its top priority at the expense of economic growth. The French president Nicolas Sarkozy even went on record as saying that he would attempt to “talk some sense” into ECB members with regards to interest rates. This story was echoed in the US and the UK which both saw levels of inflation that exceeded their admitted comfort zones.

As if some tide had gone out, everything began to change around the mid-point of 2008 as the financial crisis began to gather momentum and accelerate very rapidly, leading to the pinnacle of this acceleration in September 2008 when Lehmann Brothers, AIG, Fannie Mae, Freddie Mac, Merrill Lynch, Morgan Stanley and others went out of business as independent entities or having to rely on government nationalisation from then on. Currencies began to take their cue from daily headlines that were affecting sentiment very significantly and interest rate expectations were not as important as risk aversion because investors were more interested in knowing where their assets would be safe rather than worrying about the prospect of being 1%-3% worse off. Fear and near panic ensued as several institutions faced crises of confidence which made independently funded investment banks become history altogether in the US. Now, there are no independent investment banks left in the US.

Since September 2008, the level of fear has subsided accompanied by mass de-facto nationalisation of banking sectors across the globe. This has been the next theme that has influenced FX direction and volatility. The US and the UK (traditionally free market proponents) have taken the lead in supporting their respective banking sectors by directly taking stakes in banks or offering loans at very favourable rates for fear of major instability that could ensue if nothing was done. Currencies have reacted with



### Market Research

**George Tchetvertakov**  
Head of Market Research  
gtchetvertakov@alpari.co.uk

some dismay at these actions. GBP has suffered greatly because of the sudden loose monetary policy employed by the Bank of England combined with de-facto nationalisations of RBS and HBOS. The UK's current account deficit is relatively large compared to other European nations which has added to Sterling's overvaluation. The EUR has had modest falls against major currencies because economic fundamentals in the EU have remained strong despite several banks facing the same troubles as their US and UK counterparts. The financial crisis contagion has affected all currencies but to different degrees because not all countries have the same exposure to US sub-prime debt within their banks, pension funds and insurance firms.

The theme that is now most prevalent in currency markets is interest rate differentials and their expectations. The best example of this effect is the price action in EUR/GBP which has seen the EUR appreciate by 12% against Sterling since October 2008 as UK interest rates fall faster than Europe's. Japan has the lowest interest rate in the world although it currently has the strongest currency, this is partly explained by interest rate differentials added to risk aversion. It is widely expected for most G10 countries to be lowering their interest rates quite close to zero over the course of this current financial crisis so it is quite conceivable that the JPY will be yielding almost as much as the USD, GBP, EUR and CHF in the very near future but with the benefit of being more insulated from the credit market turmoil than most other leading nations.

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