London Session: The markets rally on a potential liquidity boost looks fragile

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The markets have decided that Ben Bernanke was dovish at his speech yesterday, although not as dovish as his fellow Princeton economist Paul Krugman. The Fed Governor reiterated that economic conditions “are likely to warrant exceptionally low levels for the Federal Funds rate at least through late 2014”.

This was expected, although the FOMC’s statement highlighted that the Bank remains concerned about external and internal factors that could weigh on growth. Although the statement said that the “economy has been expanding moderately” and that the unemployment rate has declined it also stuck a note of caution saying that the unemployment rate remains elevated and the housing sector remains depressed. Perhaps the biggest cause of concern for the Fed is outside risks, especially the sovereign debt crisis. The Fed considers “strains in the global financial markets (to) continue to pose significant downside risks to the economic outlook”. This is out of the Fed’s control, however if things take a turn for the worse in Europe then the Fed will be ready and waiting to pump the US economy with stimulus and protect it from the ravages of the sovereign debt crisis.

However, the Fed remains firmly in wait-and-see mode and did not suggest that it would add more stimulus to the economy once Operation Twist comes to an end in June. However, it won’t start shrinking its balance sheet any time soon either. As we have pointed out, the total assets on the Fed’s balance sheet fell from $2.94 trillion in mid-Feb to $2.89 trillion earlier this month, although in the last couple of weeks it has started to move higher again. While we don’t expect the Fed’s balance sheet to expand any time soon, we also don’t think it will shrink significantly. This is important for the dollar since we can’t see a significant uptrend in the greenback until the Fed starts shrinking (through tightening monetary policy) its enormous balance sheet.

The dollar has been on the back foot today, which helped EURUSD and GBPUSD claw back some of yesterday’s losses. EURUSD was above 1.3240 – a key resistance zone - and GBPUSD was above 1.62 at one stage, as the dollar move overtook European sovereign concerns and weak UK GDP data to dominate the FX market this morning. “Don’t fight the Fed” is a decent mantra, and once again the Federal Reserve has shown its control over asset markets.

The fall in the dollar has helped to boost the oil price and European stock markets also opened higher. However, we are sceptical about the decline in the dollar today, and we believe there could be some volatility in the next 24 hours. The US releases Q1 GDP on Friday at 1330BST, which is expected to show that the economy expanded by 2.5%, down from the 3% annual expansion recorded in the fourth quarter 2011. However, this is a much stronger growth rate than the UK or Europe and it could boost the dollar crosses. The market expects personal consumption to expand at a faster pace in Q1 than in Q4 2011, which would be very good news as the consumer is the major engine of US economic growth. So the fundamental back-drop may be dollar positive but if the Fed remains “concerned” about the US economic outlook then it could keep the dollar under some downward pressure for the medium-term.

The Eurozone has been out of the headlines in the latter part of this week; however that doesn’t mean that all is quiet regarding the sovereign debt crisis. Mario Draghi commented yesterday that the Eurozone needs a growth pact to run alongside the fiscal pact. This could become even more urgent tomorrow when Spain releases some key economic data. It releases retail sales for March and the unemployment rate for the first quarter, which is expected to rise to 23.8% from 22.85% in Q4 2011. If unemployment in Spain is as bad as the market expects then it highlights the urgency with which the Eurozone authorities need to put together a convincing growth pact or else see Europe’s peripheral nations slide into deep economic depressions.

Italy sold short-term debt today although Rome had to pay up to attract investors. Yields rose to 1.772% from 1.119% at an auction in March. This was the highest yield since January. There were more signs that Europe’s LTRO was wearing off, economic confidence in the currency bloc fell to 92.8 from 94.5 in March – the lowest level since December 2011.

Market moves:

The dollar has clawed back some losses this morning as stock markets in Europe have come under pressure in mid-morning. The fact the Fed offered no signs of more stimuli (unless something catastrophic happens in the global economy) could weigh on risk assets later today, hence why we are sceptical of the move higher in risk assets in the last 24 hours.

USDJPY will be in focus tomorrow as the BOJ is expected to add more stimuli to the economy and the US is releasing GDP data. This could have a big impact on the rate differential between the US and Japan, which is a key driver of USDJPY. The last time the BOJ pumped stimuli into the economy in February it caused the yen to weaken substantially. We expect a move tomorrow to weaken the yen, although it may not have such an effect as it did back in Feb. Read more here.

The Kiwi has moved with overall risk appetite rather than the RBNZ meeting, which suggested the central bank will remain on hold for some time. It continues to hover near a key support zone at 0.8169 – the bottom of the Ichimoku cloud chart – and the start of a technical downtrend.

Best Regards,

Kathleen Brooks