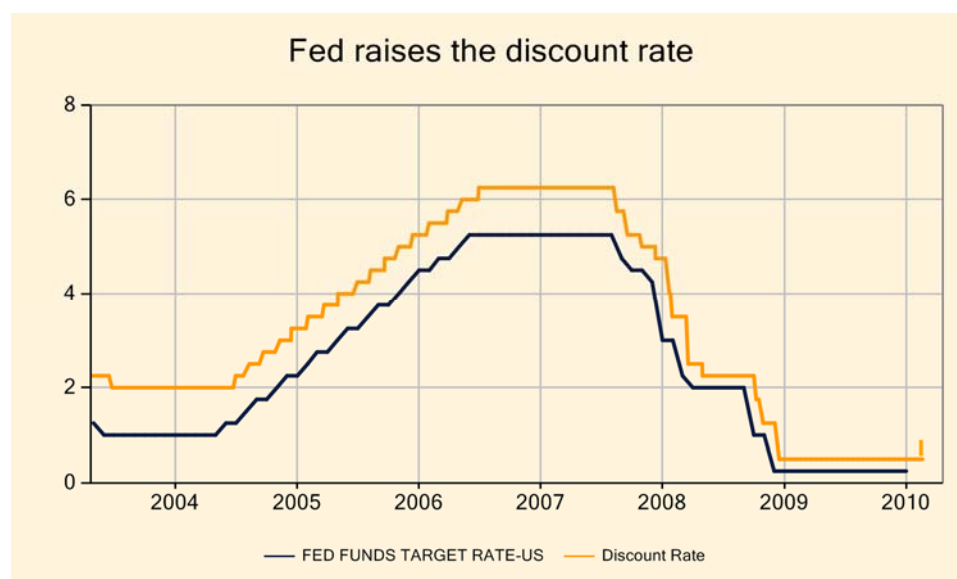


The Week Ahead

22 February 2010

The week ahead will continue to be dominated by the reverberations from the Fed's decision to raise the discount rate by 25bps to 0.75% at the end of last week. Although the Fed had flagged its intention to raise the discount rate at its 27 January FOMC meeting few had anticipated that this would happen quite so quickly, and hence it came as something of a surprise to financial markets when it was announced on Friday. Bond yields rose sharply, equity markets moved lower and the dollar gained additional ground, although some of these moves were unwound by the end of the day. While the authorities in the US have been keen to portray the move as simply a technical adjustment that will ultimately bring the spread over the Fed funds rate back up to more normal levels near 1.00%, symbolically it clearly carries more weight. This was the first hike in the discount rate since June 2006, and it clearly puts the Fed ahead of the other major central banks in the global tightening race.



The discount rate spread was originally lowered in response to the severity of the financial crisis that started in August 2007. In response to the near drying up of interbank liquidity the Fed lowered the discount rate spread, and encouraged banks to borrow at the discount window to alleviate severe strains in the market for short-term liquidity. Now that the liquidity crisis has been effectively over for many months, this unusually low spread of the discount rate is no longer necessary. While the policy rate (Fed funds) remains unchanged, however, last week's move will still have policy implications allowing the Fed the room to raise the Fed funds rate when it so wishes. As such monetary conditions have thus been tightened as a result of Friday's decision. Further clarification on Fed policy will come in the coming week when Fed Chairman Bernanke gives his semi-annual testimony on monetary policy to the Houses of Congress. Bernanke will clearly take some pressure for this decision, which underlines the importance he attached to getting it out of the way. No doubt he will try to deflect it by saying that it was merely a normalization measure, but other announcements last week in the FOMC minutes show that the Fed is moving fast to withdraw the emergency stimulus of 2009, with the minutes showing that the Fed is now considering selling back securities as the economy recovers. This week's data will play second fiddle to Bernanke's statement, with consumer confidence, home sales, house price data and the first revision to Q4 GDP the main offerings.

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The contrast between the Fed and the ECB and BoE is now becoming quite stark. The ECB (and the eurozone) currently has its hands filled with Greece, and in the absence of any breakthrough the ECB will be unwilling to rock the boat by threatening to tighten policy prematurely, especially as recent data has shown growth deteriorate in Q4 and activity data in Q110 remain muted. The IFO data from Germany this week will add more colour on this front. Our own sense is that while the Fed is likely to raise the Fed funds rate in H210, the ECB will wait until 2011. The same goes for the UK, even more so, as the Bank of England finds itself in between a rock and a hard place as far as monetary policy is concerned. With Governor King having just sent a letter to the Chancellor explaining the rise in inflation to 3.5%, the markets know the policy response is severely restricted due to the weakness of the underlying economy. Retail sales fell by a bigger than expected 1.8% in January, while the budget deficit deteriorated further and money supply growth remained weak. In the coming week we will see the revised estimate of Q4 GDP, which may see a slight upward revision to the 0.1% advance estimate. However, even so with the early Q110 data proving worse than expected, it remains entirely possible that the UK economy could move back into recession in early 2010, especially with the mood darkening as the general election draws nearer. While the EUR regained most of Friday's losses by the close (helped further this morning by reports that the eurozone has put aside EUR25bn to help Greece), the GBP did not and it appears to be becoming one of the more vulnerable G4 currencies to renewed USD strength. USD/JPY is also holding on to most of its gains and could be in line to rise further as well, as the BoJ seems intent to maintain its monetary policy stimulus despite better than expected GDP figures in Q4.

Central Bank reaction to last week's US discount rate hike will drive interest rate expectations in the region. Key markets to watch will be Egypt, where BOP funding flows have come in lower than expected. First half foreign investment flow data shows foreign direct investment down 35% in the first six months of the fiscal year and USDEGP has shown upside momentum in recent days, with a move above 5.50 in the offing. At the same time, the current account deficit fell as import demand declined 17%/y, some 2 percent faster than exports. This leaves the Central Bank in a position where it can moderately increase deposit rates to increase the attractiveness of EGP assets whilst leaving the prime lending rate unchanged, despite inflation being above expectations in the first month of 2010. January's data, which showed inflation at 13.2%yoy, came after two months of relatively weak data in November and December. Tightening to head of demand-led inflation is not a priority at the moment.

MAJOR UPCOMING ECONOMIC EVENTS & DATA

	Expected	Previous
◆ Germany IFO (Tue)	96.1	95.8
◆ US Consumer Conf. (Tue)	55.0	5.9
◆ US New Home Sales (Wed)	352K	342K
◆ Germany unemployment ((Thu)	8.2%	8.2%
◆ US Durable Goods (Thu)	1.50%	0.3%
◆ UK GDP Q4 rev (Fri)	0.2% q/q	0.1%
◆ US GDP Q4 rev (Fri)	5.7%	5.7%
◆ US Chicago PMI (Fri)	58.5	61.5
◆ US U. Michigan Cons. Conf (Fri)		73.7

Tim Fox, Chief Economist, Emirates NBD 00 971 (0) 4 7014663. email: timothyf@emiratesnbd.com

Mark McFarland, Emerging Markets Economist, Emirates NBD 00 971 (0) 47015466 email smark@emiratesnbd.com

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