

FX Weekly

Review: 27th April – 4th May

Recap

- Economic recovery gains further momentum; risk tolerance escalates
- Sterling significantly higher as investor concerns surrounding banks are soothed
- US Dollar remains volatile, erratic and broadly lower against in most pairs
- Japanese Yen suffers extended losses, especially against cyclicals and commodities
- Commodity currencies stronger overall as raw materials demand expected to rise



Market Research

George Tchetvertakov

Head of Market Research

gtchetvertakov@alpari.co.uk

Currency pair	At Open on April 27 th	At 09:05 GMT on May 5 th	Nominal Change	% Change	Volatility
EUR/USD	1.3240	1.3349	0.0109	0.82%	3.18%
GBP/USD	1.4664	1.5032	0.0368	2.51%	2.95%
USD/JPY	96.81	99.03	2.22	2.29%	4.09%
USD/CHF	1.1380	1.1344	-0.0036	-0.32%	2.93%
EUR/GBP	0.9026	0.8879	-0.0147	-1.63%	1.91%
EUR/CHF	1.5071	1.5147	0.0076	0.50%	0.74%
GBP/CHF	1.6688	1.7054	0.0366	2.19%	1.92%
GBP/JPY	141.95	148.86	6.91	4.87%	6.58%
EUR/JPY	128.21	132.20	3.99	3.11%	6.21%
CHF/JPY	85.00	87.26	2.26	2.66%	5.84%
AUD/USD	0.7211	0.7401	0.0190	2.63%	5.46%
NZD/USD	0.5679	0.5766	0.0087	1.54%	4.40%
USD/CAD	1.2108	1.1755	-0.0353	-2.92%	3.60%

| Source: Alpari (UK)

A swine flu outbreak last weekend set a risk-averse tone leading to JPY and USD gains but this could not be sustained as the effects of the outbreak were/are clearly transitory both in humanitarian and economic terms. Initial JPY and USD buying was reversed mid-week leading to sharp falls in both by market close on Friday. In fact, USD could only gain against JPY as the battle of the risk-havens went USD's way.

Equities, commodity currencies, oil and gold all bounced as swine flu panic subsided. Although latent fears still persist, the overall level of concern and hype has largely gone away with the absence of significant news from the WHO and other agencies. Commodities and affected currencies were boosted by rising stock markets which traded off each other's lead thus creating strong upward momentum.

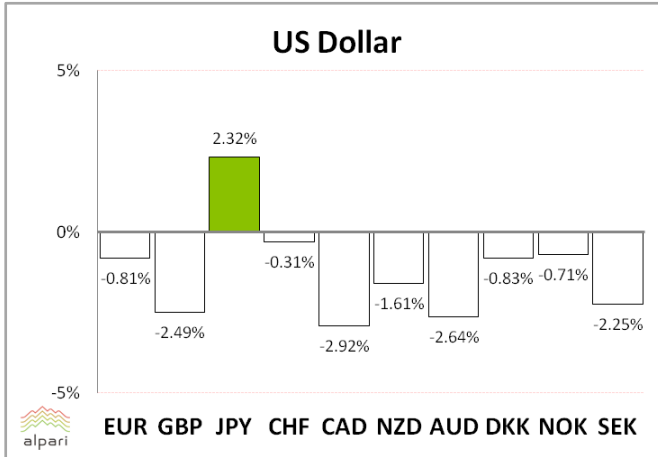
Rosy results and outlook of US, UK and European banks maintained a bullish risk attitude. Stocks and commodity currencies climbed at the expense of JPY, USD and CHF. Stock markets refused to see the probable bankruptcies of several US auto firms as signs of systemic weakness and instead climbed higher on the back of widespread confidence in continuation of the recent recovery. Market participants are falling over each other to get into a position that takes

advantage of an economic bounce, in the same vein as they were running for the exits as markets plunged over the course of 2008.



USD

Weak US GDP figures (-6.1% vs. -4.8% exp) made almost no impact on the US Dollar with attention firmly on the long-term benefits of stimulus packages and economic recovery. Scheduled FOMC meeting ended with rates unchanged and a statement that no further quantitative easing would be done beyond the \$1.1 Trillion already being conducted. USD rose because USD holders were reassured that currency devaluation



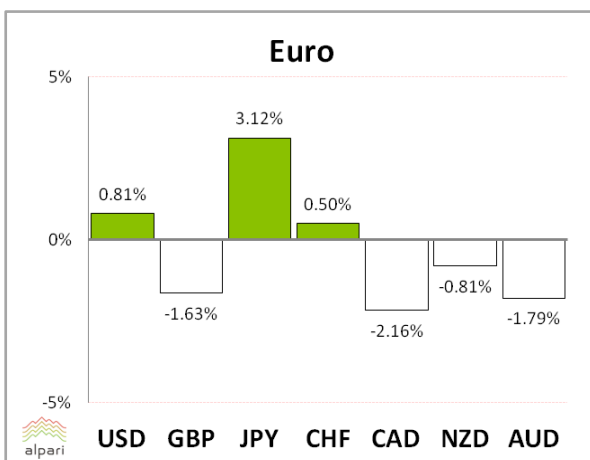
wouldn't take place as a result of the mammoth amounts of capital being used to stimulate the US economy. Aside from the primary macro data, the ISM manufacturing PMI (40.1 vs. 38.4 exp) indicator cemented opinions of imminent recovery.

One other important USD factor last week was the delay of stress tests results until May 6th at the earliest. Some estimates suggest that they may be released even later which played on fears that something significant is to be revealed. A large

proportion of market participants have already decided to ignore speculation going into the publication of results because some of the key points are already in the public domain. We know that potentially 10 banks will need fresh injections of capital, most likely to come from private sources although the TARP fund set up last year still has more than adequate reserves to support those banks not able to meet their capital requirements.

EUR

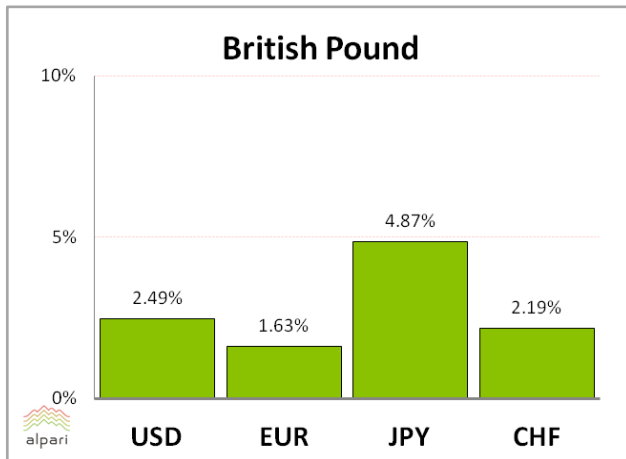
Considering the heavily risk tolerant atmosphere in the FX market last week it was of little surprise that the Euro fell against currencies like AUD, NZD, CAD and GBP and rose against USD, JPY and CHF. In addition, most of the gains or losses were largely <2% indicating a lack of clear direction. There were definitely mixed feelings regarding future development of the Euro because of imminent clarification regarding the ECB's quantitative easing stance.



The Euro fell rapidly after Ewald Nowotny confirmed the announcement of ECB's QE policy stance in May. The respected central banker did not give details but then he didn't have to. Speculators and worried EUR holders shorted the EUR just to be safe anyway. The lingering swine flu influence dragged on sentiment so a potential 50/50 decision to get out of anything risky was a no brainer considering the systemic threat posed by the swine flu theme.

GBP

The prevailing good mood combined with further upward surprises to macro data helped Sterling higher last week. CBI retail sales (3 vs. -40 exp.) strength, a slowdown in house price declines (Nationwide HPI at -0.4% vs. -1.2% exp.) and a stronger than expected Manufacturing PMI reading (42.9 vs. 40.2 exp.) led to strong GBP gains against all its counterparts. The majority of buying interest was at the expense of the Yen (+4.87%).

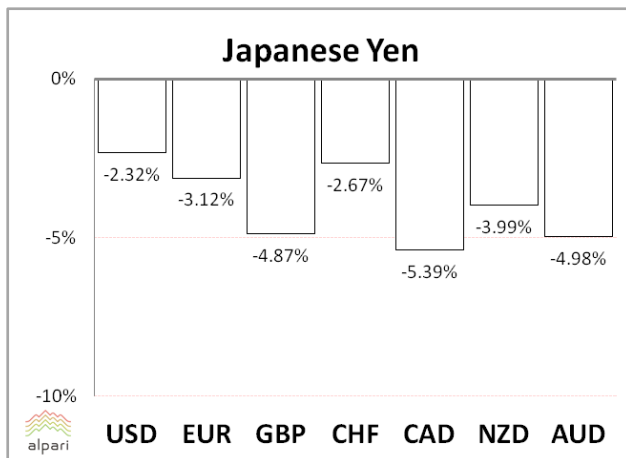


On a broader note, UK government estimates for future economic performance were being severely questioned last week for their alleged accuracy. Many investors feel the UK Treasury's estimates are far too optimistic which consider UK economic growth (or lack of) as a cyclical issue, and not a systematic, structural one which means any recovery is likely to be gradual and slow rather than rapid. For GBP traders this aspect is important because if market participants lose confidence in the stability of future price moves, they could

negate a recovery that is taking place by disinvesting from GBP denominated assets.

JPY

A change to the GDP growth estimate (0% to -3.3% in 2009) was diluted by other factors including swine flu and risk-averse impulse buying. Traders seemed to largely ignore the downward revision as anxiety surrounding the swine flu outbreak ensured JPY bulls took a lead role. By the end of the week, our estimate that the swine flu 'pandemic of panic' would subside quickly, allowing a retracement of knee-jerk rises plus pricing in of lower GDP estimates came true. From a seemingly dominant position on Tuesday morning, the Yen went on to shed value against every tradable currency; losses were heaviest against CAD (-5.39%) and AUD (-4.98%).



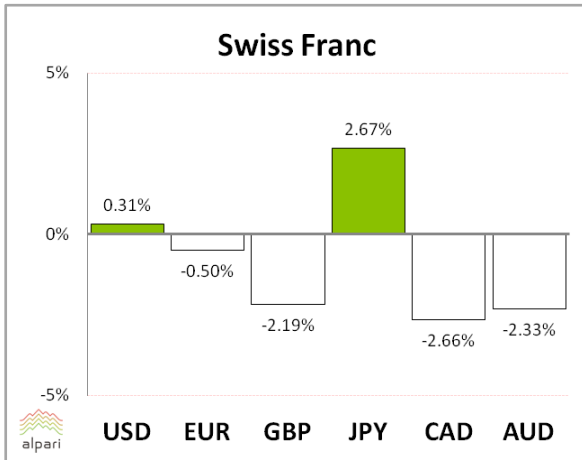
Better than expected retail sales figures (-3.9% vs. -4.8% exp) added momentum to Yen buying as investors hedged possible swine flu impacts. However, whereas the macro data effect added to JPY strength within a risk-averse environment, it also acted as a catalyst for JPY falls as the swine flu effect subsided. This was primarily due to the way traders interpreted the data. A 3.9% fall in retail sales is good if you expected a 4.7% fall but if looked at nominally, a 3.9% fall is a record decline that indicates significant weakness in the retail sector – important for GDP and prosperity i.e. far from

good. Exactly how data releases are interpreted is always fascinating because the end effect on FX prices is often altered once you overlay one factor after another. One clear outcome of varying FX interpretations has been the extremist way in which different factors have been priced in to FX values. Last week's swine flu is a perfect example of how a factor can influence almost every currency pair as it first breaks, playing on investor fears and anxieties in the process. Once the theme fades away, the affected currency suffers to a

higher degree because of the over-compensation that takes place, usually due to speculation induced volatility.



CHF



Recently, CHF has disassociated itself to a degree from the risk-haven reputation it has kept for years. A quantitative easing policy combined with vocal and actual central bank intervention has also weakened confidence in the long-term stamina of the currency. The connection was clearly in play last week as the swine flu panic ensured CHF was well supported, regardless of any other factors. As fears ebbed away, the Swiss Franc traded in similar fashion to the Euro by gaining against JPY and USD and falling in its other crosses. Amidst an atmosphere of confidence and optimism, it was the 3rd weakest currency behind the USD and JPY.

Others

Immediate NZD weakness following the expected 0.50% rate cut was due to an accompanying statement saying that rates would not rise above 2.5% until late 2010. Investor opinions immediately concentrated on future yield differentials between NZD and AUD. Weakness against USD was not sustained going into Thursday's European open but against AUD, the NZD continued to weaken suggesting that yield differentials were in fact the primary driver behind NZD price action.

Norwegian credit and retail sales figures published on Thursday were weaker than expected, weakening NOK and cementing expectations for a 50 bps rate cut this week. Unemployment data was mostly in line with forecasts as the amount of people unemployed continues to rise, similar to most other nations.

It is clear that positive market moves in equities, commodities and risk driven currencies have been based solely on expectations of a quick recovery in the near future rather than clear evidence of a recovery today. Such a forward looking way of investment tends to generate volatility and ultimately disappointment because picking a top or a bottom can only be done correctly once, whereas picking incorrectly can be done numerous times. This aspect can be applied to commodity linked currencies such as NOK, AUD and NZD because their trawls higher against the US Dollar have occurred largely because of expectations that countries like Norway are on their way to recovery from the financial crisis, leaving no need for large amounts of capital to be held in USD. Taking into account this view, we are still seeing large deteriorations in employment, housing, retail, manufacturing and services sectors across most of the G20 nations, but at slowing rates. This has already given enough reason for speculators to start selling USD and JPY at the expense of riskier alternatives; it should be remembered however that speculators are just as quick to exit positions with a forward-looking view as they are entering them.

Preview: 5th – 10th May



Looking ahead

- Four interest rate decisions dominate the FX space with most attention on the ECB
- US bank stress test results should be finally be revealed, to the relief of bored investors
- Multiple employment readings could play a part in reigning back runaway expectations of sharp recovery
- Extended amount of central bank commentary expected from several G10 nations; focus still firmly on QE plus validity and rate of economic recovery

This week sees no less than 4 interest rate decisions from Australia (no change exp.), Norway (-0.50% exp.), EU (-0.25% exp.) and UK (no change exp.). All could be significant depending on the outcomes. Norway and Australia have the most potential to surprise from a conventional perspective i.e. a rate cut against and/or beyond expectations whereas the EU and UK could well surprise from an unconventional perspective – announcing key changes to central bank policy regarding private sector asset purchases. The BoE is already conducting a QE policy by buying Gilts and corporate debt so we expect subdued trade in GBP surrounding the BoE statement on Thursday, unless a halt/expansion to the current policy is made.

In the case of the Euro we see the greatest probability for an extended move because of various factors. Although several ECB members have confirmed that a QE policy would be announced at this week's meeting, we have seen a consistently upbeat news flow and rapid improvements in key sentiment indicators around Europe. This adds weight to the argument that an unconventional policy is unsuitable at this precise time. Surely it is better to save such a fault-shifting policy announcement until a time when it is needed rather than just demanded by anxious investors? In addition, financial markets are seemingly beginning to recover so overdoing any kind of stimulus right now could be counter-productive as investors become spooked at the prospect of another substantial support package. Consequently, considering that no action at all would also upset the market, a 0.25% reduction in the base interest rate accompanied by commentary suggesting a QE policy is ready to be utilised – but not just now - is quite likely.

FX Sensitive Calendar Events

<p><u>Tuesday 5th May</u> (AUD) Interest Rate decision + statement (USD) ISM Non-Manufacturing PMI</p>	<p><u>Wednesday 6th May</u> (AUD) Retail Sales (AUD) Trade Balance (GBP) Halifax HPI (GBP) Services PMI (EUR) Retail Sales (USD) ADP Non-farm Employment (NZD) Employment Change & Unemployment Rate</p>
<p><u>Thursday 7th May</u> (AUD) Employment Change & Unemployment Rate (GBP) Interest Rate decision + statement (EUR) Interest Rate decision + statement (USD) Unemployment claims (USD) Bank Stress Test Results</p>	<p><u>Friday 8th May</u> (CHF) Unemployment Rate (GBP) Producer Price Index (CAD) Unemployment Rate (USD) Non-farm Payrolls</p>

A regular sight on our preview section have been US stress test results – widely touted to make or break the US banking industry. In the case of the former, investors would be tempted to continue their stampede in search of yield and profit and in the case of the latter, the US banking industry would be split into the haves and have not's. Some banks would be seen to be well capitalised, healthy and able to take on obligations

versus those who are still plagued by the sub-prime fallout and thus not worthy of fresh investment. Expectations and speculation regarding this issue has been astronomic over the past few weeks so expect that to continue until the results are revealed in whatever form. Some kind of result or further clarification is expected tomorrow (May 6th) although several news agencies have May 7th as a more likely announcement date. Investors are keenly awaiting the outcome as initial expectations are varied; some believe a significant proportion of banks will need further capital and some believe that most banks are now more or less OK (given positive Q1 results and a better operating environment) with the government standing behind them regardless of their health. Overall, many market participants are to an extent bored at seeing constantly changing developments to a theme which has already been priced in – even its worst case. The US Treasury has admitted that key financial institutions would not be allowed to fail so even if stress tests are failed industry-wide, US authorities would support pivotal banks. Bank stocks have taken so much flak in the past year and have fallen so graciously from their highs that even a large-scale nationalisation of the US banking industry would not be so shocking.

A multitude of employment reports from several countries could be important this week as market participants look for confirmation or disconfirmation of an economic recovery. Stock markets have definitely taken the lead in indicating a surge in confidence but in the end, it will be fundamental factors such as house prices, employment rates and retail sales that have the most impact in confirming or denying economic recovery. Over the past 2 months a continuous climb higher in major indices has been accompanied by risk flooding back to FX markets – and yet most measures of unemployment, spending, investment and production have continued to show declines at unprecedented rates during the period. The bear market rally is now turning into a bull market on the back of slower than expected deterioration in key indicators. This forgetful, forward-hopping approach may well prove all the critics wrong but we still expect unemployment to have increased in the US, New Zealand, Australia, Canada and Switzerland from previous readings.

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