

FX Weekly

Review: 11th – 17th May

Recap

- UK, EU and US stocks all 2-3% lower as risk-appetite was reigned in
- JPY and USD became the clear beneficiaries of returning scepticism surrounding economic recovery
- Japanese Yen makes sensational gains across the board in accordance with a 'security-over-yield' preference
- Deteriorating growth conditions in the UK, EU and US outweighed positive signs for global trade as investors covered cyclical longs and took profits
- A subdued Sterling held up well in all crosses despite a sombre Inflation Report



Market Research

George Tchetvertakov

Head of Market Research

gtchetvertakov@alpari.co.uk

Currency pair	At Open on May 11 th	At Close on May 15 th	Nominal Change	% Change	Volatility
EUR/USD	1.3654	1.3494	-0.0160	-1.17%	1.90%
GBP/USD	1.5227	1.5177	-0.0050	-0.33%	1.92%
USD/JPY	98.67	95.18	-3.49	-3.54%	4.18%
USD/CHF	1.1039	1.1212	0.0173	1.57%	2.45%
EUR/GBP	0.8962	0.8888	-0.0074	-0.83%	1.75%
EUR/CHF	1.5076	1.5132	0.0056	0.37%	0.94%
GBP/CHF	1.6807	1.7018	0.0211	1.26%	2.34%
GBP/JPY	150.22	144.46	-5.76	-3.83%	4.69%
EUR/JPY	134.72	128.44	-6.28	-4.66%	5.10%
CHF/JPY	89.33	84.85	-4.48	-5.02%	5.53%
AUD/USD	0.7710	0.7488	-0.0222	-2.88%	3.19%
NZD/USD	0.6043	0.5845	-0.0198	-3.28%	4.90%
USD/CAD	1.1490	1.1774	0.0284	2.47%	2.89%

| Source: Alpari (UK)

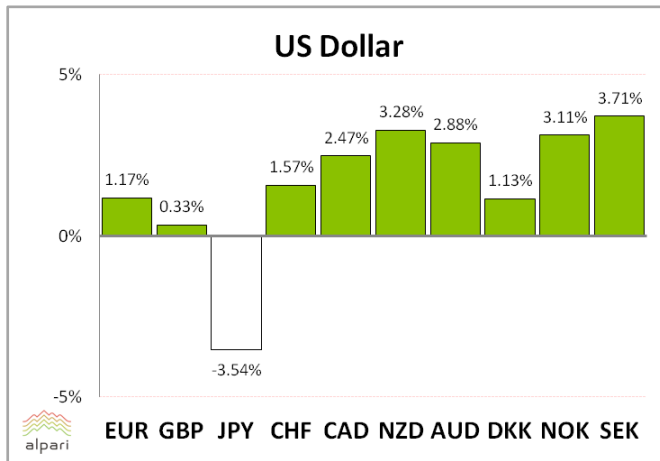
Financial markets caught up with their own excitement last week as lingering questions regarding the current risk-rally gained enough momentum to pull cyclical currencies off their highs. The Yen and US Dollar benefited most from the risk intolerant environment induced by unexpected weakness in the US retail sector accompanied by a sense of over-extension by bullish market participants.

Equity markets were broadly lower alongside commodities despite crude oil hitting a 6 month high of \$60 per barrel. Sterling was under severe pressure this week which could continue into next with scheduled macro data weighing on expectations. Overall, the Japanese Yen staged the biggest gains and was the most volatile currency in the G10.

From a broader perspective key themes in the FX market remain; possible developments of quantitative easing policies in participating countries and the validity of optimistic hopes for global aggregate demand. Following last week's corrections in several asset classes, this week's events will help resolve the argument of whether gains made since March were well founded as part of an economic recovery or whether retracements made over the past seven days were actually a call to clarity for investors.

USD

The US Dollar rose against every currency with the exception of the Yen last week as risk was reigned in across all assets classes. The largest gains came against Commodity and Scandinavian currencies with investors casting doubts over the sharp moves higher in equity and commodity markets. More than likely, a triple effect of investor doubts, profit taking and speculative exacerbation of predominating moves caused the retracements in FX markets last week.



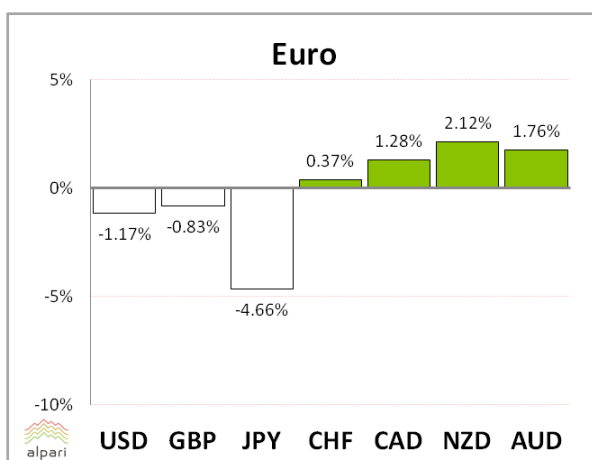
Positive data from the economic calendar acted as a weight on USD because of the currently negative correlation between upbeat US data and USD pricing. Better trade balances in the US (-\$27.6bn vs. -29.2bn exp.) and Canada (C\$1.1bn vs. C\$0.5bn exp.) were good figures for equity markets and added to good trade balance figures from the UK. Positive data surprises are beginning to take over from negative ones and follows on from previous week's performance when we saw better employment data from several countries as

well as strong PMI figures from Europe. All in all market participants had the ammunition to continue the risk-rally begun in March but this was halted by a theory-questioning retail sales figure which took everyone by surprise. US retail sales (-0.4% vs. 0.0% exp) on Wednesday drove investors into a risk-averse mood leading to a sharply stronger USD and JPY consistent with previous dashes for the exit amongst risk assets.

Much better than feared US TIC data (\$55.8bn vs. \$33.3bn exp.) lead to modest USD gains but did nothing significant in terms of price. The most important aspect of this news is that fears regarding the Dollar plus scepticism of the US economy overall were allayed. International investors clearly have an appetite for US assets even as risk tolerance is rising and USD comes under pressure from risk-averse flows leaving the Dollar.

EUR

The Euro once again found itself in a slipstream between risk-averse buying of USD and JPY and risk-averse selling of cyclical currencies such as CAD, NZD and AUD. A neutral risk stance allows the Euro to be favoured



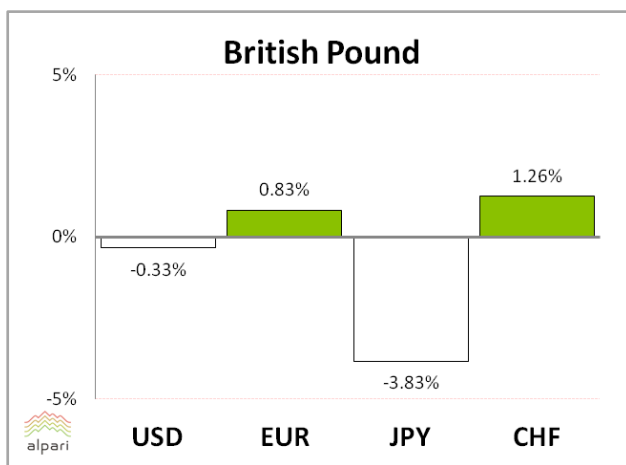
both in times of pessimism and optimism depending on other factors. Last week, despite suffering from worse than expected growth revisions and extremely dovish commentary from ECB member Kranjec, the Euro staged strong gains against CAD (+1.28%), NZD (+2.12%) and AUD (+1.76%) and even managed to gain against CHF (+0.78%). Gains against the Swiss Franc owed not only to Swiss side factors but also because a sense of the Franc losing its safe-haven status following persistently depreciative central bank talk and open market activity is beginning to turn the tide towards the Euro in the EUR/CHF pair, even in risk intolerant conditions.

ECB member Marco Kranjec suggested the ECB will widen the scope and breadth of the current bond purchasing policy. The suggestion spooked EUR bulls because only a week earlier, Trichet was clear that more severe measures would not be conducted. Effectively, the fragile appeasement done by the ECB of only buying covered bonds within the EU rather than conducting a full heartened policy (like in the UK, US and Switzerland) has given the Euro the best of both worlds: stronger sentiment because a debasement of the currency looks less likely under a featherweight QE policy alongside an answer to market calls for stimulus and assistance to struggling businesses and consumers in the EU. Kranjec's comments dented this balance because the possibility of more active policy creates fear of inflation in the medium-long term.

Worse than expected GDP figures for the EU (-4.6% vs. -4.0% exp Y/Y and -2.5% vs. -2.0% exp Q/Q) pushed the Euro lower on Friday with added downward momentum coming from speculation regarding the expansion of ECB's QE policy. The Euro was broadly weaker, especially against USD, JPY, CHF and GBP but held up quite nicely against AUD, NZD and CAD because weakness in those currencies capped EUR depreciation. A factor that mitigated the effect of the QE theme was Trichet's defensive which attempted to play down any QE expansion plans. Kranjec is a peripheral member with limited influence in comparison to other central bank members from larger EU countries so the effect on the Euro was minimal.

GBP

A very mixed week for Sterling as diverging news flow prevented any protracted moves leading to fairly tight ranges in Sterling pairs. A 3.83% fall against the Yen was the highlight for GBP traders as the global risk/economic recovery theme overshadowed better housing, industrial, labour and manufacturing sector data. Better trade balance numbers also helped to push Sterling higher early in the week with persisting expectations of better growth, demand and banking fortunes connecting Sterling with the ongoing risk-rally.

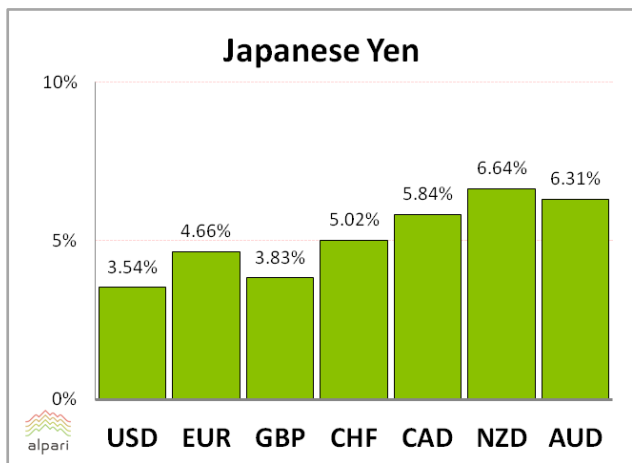


However, Wednesday's inflation report took significant value out of Sterling as growth recovery forecasts were revised lower and over a longer time frame. Before the press conference investors were expecting to see projected GDP figures lower than the Treasury's forecast announced in the Budget statement; but the degree of pessimism by the BoE governor spurred a sell-off that was already looking more and more likely as safe-haven demand was stoked via other factors. Also, the prospect of current interest rates rising to attract foreign capital, sooner rather

than later, became less likely as a result of Mervyn King's commentary suggesting economic resurgence should not be taken for granted because there is still major uncertainty concerning UK's growth outlook.

JPY

Within a lower equity and commodity market environment the Yen was boosted by safe-haven demand. The currency hasn't seen such strong moves in all pairs since the start of this year; strongest gains came against NZD (+6.64%), AUD (+6.31%) and CAD (+5.84%) as the commodity pullback forced related currencies off their highs despite crude oil prices touching \$60 per barrel, for the first time since November 2008.



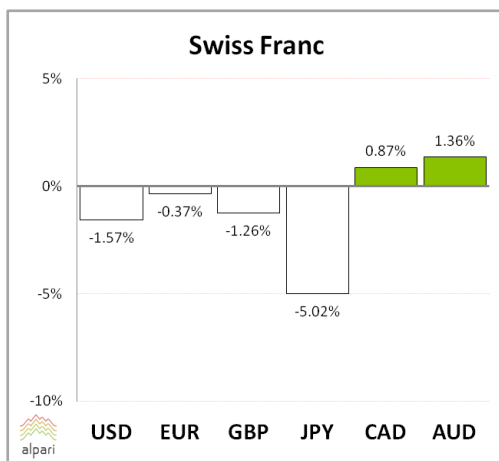
The prime driver for JPY strength came from the US following against-the-grain retail sales figures. The recent story in FX has been the risk-rally which has put pressure on USD, JPY and CHF as traditional safe-havens. This is largely because economic recovery signifies a return to risk taking and attraction to higher yielding currencies that tend to be from peripheral countries like the Emerging markets, Scandinavia etc. The negative retail sales reading from the US acted as a reality check for the economic recovery bandwagon with green shoots never looking so small. Another factor



lending a hand to JPY buyers was the slowing pace in the fall of Core Machinery Orders (-1.3% vs. -4.7% exp.). Japanese manufacturing has been rocked by lower global demand for Japanese exports so a stabilisation in production levels coinciding with a return to risk-aversion was always likely to help the Yen.

CHF

The Swiss Franc's reputation of being a good currency in times of instability and/or risk covering could not have had a better test than last week. In the end, the Franc fell against all its counterparts with the exception of CAD (+0.87%) and AUD (+1.36%). Comparing this performance with that of the Yen, Euro and the US Dollar suggests the Swissie is now no more of a safe-haven currency than the Euro.



Aside from the global risk theme which clearly predominated FX related events, Swiss side influences came from one macro data event in particular, depreciative central bank comments and rumoured market intervention late on in the week. Swiss PPI (-0.2% vs. 0.4% exp.) exacerbated deflation fears and increased the likelihood of SNB intervention in line with their stance of fighting deflation because falling producer prices can often lead to falling consumer prices especially in times of falling demand.

Thomas Jordan, a SNB central bank member reiterated SNB's stance of actively pursuing a weaker CHF which

removed good support beyond limited short-term moves higher following stronger retail sales figures (1.2% vs. -2.2% exp) which led to CHF gains across the board. Extended gains were capped by the spectre of SNB intervention but from a fundamental point of view, deflationary expectations were significantly eased by the number thus re-introducing confidence in the Swiss Franc.

The sharpest move in CHF came at the end of a week where modest gains stemming from shifts away from risk assets turned into a modestly negative one because of rumoured intervention in CHF late in Friday's European trading session. The Swissie fell by over 100 pips in minutes against EUR and USD as speculation suggesting the BIS (Bank of International Settlements) was a heavy seller of CHF. More likely, the SNB was selling CHF to keep currency rates down; both parties declined to comment on the moves. The SNB has been repeatedly active going into the weekend because of usually lower volumes being traded towards the end of Europe's Friday trading session thus we are of the view that the SNB was the more likely party responsible.

Preview: 18th – 24th May



Looking ahead

- Economic recovery aspirations under the microscope as investors re-assess their validity
- Central banks in focus with policy meeting minutes and commentary being the key risks
- Key data releases scheduled for several currencies - most attention on the UK and EU
- Fully complete earnings season coupled with completed US bank stress tests could see equity effect on FX diminishing
- Scope for negative macro data to have a substantial impact as attention is firmly fixed on upside surprises

The events of last week were considered overdue by some because of the overextension in the appetite for risk in recent months. Green shoots are seemingly being seen as fully grown trees because the rallies seen in equity, commodity and risk FX markets have not resembled what you would expect amidst the severest financial crisis since the 1930's. Following on from last week's substantial retracements, this week is thus a curious one because we should get an element of clarification as to what the mood is amongst investors. Do we return to the buying frenzy based on the notion of stress-tested banks being profitable again and macro data being just bad rather than awful? Or will market participants reel in their optimism at least until more solid clarification of an economic recovery becomes evident? The events of this week should assist in playing out these two opposing views.

Several macro risks could play a part in swaying sentiment and capital flows. The key focuses for the EU are the ZEW Sentiment Index and PMI readings for the manufacturing and services sectors. Both releases will affect future EU growth prospects and could thus impact the ECB's decision making process regarding expansion of QE. Even if the ECB pays no attention to the figures, speculative flows are likely to create intra-day volatility.

The UK has several prime macro data releases scheduled; inflation and growth data is supplemented by retail spending estimates and government borrowing figures. All of the above have made headlines recently for either being too optimistic or simply unmanageable within current economic conditions. As a result, we think market participants will be expecting downside surprises which could weigh on Sterling.

The central bank issue is very important this week as US, UK and Australia release policy minutes from their latest policy meetings. Most attention is likely to be on minutes from the UK because a decision to extend asset purchases by £50bn was made at the May 7th meeting. Exactly how much further the BoE will go and where it plans to exit its QE policy are both relative unknowns despite BoE assurances of a maximum of £150bn. The US equivalent is due for release on May 20th although seeing as the previous meeting was 3 weeks ago, their contents are unlikely to impact FX values significantly. RBoA will also be releasing policy minutes with the risk being that further policy easing was discussed and/or is on the verge of occurring. RBoA has cut interest rates from 7.25% in August 2008 down to a current level of 3%, reached in April 2009 yet AUD continues to carry a significant yield differential compared to other G10 currencies. The risk is that this advantage will be eroded by dovish policy thus undermining the value of AUD.

On top of the central bank activity mentioned we are also expecting an interest rate decision from Japan (no change expected). An interest rate cut is not possible as it is virtually zero already whereas an interest rate increase would simply be unthinkable. Focus will be on the statement following the rate announcement with a possibility of the stimulus policy in Japan being extended in scope or scale. A significant extension would be JPY negative whereas a mild extension that is aimed firmly at a particular problem sector could induce a positive reaction in the Yen as investors perceive a stimulating effect (in similar vein to ECB reaction) that has little or no inflationary effect.

FX Sensitive Calendar Events

<u>Tuesday 19th May</u> (AUD) Monetary Policy Meeting Minutes (JPY) Revised Industrial Production (GBP) Consumer Price Index (GBP) Retail Price Index (EUR) ZEW Sentiment Index	<u>Wednesday 20th May</u> (JPY) Preliminary GDP (GBP) Monetary Policy Meeting Minutes (CHF) ZEW Economic expectations (CAD) Consumer Price Index (USD) Monetary Policy Meeting Minutes
<u>Thursday 21st May</u> French, Swiss and German Bank Holiday (EUR) French, German and European Manufacturing PMI's (EUR) French, German and European Services PMI's (GBP) Retail Sales (GBP) Public Sector Net Borrowing (USD) Unemployment Claims	<u>Friday 22nd May</u> (JPY) Interest Rate Decision + Statement (GBP) Revised GDP (CAD) Retail Sales

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