

FX Weekly

Review: 18th – 25th May

Recap

- Eventful week stimulates consolidation in equity and commodity markets; G10 FX sees extensive moves in USD, JPY and GBP
- Standard & Poor's outlook over UK had transitory effect on Sterling but fears regarding US sovereign debt were priced in aggressively instead
- Cyclical currencies again in favour as the FX portion of the green shoots recovery rumbled on despite the drag in other asset classes



Market Research

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Currency pair	At Open on May 18 th	At Close on May 22 nd	Nominal Change	% Change	Volatility
EUR/USD	1.3481	1.3996	0.0515	3.82%	4.65%
GBP/USD	1.5172	1.5932	0.0760	5.01%	5.46%
USD/JPY	95.03	94.76	-0.27	-0.28%	3.01%
USD/CHF	1.1221	1.0854	-0.0367	-3.27%	4.04%
EUR/GBP	0.8883	0.8784	-0.0099	-1.11%	1.93%
EUR/CHF	1.5129	1.5194	0.0065	0.43%	0.93%
GBP/CHF	1.7023	1.7293	0.0270	1.59%	2.33%
GBP/JPY	144.17	150.95	6.78	4.70%	5.58%
EUR/JPY	128.14	132.63	4.49	3.50%	4.69%
CHF/JPY	84.66	87.24	2.58	3.05%	4.13%
AUD/USD	0.7499	0.7825	0.0326	4.35%	5.57%
NZD/USD	0.5861	0.6196	0.0335	5.72%	6.93%
USD/CAD	1.1783	1.1192	-0.0591	-5.02%	5.32%

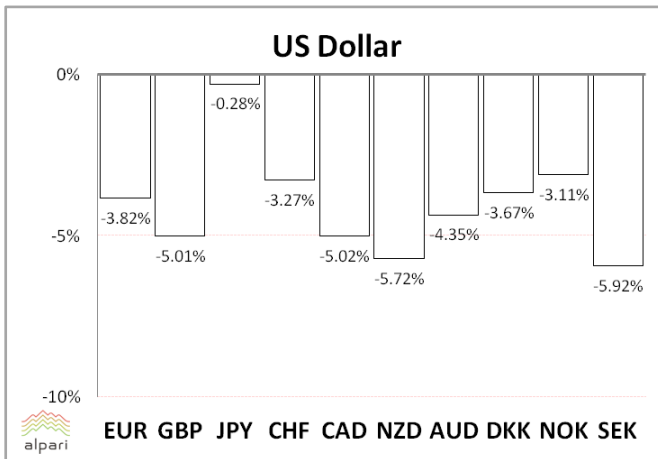
| Source: Alpari (UK)

Financial markets regained their composure this week as risk assets were in strong demand. Last week's retracements were not a prelude for further moves down with macro data in the UK, EU and Japan being broadly risk supportive. Volatile equity markets seesawed subject to changing news flow, closing around the same levels as they opened by the end of the week although doubts remain among investors as downward revisions to growth by the Fed reminded market participants that broad economic recovery could be a difficult and prolonged process rather than a bounce back. Commodities were stronger over the course of the week as crude oil made a confident push through \$60 per barrel. Commodity currencies were good beneficiaries of the risk tolerant mood at the expense of the US Dollar and the Yen as idle capital was reinvested into riskier, higher yielding investments.

The outlook for next week is primarily focused on US, European and Japanese calendar events as scheduled inflation, growth and unemployment figures threaten to derail the green shoots bandwagon. The rate of recovery in aggregate demand is a key driver for all asset classes which increases macro data risk. Sentiment indicators are mostly better across the G10 but actual fundamental data continues to be mixed and remains capable of offsetting high-spirited expectations.

USD

The US Dollar made steep falls last week, the largest losses came against SEK (-5.92%), NZD (-5.72%) and CAD (-5.02%) as risk tolerant flows out of USD denominated assets were given extra momentum by speculation that the US sovereign debt outlook would be downgraded by Standard & Poor's following the UK's downgrade last week. US stocks, bonds and currency fell simultaneously on Thursday as possible downgrade of US sovereign debt came to the fore. Although an actual downgrade is unlikely in the short-term, the chances of this possibility have increased leading to USD-averse sentiment. Widespread weakness in US based assets was not extensive but the symbolic nature of the announcement has intensified doubts over the US Dollar's long-term value. This theme could develop into something more substantial further down the line with speculative flows taking control in the short-term.

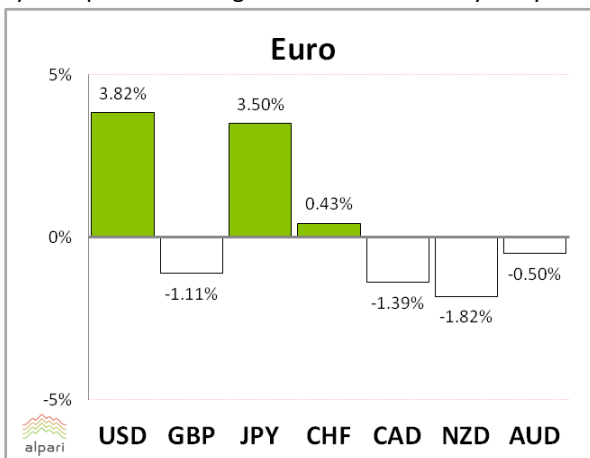


The Fed released keenly awaited meeting minutes from their April 28th gathering. Aside from the widely expected negative tone of the wording, there were two clear USD bearish factors. It became clear that the possibility of asset purchases being expanded beyond the \$1.2 Trillion already announced were likely. Investors have perceived the asset purchases as a negative USD factor so talk of further expansions has tended to pull USD lower. The other important factors were the sharp downward revisions to Fed estimates on US

growth and unemployment in particular. The Fed increased their estimated level of unemployment from 8.5%-8.8% to 9.2%-9.6% and GDP was estimated to fall -1.3% - -0.5% in 2009. The revisions clearly contradicted the current consensus of a quick recovery and surprised market participants expecting USD strength due to its risk-haven status. Last week showed that a disconnection between weak US data and USD strength is possible which could in turn mean that USD regains ground via a positive correlation with macro data as the economic recovery continues.

EUR

The Euro had a good week against the major currencies and recovered well to close marginally lower in cyclical pairs following a substantial risk rally early in the week which saw the Euro fall 2-3% against AUD, NZD and CAD in the space of 48 hours. All this was



despite much better than expected sentiment readings from the ZEW institute, a very highly regarded macro data source. The tide did turn however as strong EU PMI's helped to support the argument that the worst of the financial crisis is over. Effect on EUR was profound as investors priced in better than expected numbers from the day before. Sentiment indicators can be a very good gauge of actual future performance; in the case of the Euro, other factors are still putting pressure on EUR longs and capping extended gains. One such factor is the spectre of asset

purchases within the EU being expanded closer to UK and US levels as ECB members continue their search for a hymn sheet. Another factor holding Euro bulls back is the persistent speculation that EUR based loans made to emerging market nations may turn sour as Eastern European economies deteriorate further. The

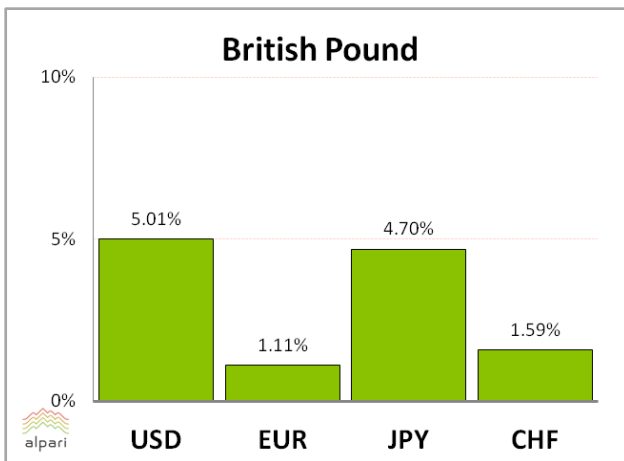
green shoots so widely touted have seemingly not be able to sprout in certain regions because fiscal stimulus has been minute in comparison to the US, Japan and mainland Europe.



Flash PMI readings	Previous	Expected	Actual
French Manufacturing	40.1	40.9	43.1
French Services	46.5	46.7	47.6
German Manufacturing	35.4	37.0	39.1
German Services	43.8	44.3	46.0
EU Manufacturing	36.8	38.4	40.5
EU Services	43.8	44.6	44.7

GBP

A solid week for GBP was capped by Standard & Poor's (S&P) statement that UK AAA rating is being put on negative watch. This can occur as a prelude to downgrading UK sovereign debt outright. The news ensured GBP fell against every other major currency. Very positive retail sales data around the same time was washed away within a very negative reaction in Sterling trade. Despite the initial knee-jerk reaction leading to sharp GBP falls, Sterling managed to retrace all of its losses post announcement and post strong weekly



gains, especially against USD (+5.01%) and JPY (+4.70%) as bearish factors in the US and Japan added momentum to GBP appreciation.

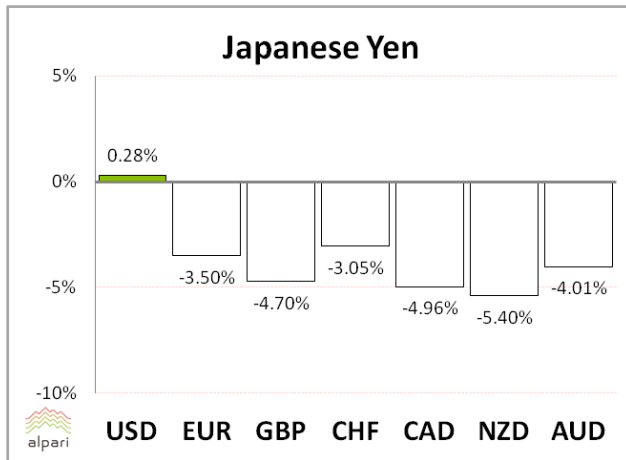
Widely accepted rumours that nationalised stakes in UK banks will be sold to foreign investors in the near future boosted sentiment in UK equity markets with banking being the largest beneficiary. GBP rose as well because of the highly correlated relationship of Sterling and the financial sector in the UK. The economic recovery has been occurring alongside a huge bounce in sentiment towards

the financial sector in the US, UK and to some extent, the EU. Sterling has benefited because UK GDP is highly reliant on the financial sector for its tax revenue provision, capital flow attraction and multiplier effect of related economic activity. In addition, US banks that have received state funding are desperately trying to repay borrowed capital but the key issue here is that they *can afford* to do so. This psychological factor has been instrumental in regenerating confidence and trust in Western banks, to the benefit of Sterling because US related issues have tended to overlap those of the UK over the past year.

JPY

The Yen toiled in the risk tolerant environment, with the only gain coming against USD because USD related news flow was worse than JPY's. The largest losses were against commodity currencies as several factors drew Yen bulls away. Commentary from Japan's Vice Finance Minister, stating that Japanese authorities were watching FX rates closely led market participants to assume BoJ intervention in JPY could be on the cards. The comments were made at the start of the week when the previous week's extended gains were still fresh in the memory of central bank officials. The significance of those comments diminished as the week unfolded because JPY weakness was clearly possible without any actual intervention. FX intervention in Japan is historically rare; more often than not, Japanese authorities try to talk the Yen down through comments rather than through open market operations.

A buy-side influence was Moody's ratings changes. The Japanese government debt rating was changed to Aa2 from Aa3 its foreign currency bond rating was changed to Aa2 from AAA. The combined effect was modest JPY strength against USD and other currencies. Preliminary GDP figures showed an estimated fall of 4% in Q2 2009 which was perceived as relatively good due to expectations of a larger fall.

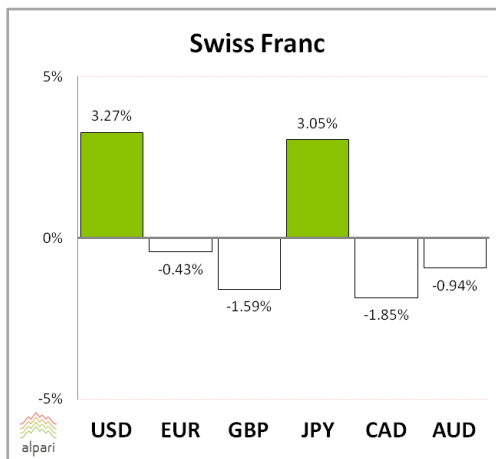


At market close last Friday, JPY was sharply down against every currency apart from USD, a mirror image of the previous weeks' strength. Equity market consolidation and a re-sync of risk appetite with recovery expectations brought interest back into cyclical currencies at the expense of JPY and USD.

Japanese officials stoked dismay, confusion and speculation by ruling out intervention in the FX market on Thursday. The contradictory statements made by various officials were

taken at face value and interpreted as attempts at verbal intervention rather than a prelude to something tangible; the comments has a bullish effect allowing JPY to reach its highest rate against USD since mid-March.

CHF



CHF trade was focused on external and technical factors due to an absence of macro data risks and meaningful central bank commentary. The risk tolerant environment led to falls against EUR, GBP, CAD and AUD and gains against USD and JPY as the Swissie's performance was almost a carbon copy as that of the Euro's by week end. Both currencies have taken up a neutral position in between risk havens (USD and JPY) and cyclicals (AUD, CAD, NZD, SEK) that sees regular weakening against the latter and strengthening against the former within the ongoing risk rally. One data release of note was the Swiss ZEW survey reaching a 2 year high. The headline number masked continuing weakness as most respondents to the

survey maintained a 'bad' economic outlook. The biggest concern is future labour market weakness according to the survey; when combined with very loose monetary policy by the SNB, ongoing CHF trade is likely to remain subdued.

Preview: 26th – 31st May 2009



Looking ahead

- Several macro risks scheduled for this week have the capability of scuppering good investor sentiment
- Political risk from N. Korea could prove significant for currencies if the prospect of a broad conflict draws nearer. Severity of United States reaction is key
- Several central bank speakers scheduled throughout the week; attention likely to focus on Trichet as ECB policy framework has most uncertainty
- Swedish and Norwegian central banks rumoured to be on the QE trail; developments are not necessarily likely but speculation could drive short-term price action

Due to the Bank Holiday weekend our report will look forward to Wednesday's events onwards. Towards the end of Tuesday's trading session, the two significant developments were the North Korean missile test including the consequential knock-on effects this may bring and the exceptional consumer confidence reading from the US (54.9 vs. 42.7 exp).

The North Korean theme was a massive surprise on Monday which benefited the Swiss Franc and the Yen although as yet, clear indications of the medium-long term impact of the tests is unclear. Another unknown is the ferocity of the international response to the tests. Essentially, market participants are in wait-and-see mode because political risks have often come and gone within the same week. Previous examples include Iran's development of nuclear technologies, Russia's invasion of Georgia as well as North Korea's earlier experimentation with nuclear technology. All have induced media headlines and a propensity to dive into safe-havens although it is rare for a political spark to turn into a fire unless a serious conflict occurs that leads to widespread fear for economic prosperity in the region as a whole. For the time being, the North Korean issue at least from an economic perspective has been limited in its effect although ongoing developments are being closely watched. Going forward, we expect political reaction to grab headlines which could induce short-term speculative longs in JPY, USD and CHF. There is also the possibility that currencies completely on the other side of the globe that are unlikely to be affected by any military developments (such as NOK, SEK, DKK) could continue their upward trends despite a risk-averse element being present in the minds of investors.

The surge in consumer confidence in the US had a strong bullish effect on equities, commodities and risk sensitive currencies because it acted as yet another confirmation of the tentative economic recovery in the US. Following on from positive banking sector news and broad increases in sentiment indicators across several sectors, even green shoot sceptics are beginning to change their minds. There is of course the danger of unemployment numbers and housing sector weakness around the G10 putting a severe drag on the recovery and paving the way for a return of risk-aversion. We are of the opinion that the final outcome will be somewhere between the two as the ongoing recovery suffers occasional setbacks within a broad period of consolidation, at least for the time being. The financial crisis is unlikely to go away as quickly as it unravelled which leads us to the opinion that downside risks to the current risk rally remain, primarily in housing because house prices continue to fall across the G10 although at slower rates than in 2008. Any recovery in lending, borrowing and spending can only take place if deterioration in the primary store of wealth (housing) stabilises for a significant amount of people.

Other macro risks this week are likely to be preliminary GDP figures in the US, not only because last week's Fed estimates will be compared and contrasted but also because a downward estimate would put into serious doubt the validity of all the improving sentiment indicators, including today's (May 26th).

CPI figures for the EU are due on Friday and could impact expectations regarding ECB asset purchases. A severe shortfall in consumer price inflation would make the possibility of deflation more likely and in turn increase the chances of the ECB widening their quantitative easing policy. This would be severely EUR negative because strong EUR support has been established for precisely this reason i.e. ECB reluctance to expand the money supply because economic conditions do not require it with the chances of Euro value being eroded due to excessive inflation reduced.

FX Sensitive Calendar Events

<u>Wednesday 27th May</u>	<u>Thursday 28th May</u>
(JPY) Monetary Policy Meeting minutes	(JPY) Retail Sales
(JPY) Trade Balance	(USD) Durable Goods Orders
(GBP) Nationwide House Prices Index	(USD) Unemployment Claims
(EUR) German Preliminary CPI	(USD) New Home Sales
(GBP) Mortgage Approvals	
(USD) Existing Home Sales	
<u>Friday 29th May</u>	
(JPY) Consumer Price Index	
(JPY) Unemployment Rate	
(NZD) Annual Budget	
(EUR) German Retail Sales	
(EUR) CPI Flash estimate	
(CHF) KOF Economic Barometer	
(CAD) Current Account	
(USD) Preliminary GDP	
(USD) University of Michigan Consumer Sentiment	

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