Fundamental | FX

8th June 2009

FX Weekly

Review: 1st – 7th June 2009

Recap

- The US Dollar and Yen diverged significantly as region specific themes prevailed over risk sentiment. Both short and long-term US yields continued their push higher, weighing on recovery expectations
- EUR weathered the growing Baltic storm, closing higher across the board on Fri
- Cyclical currencies deviated from their peloton-like pattern as the risk theme faded and remained peripheral

Currency pair	At Open on June 1st	At Close on June 5th	Nominal Change	% Change	Volatility
EUR/USD	1.4130	1.3967	-0.0163	-1.15%	2.87%
GBP/USD	1.6182	1.5980	-0.0202	-1.25%	4.47%
USD/JPY	95.28	98.64	3.36	3.53%	4.65%
USD/CHF	1.0670	1.0855	0.0185	1.73%	2.96%
EUR/GBP	0.8728	0.8738	0.0010	0.11%	3.33%
EUR/CHF	1.5080	1.5162	0.0082	0.54%	1.02%
GBP/CHF	1.7266	1.7345	0.0079	0.46%	3.42%
GBP/JPY	154.18	157.60	3.42	2.22%	4.52%
EUR/JPY	134.65	137.78	3.13	2.32%	3.96%
CHF/JPY	89.23	90.82	1.59	1.78%	2.98%
AUD/USD	0.8027	0.7930	-0.0097	-1.21%	4.36%
NZD/USD	0.6410	0.6258	-0.0152	-2.37%	5.69%
USD/CAD	1.0905	1.1188	0.0283	2.60%	3.91%

| Source: Alpari (UK)

No clear consensus on macro developments ensured financial markets stayed range bound this week. A multitude of interest rate decisions diverted investor attention back towards comparative monetary policy as the quantitative easing theme resurfaced. There were no surprises to be had from central bankers although this couldn't prevent a consolidation in risk assets.

By the end of the week, the US Dollar regained a semblance of stability, regaining lost ground against cyclical currencies as it finally found bullish momentum in a risk supportive environment; something we haven't seen for months. US sovereign debt rating concerns eased with demand for US assets not severely affected. Equities were relatively flat as consolidation continued; the sharp moves higher since March have found increasing resistance in recent weeks with investors questioning the seemingly overextended moves higher in equity and commodity markets. Gold came within striking distance of $1000 per troy ounce on several occasions.

Next week, attention is likely to be on G10 trade balances and US retail sales figures for May as the capacity of the US consumer to drive US growth and international trade conditions remain important factors for further economic recovery.

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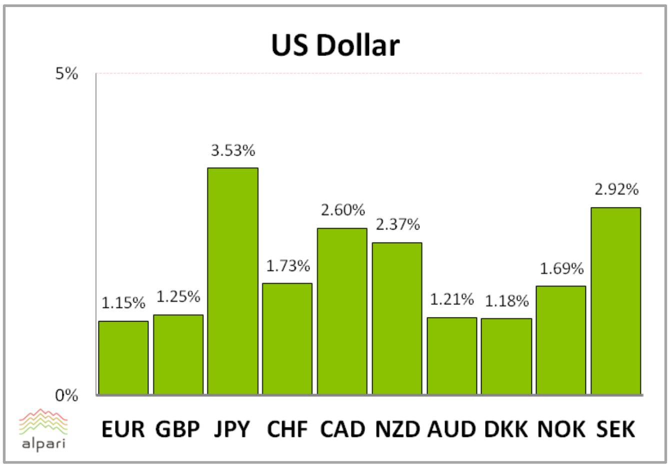
USD

G10 FX broke away from the expected norm last week as several currencies disconnected with their recent trading patterns. The best example of this was the US Dollar as a broadly positive macro data set actually helped USD rather than adding downward pressure. Unallocated USD holdings are being reinvested into better yielding areas but this is being tempered by rising US yields which are making these flows less necessary. In addition, short-term bouts of risk-aversion become considerably less stressful because the Dollar is still regarded as a premier risk haven. This reputation is under threat however, as the current monetary/fiscal policy framework continues to stoke credit rating worries.



Extremely buoyant US pending home sales (6.7% vs. 0.4% exp) led to a strong anti-USD reaction as risk tolerant expectations of more USD outflows into riskier currencies dominated investor thinking. The sharp increase heightened expectations of a speedy economic recovery encouraging market participants to price in expectations of rate *increases* by the end of 2009. How things have changed.

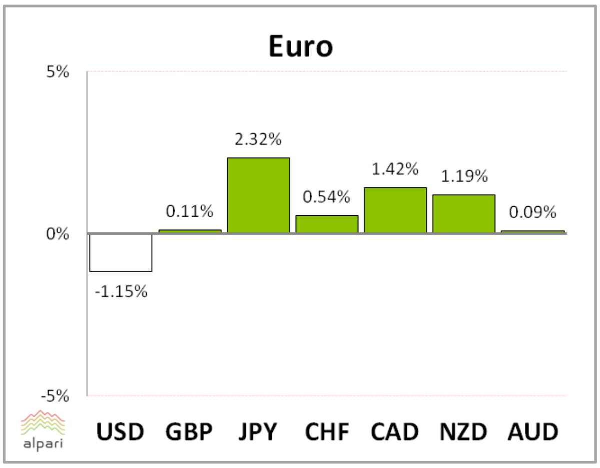
US long-term mortgage rates rose according to official figures on Wednesday alongside falling mortgage applications. USD rose as anxiety returned. Investors are worried that rising US yields and mortgage rates will constrain a US led economic recovery because housing market activity is likely to slow leading to lower house prices and higher default rates. It should also be noted that many of the losses taken by financial institutions over the past 2 years have been indirectly linked to the US housing market through securitised investment vehicles. Essentially, the more house prices fall, the higher the burden on those institutions that hold sub-prime securities. The highly touted economic recovery is using bank stability as validation that the financial crisis has subsided so any countering effects that suggest otherwise could have significant impact on the risk rally.

Commentary from several central bankers in Asia and the Far East suggest that most central banks will not diversify out of USD holdings if a downgrade to US debt became a reality. The important aspect is liquidity and stability rather than short-term price moves; this is of course exactly what you would expect to hear from someone holding the vast majority of their portfolio in USD. Despite the likely bias, market participants digested the news as USD positive which helped to par back losses, made following the downgrade theme coming to the fore. A strong dose of risk aversion came about on Wed leading to a sharp rises in JPY and USD vs. CAD, NZD and AUD.

Last week's USD rally could be a short term pullback within a downward trend or a breakdown in the economic recovery story which suggests USD is being bought for safety reasons. The likelihood is that both are true to an extent – questioning of the ongoing risk rally has taken impetus out of equities and commodities reducing interest for risk assets although the recovery theme continues to win supporters with each week. This week's price action will be intriguing because USD looks like it can benefit both from its rising yield as equities climb higher as well as from risk averse flows during times of anxiety.

EUR

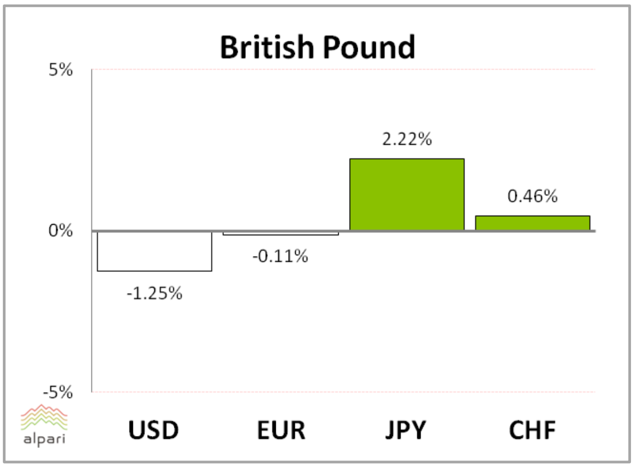
Failed government bond auction in Latvia lead to SEK and EUR weakness. Concerns are mounting over E. European and Baltic states as budget deficits, horrendous growth expectations and rising unemployment put pressure on existing pegs. Currencies in the region are looking increasingly fragile; SEK and EUR could suffer further because Swedish and European banks have sizeable exposure in the region. A lot of the growth seen in the region over the past 10 years has been driven by credit from Europe and Scandinavia with some banks taking on more exposure than others. The Baltic exposure theme has sporadically drifted in and out of focus over the past 12 months but the difference now is that more important themes (US bank solvency, banking system integrity and global wholesale funding rates) have more or less been appeased, at least for now.



Euro pairs held up extremely well despite the aforementioned exposure risk and increasing unemployment figures (9.2% vs. 9.1% exp.). Also helping the Euro were better retail sales figures and a strongly worded ECB statement following its interest rate decision (unchanged at 1%). Media focus was on ECB QE expansion and the specifics of their previously announced bond purchase programme. Neither issue brought any surprises whereas renewed insistence by Trichet that a wider programme is not in the pipeline reassured nervous EUR bulls. Over the week, the Euro gained most against JPY (+2.32%), CAD (+1.42%) and NZD (+1.19%). The surprising aspect of last week's events was that risk tolerance was not the predominant issue for once, as demonstrated by the mixed performance of G10 currencies.

GBP

Sterling trade was dominated by political risks relating to the future of the current Labour government. A strong start to the week evaporated on Thursday following the scheduled interest rate decision (unchanged at 0.5% with no further expansion to the £125bn asset purchase programme).



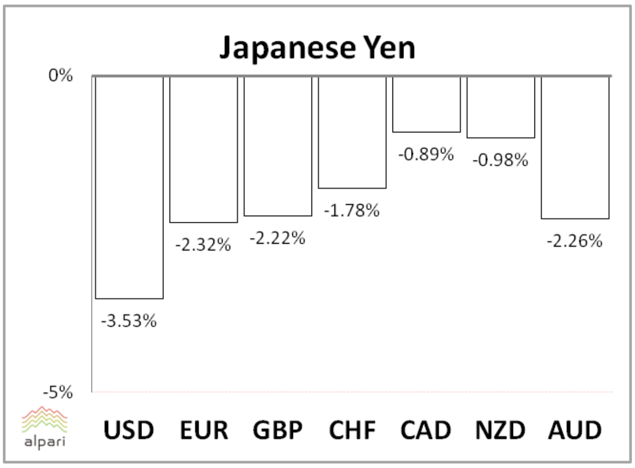
Rumours surrounding the future tenure of Gordon Brown suggested he will be resigning by the end of the week; the news raised fears of a power vacuum in the UK at worst or a prolonged process to install a new government at best – either case is negative for the UK economy and Sterling. At the time of writing Sterling continued to deteriorate in early Monday trade on Monday, pressurised by a debt downgrade in Ireland and heightened political uncertainty in view of very weak election results for Labour. Investors seem to be unnerved by the fact that the current government is refusing to give way by calling an election or electing a new party leader. The political factor will continue to influence Sterling because it is by far the predominant story in the UK. In addition, as soon as the instability is resolved (either via an election being called or a credible replacement for Gordon Brown being found) it is certainly possible that losses made last week are recouped.

A continuation of improving macro data in the UK helped GBP to hold off the negative outlook; improving sentiment in construction, higher levels of lending and higher mortgage approvals sustained the economic recovery story. Recovering house prices were also a factor as an expected fall in May was in actual fact a 2.6% rise – boosting confidence in the UK housing market and the UK economy overall.

Despite the political furore, GBP was largely unchanged against CHF, EUR and fell by a modest 1.25% against USD. Strong gains came against JPY (+2.22%) but this should be taken in context because JPY fell against every single currency in the G10 last week which suggests that Japanese factors were more responsible for a higher GBP/JPY rather than UK ones.

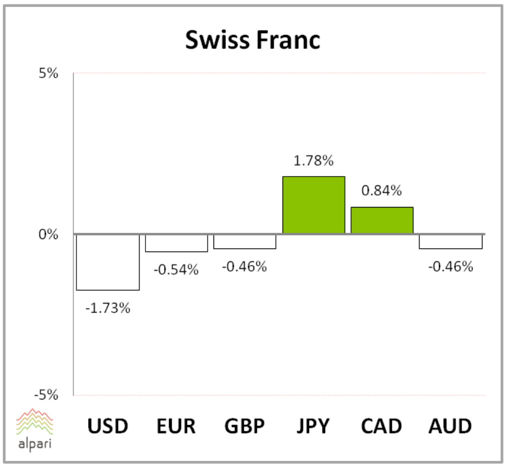
JPY

It was an uneventful week as far as the Japanese data set was concerned with only capital spending figures making an impact on JPY value. Stronger than feared capital spending figures weighed on the Yen despite beating expectations. The term ‘beating expectations’ should really be taken with a pinch of salt these days because the expected fall in capital spending was -28.5%. The sheer size of the fall (-25.3%) underlined persisting economic weakness and raised fears over the security potential of the Yen.



The prevailing factor in JPY weakness was more likely the continued rise in US yields leading to a greater demand for US assets by Japanese institutionals and capital flows away from the Yen as sidelined risk-intolerant capital was redeployed. The Yen’s largest fall was against the US Dollar rather than any particular cyclical currency which rules out the higher yield incentive to some extent. In our opinion, recent market developments and commentary have raised the possibility of the economic recovery petering out prematurely which could result in renewed demand for safe-haven currencies. Consequently, the US Dollar is being seen as a good compromise because of its rising yield offering investors increasingly better returns and maintaining its reserve status thus offering added security to those returns.

CHF



The Swissie was largely range bound as a shortened trading week combined with a lack of significant macro data ensured relative calm. In addition, central bank intervention, both verbal and actual, wasn’t forthcoming as CHF rates failed to threaten SNB boundaries. One very surprising event was the complete lack of reaction in CHF pairs following a much better than expected GDP reading (-0.8% vs. -1.4% exp.) on Tuesday. CHF strengthened against other G10 currencies over the rest of the week but extended gains were capped due to a lack of buyers willing to push the currency higher. Since the SNB announced intervention plans in mid-March, the Franc has been unable to extend gains because of the spectre of intervention. In the case of EUR/CHF, a zone of 1.50-1.51 has been established where the SNB plans to sell increasing quantities of its currency to prevent further appreciation.

Others

Commodity currencies were mixed as broad risk sentiments merged with country specific events leading to mixed performances by cyclical currencies. RBOA held rates at 3% but left scope to cut rates further in the economic cycle. AUD was sold immediately after the bank’s statement although losses were tempered by strong risk appetite and medium-long term speculative flows aiming to take advantage of the yield differential between AUD and other low yielding currencies.

SEK fell sharply after the Riksbank forecast loan losses at Swedish banks amounting to SEK170bn ($23bn) in 2009 and 2010.Exposure to Baltic and Emerging countries has weighed on SEK via speculative capital flows but actual loan losses would likely add to SEK weakness.

Australian GDP at 0.4% - much better than expected. Added to goodwill feeling from US pending home sales late in the London trading session on Tuesday thus adding further demand for risk assets. Australian growth figures contrasted well with EU growth (-2.5%) showing investors that the Australian economy has weathered recent financial storms very well, in part due to well supported demand for exports from China and Japan. The GDP figure also highlighted Australia's relative insulation from the sub-prime related problems that have plagued so many other economies. Most of the effect upon Australia has been via a secondary effect of falling export demand (leading to falls in manufacturing, industrial production, higher unemployment etc) in similar fashion to Japan which was also well insulated from toxic asset exposure.

Preview: 8th – 14th June

Looking ahead

- Ongoing speculation regarding USD safety alongside added issue of rising long-term yields is likely to predominate sentiment
- Multiple trade balance readings made available this week should clarify status of international trade, a key economic driver for several currencies
- Political risk in the UK should continue to weigh on UK fundamentals although the prospect of a resolution could help Sterling recover
- G8 meetings commencing June 12th are likely to draw media focus and induce speculative volatility
- Heightened macro risk from RBNZ rate decision as level of easing remains uncertain

Varied FX themes could come into play this week as a lacklustre economic calendar leaves room for other factors to take centre stage. Ongoing speculation regarding the future of the US Dollar could be important as long-term yields continue to rise. Last week, US 10yr yields reached their highest level (3.90) since November 2008, encouraging doubts that the US cannot sustain increasing interest payments on its ballooning external debt. The Dollar performed very strongly last week because rising yields on US assets looked even more attractive via a cheaper USD; if yields continue to rise, we could see further demand as yield hungry investors buy increasing amounts of the world's premier reserve currency. It has been widely reported that Asian market participants (including governments) still consider the US Dollar as the dominant currency regardless of ratings or funding concerns purely because of the liquidity US markets offer. Considering that countries such as Japan and China have almost no other options apart from continuing to buy USD to fund Treasuries, it is highly unlikely for a USD crisis to occur in the short-term. The risk to continued appreciation comes from the Fed's $1.2 Trillion asset purchase programme, and expansion thereof. Higher yields will become unsustainable if left unchecked (as a tipping point is reached whereby higher yields stop acting as an incentive but become a warning signal of heightened default risk) so by expanding the scope or magnitude of purchases, long-term yields could be forced lower. However, ramping up the monetisation of debt would be USD-negative so the key question is which effect outweighs the other; essentially, USD traders should be asking themselves - to what extent does foreign demand for US assets matches the US need for foreign capital.

Quite appropriately, this week has three Treasury auctions ($30bn on Tuesday, $20bn on Wednesday and $10bn on Thursday) which will be important in determining demand for US debt issuance. A weak uptake would be negative for USD and is likely to heighten fears of US issuance not finding sufficient buyers in the future. A failed auction would be catastrophic.

Another important factor for this week is how the US Dollar performs if financial markets are risk supportive. Since the start of the financial crisis in 2007, capital flows into USD have had a significant element of risk-aversion attached to them whereas last week we saw a stronger Dollar despite stronger US housing and employment data. We are hoping to ascertain whether last week was a USD bounce on the back of better data, improving sentiment and evidence of the Dollar reconnecting with traditional psychology (better US data leading to a higher USD). Or just a short-term pullback before further weakness materialises on the back of fiscal and monetary policy concerns. Retail sales figures due on Thursday will be vital as this event carries the highest macro risk.

Sterling traders are in for a fun time this week as fundamental risks are amplified by persistent political uncertainty which could retreat at any time, opening the way for a recovery in GBP/USD following last week's protracted losses. We expect speculative motives to dominate GBP trade, with the BoE Quarterly Bulletin offering the potential to surprise.

G8 meetings commencing on June 12th could have a key impact. Although mentions of FX rates are unlikely, talk of more stimulus and changes to financial market regulation could add confidence and extend rallies in equities, commodities and cyclical currencies.

One interest rate decision expected this week comes from New Zealand. Market participants are expecting no change from 2.50% in consideration of improving economic conditions worldwide. The rationale is that more easing can be saved for a rainy day. Our research suggests that investors are pricing in the possibility of a 25bp cut so a sharp move lower in the Kiwi remains a credible risk.

FX Sensitive Calendar Events

Tuesday 9th June (EUR) German Trade Balance (EUR) French Trade Balance	*Wednesday 10th June* (GBP) Manufacturing Production (GBP) Trade Balance (CAD) Trade Balance (USD) Trade Balance (USD) Beige Book (USD) Federal Budget Balance (NZD) Interest Rate Decision + Statement
Thursday 11th June (JPY) Final GDP (AUD) Unemployment Rate (USD) Retail Sales (USD) Unemployment Claims (NZD) Retail Sales	*Friday 12th June* (GBP) BoE Quarterly Bulletin (EUR) Industrial Production (USD) Import Prices (USD) University of Michigan Consumer Sentiment