Fundamental | FX

15th June 2009

FX Weekly

Review: 8th – 14th June 2009

Market Research

George Tchetvertakov
Head of Market Research
gtchetvertakov@alpari.co.uk

Recap

- UK political risk diminishes, pushing Sterling bears to the sidelines
- US Dollar dynamics dominated by yields, mortgage rates and debt auctions with strong risk-appetite continuing to weigh
- Commodity currencies stronger again in line with ongoing risky rally – although at diminishing rates. Canadian Dollar in the spotlight for intervention.
- Commodities continue upward trends as crude oil surged through $70; Gold continued its retreat from early June highs

Currency pair	At Open on June 7th	At Close on June 12th	Nominal Change	% Change	Volatility
EUR/USD	1.3943	1.4015	0.0072	**0.52%**	2.64%
GBP/USD	1.5953	1.6442	0.0489	**3.07%**	**5.12%**
USD/JPY	98.56	98.42	-0.14	**-0.14%**	1.80%
USD/CHF	1.0874	1.0790	-0.0084	**-0.77%**	3.08%
EUR/GBP	0.8738	0.8520	-0.0218	**-2.49%**	3.59%
EUR/CHF	1.5162	1.5123	-0.0039	**-0.26%**	0.85%
GBP/CHF	1.7345	1.7741	0.0396	**2.28%**	3.22%
GBP/JPY	157.24	161.78	4.54	**2.89%**	4.48%
EUR/JPY	137.46	137.92	0.46	**0.33%**	1.91%
CHF/JPY	90.60	91.15	0.55	**0.61%**	2.31%
AUD/USD	0.7934	0.8121	0.0187	**2.36%**	**5.17%**
NZD/USD	0.6246	0.6425	0.0179	**2.87%**	**5.04%**
USD/CAD	1.1203	1.1186	-0.0017	**-0.15%**	3.12%

| Source: Alpari (UK)

Attention last week was primarily on the US Dollar as the macro data set lacked traction for other currencies. In addition, Treasury auctions in the US were key as both sides of the US Dollar divide had room to express their views. Some market participants believe that US fundamentals are strong enough to warrant continued demand for US debt, supported by comments from reserve managers whereas others see rising US yields as confirmation of falling confidence and a weak recovery. Consequently, our FX weekly report this week focuses mainly on USD developments.

USD

Expectations of rising interest rates in the US before year end began to be priced on June 5th following the US employment report. These expectations seemed to have been premature or even misplaced which led to substantial retracements in USD pairs early in the week. Comments from Fed's Jeffrey Lacker brought those expectations back on the table with comments suggesting the Fed should be quick to raise rates as a pre-emptive measure for inflation. These types of murmurs are supporting USD going forward at the expense of green-shoot expectations.

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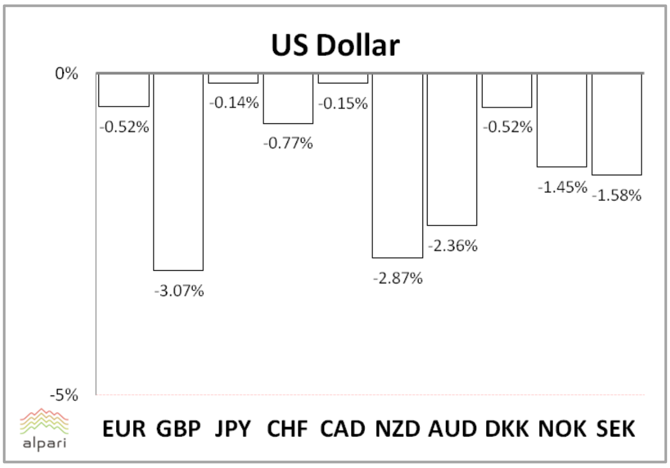
US yields continued higher, peaking above 4% as higher interest rate expectations were priced in. This led to worries about US mortgage rates but was also USD supportive in the short term because of higher returns. In our opinion, a key knock-on effect of this could be that higher rate expectations will act as a catalyst to re-sync traditional USD dynamics i.e. positive USD on improving economic data. Whether this trade logic dominates or not is likely to depend on the likelihood of interest rates rising in the short-medium term as well as central bank policy elsewhere in the G10. For the time being there are many sceptics to the possibility of US interest rates rising in 2009.

The US 10yr auction was described by some market commentators as "tepid". Fears of long-term inflation have pushed yields higher as investors demand a higher return for their investments. The 10yr yield briefly traded at 4% which is around October 2008 levels, and not too far away from pre-crisis levels. US Treasury officials as well as politicians will no doubt spin higher yields as more signs of an economic recovery because falling bond prices can either mean falling confidence in the issuing government or redirection of capital away from low, fixed incomes into higher yielding investments such as stocks/commodities/currencies. In our opinion, investors are still reeling from the events over the past 18 months so risk-taking is likely to have diminished. This is supported by the fact that long-term yields in other G10 nations have not risen as far and as quickly as in the US. More likely, investors are worried about long-term inflation in the US and thus demanding higher returns for the added risk. Inflation expectations in the US have so far been anchored although due to far-reaching QE, market participants are wary of inflation which could mean higher inflation expectations surfacing very quickly.



Last week, we saw a fall in mortgage applications in the US, probably due to the fact that mortgage rates are rising thus discouraging new purchases of homes. The property market in the US is crucial because the current crisis began with falling property values leading to losses on securitised products linked to property. Banks continue to hold large amounts of such investments so lower mortgage rates would be a blessing because they would allow the property market to recover as demand for housing rises. This would in turn help securitised products to stabilise and buyers to emerge. Essentially, the US recovery is reliant on the US consumer and the property market. Rising yields are clearly threatening both.

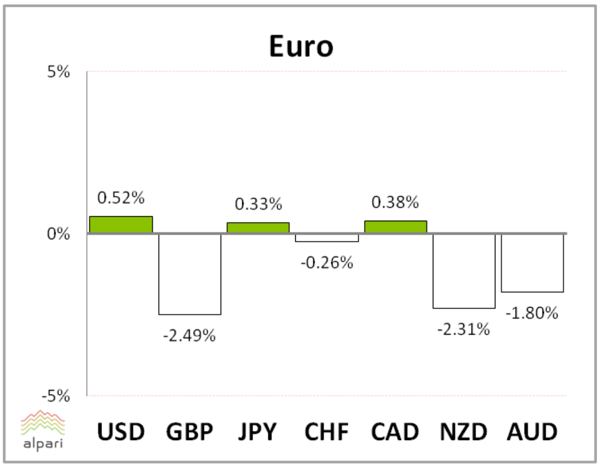
Broadly weaker trade balance figures in Canada, UK, US underlined the weakness of demand, both domestic and external. International trade has suffered due to falling expenditures and falling aggregate demand. According to the Fed, five out of its 12 US districts said the prolonged downturn was showing signs of moderating, with the outlook improving for manufacturing and housing in some areas. Credit remains tight, the labour market continues to suffer from flat or falling wages and commercial property vacancy rates are rising. On a more upbeat note, better retail sales in the US for only the second time since July 2008 led a strong USD reaction, confirming a slow re-sync of USD with macro data. US bond auction of 30yr bonds went very well, helping confidence over US solvency rise. This in turn put a bid into commodities, equities and risk currencies.

An increasing Federal Budget balance showed expenditure on stimulating specific sectors in the US economy is continuing. This is a positive if you are of the opinion that stimulus has helped recovery or negative if you consider what will happen after stimulus can no longer be applied leaving the economy to swim on its own. Funds allocated to primarily support banks and the automotive industry were allocated by US authorities to support key industries in the belief that once they were given a boost, they could reinvent and adapt themselves to become more competitive and solvent long-term. Clear evidence suggests that several banking institutions and automakers still have severe weaknesses, underlined by the bankruptcies of GM and Chrysler.

The US Dollar regained some stability towards the end of the week as over-pessimistic sentiment was appeased by better than expected auction results, recovering retail sales, profit taking and broad feeling that USD has been oversold over the past few weeks.

EUR

The Euro stayed out of the limelight, avoiding any extensive losses over the week. The macro data that was available was not crucially significant so EUR based pairs tended to be driven by other currencies. This was especially evident in EUR/USD and EUR/GBP pairs as US and UK developments predominated. Overall, the Euro fell most against GBP (-2.49%) and NZD (-2.31%) which reflected a good appetite for risk over the course of the week. EUR vs. Risk pairs such as EUR/NZD, EUR/AUD, EUR/CAD and even EUR/GBP were largely down-trending and range bound against risk-negative currencies; JPY, USD, CHF.

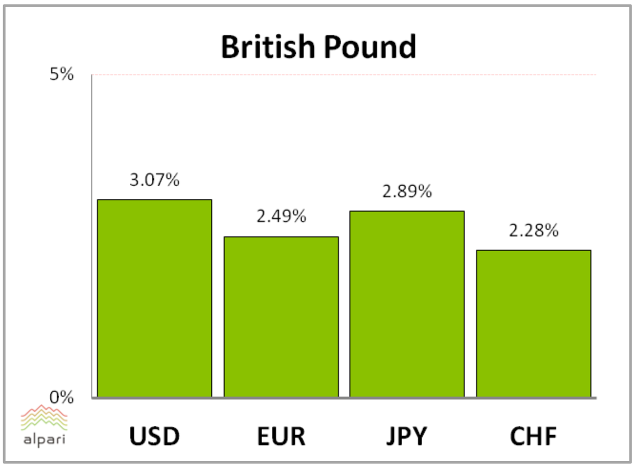


Baltic exposure concerns were allayed to some extent as the ECB announced financial support for Swedish banks and the possibility of direct support for non-EU members such as Latvia and Sweden. This however was countered by the unexpected downgrade of the Irish sovereign credit rating – EUR was lower on this news as fears of an EU member defaulting and/or leaving the EMU were lifted.

Going into week-end very weak industrial production figures for Europe (-1.9% vs. -0.4% exp) dampened the recovery story theme. The figures were pessimistic enough for the G8 communiqué to be amended – references to improving conditions in manufacturing were removed.

GBP

Sterling had a strong week, gaining most against USD on the back of rising risk sentiment and improving expectations of future growth. A media spectacle with blazing headlines of "recession is over" and the like, added to the goodwill towards the Pound. Also, better manufacturing and industrial production figures sustained recent momentum in Sterling pairs.



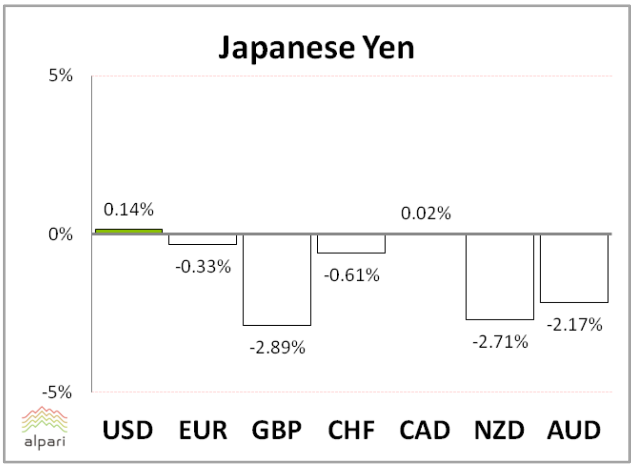
Another bonus for GBP bulls was the eerie evaporation of UK political uncertainty which allowed Sterling to recover its recent losses against USD and EUR. Several cabinet member resignations combined with the worst election results in Labour's history did not escalate into a leadership challenge or a resignation by the PM. With this particular theme, investors didn't need actual good news but simply a lack of bad news for anti-GBP opinions to ebb away. All speculative GBP losses gained on the back of political unrest in the UK were regained, pushing Sterling higher across the board.

Banking sector improvement in the UK is increasingly evident whereas European (and to some extent Swiss) banks have an overshadowing fear of more bank losses which is favouring GBP in EUR/GBP, GBP/CHF pairs. There is scope for the banking premium priced into Sterling to unwind as banking sector confidence improves in Europe thus eroding the UK's advantage.

Interestingly, GBP/USD was the most volatile currency pair last week as opinions of both Sterling and Dollar dynamics remain mixed and ambiguous.

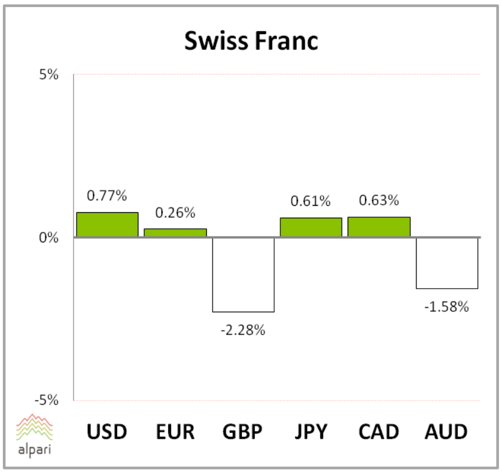
JPY

Under the limited risk-supportive conditions the Yen was able to remain flat against risk-neutral or risk-negative currencies such as USD, EUR, CHF; hardest felt losses were against NZD (-2.71%), GBP (-2.89%) and AUD (-2.17%) as the risk rally rumbled on. Yen trade was once again under the influence of deteriorating fundamentals; Machinery orders plummeted in May, contrary to political rhetoric that the worst of the recession is over – the Yen weakened as confidence in the macro outlook deteriorated.



Final GDP figures for Japan showed a moderate improvement (-3.8% vs. -4% exp). JPY was marginally stronger although confidence was subdued as other predominating factors outweighed the improvement. Marginally better macro data was never going to turn the risk-tolerant tide away from selling Yen because the stack of bad news regarding the Japanese economy is underpinned by falling demand for safe-havens thus capping any data-driven gains. In addition, reserves of idle capital built up in the Yen over the course of 2008 have only begun to be reinvested so significant upside surprises in Japanese economic indicators have the potential to add weakness rather than strength to the Yen as more investors subscribe to the recovery story.

CHF



The Swiss Franc was largely unchanged, making ±1% moves against only GBP and AUD – two risk-sensitive currencies which were bolstered under the broadly risk-supportive environment. Central bank commentary regarding intervention was lacking leaving CHF well supported against other majors. The only surprising event was the Swissie's performance against CAD; considering the risk environment CHF should have been softer against CAD rather than firmer although Canadian central bank commentary, more specifically from Mark Carney suggesting that currency strength would be a weight on the economic recovery, stoked worries that the BoC will follow SNB's policy example and artificially weaken the Canadian Dollar to assist exporter competitiveness and revenues. The effect in CAD/CHF was discounted to a small degree because both central banks in this pair could be converging in their policy stances if BoC actually decides to intervene.

Others

Baltic worries continued to drive SEK lower as Swedish authorities and banks fought to convince market participants that any Baltic exposure, including Latvia is manageable. Therefore, confidence was on the back foot as much as the front over the past week.

RBNZ (Reserve Bank of New Zealand) kept rates on hold at 2.5% - dousing speculative expectations of a rate reduction. NZD rose as higher interest rates signalled stabilisation and yield premiums to investors. Retail sales figures in May recovered as well – adding impetus to NZD gains.

Persistent comments from BRIC countries regarding USD reserve diversification have not weighed significantly on USD although this remains a core risk. Brazil, Russia, India and China control a substantial amount of Dollar denominated reserves (in excess of $2 Trillion) so the ramifications of even a small switch away from the Dollar would be substantial. Furthermore, this could precipitate further fears regarding the Dollar's reserve status creating a downward spiral in confidence. Last month Russian central bank officials were vocal about the Euro becoming its primary reserve currency, overtaking the US Dollar for the first time in history. If this phenomenon gains enough momentum Dollar dominance will be threatened. Over this past weekend several finance ministers re-affirmed their support for the Dollar despite admitting to being interested in gradual diversification and adjustments to how trade is conducted between non-USD denominated trade blocs - again, juxtaposing comments which raised as many questions as they answered. Good news for speculators nonetheless.

Oil price broke confidently through $70 per barrel, its highest level since November 2008.

Over the weekend G8 ministers agree that QE exit policies will be finalised – another psychological boost to risk markets without tangible indications that stimulus will not be required anymore. Essentially, substantial doubts remain although tentative acceptance of improving conditions continues.

Preview: 15^{th} – 21^{st} June 2009

Looking ahead

- Three rate decisions (Japan, Switzerland and Norway) scheduled; commentary will be influential as probability of rate changes is very low
- Summit of BRIC nations has the potential to add to burgeoning USD doubts as reserve currency theme stays in focus for at least another week
- Multiple CPI readings should clarify inflation expectations as investors revisit inflation/deflation uncertainty
- Policy meeting minutes from BoJ, BoE and RBA due; highest risk of surprise probably in UK

Several economic calendar events alongside a potentially explosive meeting between BRIC nations (Brazil, Russia, India and China) make up the core of the outlook this week.

The BRIC meeting in Ekaterinburg, Russia on Tuesday is important purely because the countries involved are the four largest holders of US long-term debt. Fears over USD sustainability and medium-long term value have to a large extent been created by Chinese authorities themselves by being publically vocal about seeking alternatives to the US Dollar. We anticipate a broadly USD positive outcome as preliminary comments from Russian officials (on Monday morning) seem to be USD supportive. On the other hand, there could well be a coordinated move by some or all of the BRIC nations to diversify some of their Dollar reserves in light of long-term inflation fears in the US and over-reliance on US assets overall. The latter is more unlikely than the former because such a move would create unwanted political difficulties not to mention the debasement of remaining USD reserves as speculative market participants oversell the Dollar. The prime reserve currency theme is active and will drag on for the foreseeable future because a credible alternative to the Dollar is still unavailable. The Euro is the closest currency that is able to challenge the Dollar but its comparative lack of liquidity and integration with global markets reduces the chances of 'en masse' diversification.

Three rate decisions this week; Japan (no change exp.), Switzerland (no change exp.) and Norway (no change exp.) could provide volatility when they are announced as the QE theme remains pivotal. The G8 meeting confirmed that exit strategies will be finalised soon which adds flavour to expectedly uneventful meetings. Interest rates are unlikely to fall further whereas comments from central bank members could well indicate expansions/contractions in their specific QE paths.

Taking into consideration the wide range of opinions as to what we are likely to see first (inflation or deflation), inflation indicators are crucial. Market participants have been hit hard by the financial crisis, not only because trading conditions have become tougher but also because such an unprecedented event (and the consequent policy response) has made it more difficult to gauge where inflation is going. The deflationists are pointing to the lack of economic growth and lack of aggregate demand as reasons for why deflation will surface first. The other side of the coin, inflation, could occur in the near future as QE policies begin to gain traction. So far, the expanded money supply is not being utilised by financial intermediaries thus limiting any potential follow-through into headline inflation. The theory is that as economic activity starts to rise, the oversupply of capital will force prices to rise. In terms of this week, the available CPI data will act as a barometer of whether any initial feedback into inflation is occurring as economic conditions recover; even if questionably so.

Last but not least, policy meeting minutes from BoJ, BoE and RBA could prove significant because market participants are watching for signs of changing attitudes towards QE. Some investors are anticipating references as to how QE policies will be reversed considering that improvements in economic conditions are reducing the need for further stimulus. We expect RBA minutes to be a non-event in this case, BoJ to reaffirm low rates for the foreseeable future which leaves BoE. The Monetary Policy Committee (MPC) is the most probable of the three to announce an expansion because credit market conditions, yields and lending rates have not improved considerably since asset purchases commenced in March. In addition, the sharp rises seen in US yields and mortgage rates recently could force the Fed into altering its policy, either by increasing asset purchases overall or by increasing purchases of specific assets. In this scenario, increasing purchases of government bonds is probably most likely as this would increase liquidity as well as driving down long-term yields via higher bond prices.

FX Sensitive Calendar Events

Monday 15th June (EUR) Employment Change (USD) TIC Long-Term Purchases	Tuesday 16th June (AUD) Monetary Policy Meeting Minutes (JPY) Interest Rate Decision + Statement (CHF) Industrial Production (GBP) Consumer Price Index (CPI) (GBP) Retail Price Index (RPI) (EUR) ZEW Sentiment Indicator (EUR) CPI (USD) Producer Price Index (PPI)
Wednesday 17th June (CHF) Retail Sales (GBP) Monetary Policy Meeting Minutes (GBP) Unemployment Rate (EUR) Trade Balance (USD) CPI	Thursday 18th June (CHF) Interest Rate Decision + Statement (GBP) Retail Sales (GBP) Public Sector Net Borrowing (CAD) CPI (USD) Unemployment Claims
Friday 19th June (JPY) Monetary Policy Meeting Minutes (CAD) Retail Sales	