

FX Weekly

Review: 29th June – 5th July 2009

Recap

- Broad scepticism begins to outweigh optimism as macro-data continues to falter
- Fresh uncertainty and anxiety was able to raise volatility although decisive price action was a step too far
- US Dollar was well supported given the mildly risk-averse conditions as counter-intuitive dynamics prevailed
- Economic recovery story continues to suffer with absence of new upside surprises



Market Research

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Currency pair	At Open on June 29 th	At Close on July 3 rd	Nominal Change	% Change	Volatility
EUR/USD	1.4061	1.3979	-0.0082	-0.58%	1.94%
GBP/USD	1.6501	1.6331	-0.0170	-1.03%	2.68%
USD/JPY	95.24	96.02	0.78	0.82%	1.92%
USD/CHF	1.0823	1.0863	0.0040	0.37%	1.90%
EUR/GBP	0.8518	0.8557	0.0039	0.46%	2.28%
EUR/CHF	1.5223	1.5188	-0.0035	-0.23%	0.73%
GBP/CHF	1.7863	1.7741	-0.0122	-0.68%	2.59%
GBP/JPY	157.10	156.81	-0.29	-0.18%	2.46%
EUR/JPY	133.96	134.24	0.28	0.21%	2.63%
CHF/JPY	87.94	88.33	0.39	0.44%	2.85%
AUD/USD	0.8062	0.7965	-0.0097	-1.20%	3.15%
NZD/USD	0.6447	0.6295	-0.0152	-2.36%	4.48%
USD/CAD	1.1522	1.1606	0.0084	0.73%	1.88%

| Source: Alpari (UK)

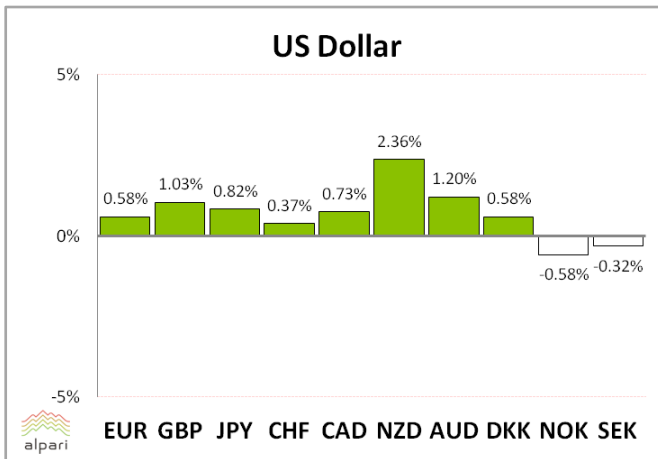
Almost all asset classes experienced volatile price action throughout the week amid uncertainty over economic recovery. Although the data set was eventful, range trading predominated leading to continued consolidation as has been the case for the past six weeks. Clouds are beginning to gather over the green-shoot recovery story, underlined by sharply weaker GDP figures in the UK, worsening unemployment in the US and slow economic conditions in Japan. Equities and commodities tested their respective upsides before trading down and finishing the week unconvincingly as traders covered risk exposure going into the weekend.

A spike in volatility on several measures (VIX, QQQ) before market close on Thursday; investors were buffeted by a week of data that forced tough questions to be asked of recent rallies in risk assets. Anxiety was evident going into a potentially eventful weekend as the media circus focused on the G8 agenda, including FX rates and the role of the US Dollar.

USD

Negative economic data in the US proved to be USD positive as the risk-averse theme dominated USD pairs. A sudden slowing in pending home sales (0.1% vs. 0.7% exp.) suggests anaemic housing market activity and increases the probability of prices falling further thus delaying stabilisation in financial products linked to mortgages. Mortgage applications also fell which underlined the fragile demand. Many banks continue to hold securitised assets that derive a large part of their core value from house prices which has given added importance to property market developments.

Over the course of the week, trading in all currency pairs was fairly reserved because market participants did not want to be drawn into taking positions prior to a highly anticipated employment report on Thursday. Fears of a surprise in the headline number were justified as the US economy lost 467,000 jobs (vs. -360k exp.) in June, bringing unemployment up to 9.5%. The level of unemployment has consistently increased since the start of the economic crisis making any valid recovery highly dependent on consumers getting back to work in order to facilitate spending and lift aggregate demand. Risk tolerance fell, leaving USD and JPY in inherently supportive conditions.



The weight of downbeat housing, unemployment and confidence data was counter-balanced by renewed calls for a re-evaluation of the Dollar. Chinese officials were quoted asking to discuss a new global reserve currency at this week's G8 summit in Italy. Speculators took the comments as USD negative, regardless of the actual possibility of USD losing its primary status. In recent weeks, we have seen repeated knee-jerk reactions in USD

pairs immediately after calls for Dollar diversification or for the introduction of a new global reserve currency – emanating primarily from Chinese officials. This phenomenon could continue as comments are expected in large quantities this week.

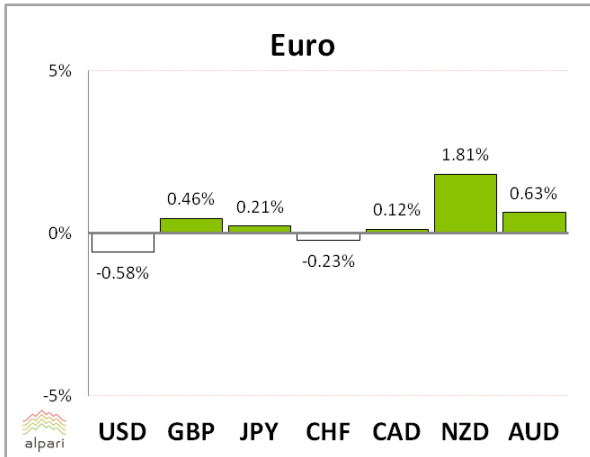
The Swedish central bank (Riksbank) cut interest rates by 0.25% from 0.5% to 0.25% and announced the provision of \$13bn of 12 month fixed rate loans – the news was very unexpected which meant sharp losses SEK in all pairs. Prior to the Riksbank's decision, SEK has been appreciating strongly against USD - hitting early June lows of around 7.5400 early in the week as risk appetite remained reasonably stable. However, reversion towards perceptibly safer currencies following poor US, UK data in addition to the unexpected interest rate cut forced SEK lower, erasing all earlier gains late in the European trading session on Thursday.

EUR

Considering the broadly risk-averse tone to last week's trade across most asset classes, the Euro was thus subdued against USD, JPY and CHF but firmer against cyclicals (NZD, AUD, CAD, GBP). News flow was mixed as a variety of European PMI's were broadly in line with expectations, highlighting contraction in manufacturing but at decreasing levels. However, a rise in

unemployment from 9.3% to 9.5% reminded everybody that recovery expectations will not be easy to sustain under present levels of job losses in Europe.

Another factor to add to the risk-averse mood was an Irish sovereign rating downgrade coupled with a negative outlook – the news sparked fears of a sovereign default as a worst case scenario because Ireland's financial stability has been repeatedly threatened, increasing the chances of an EU member leaving the monetary union (EMU).



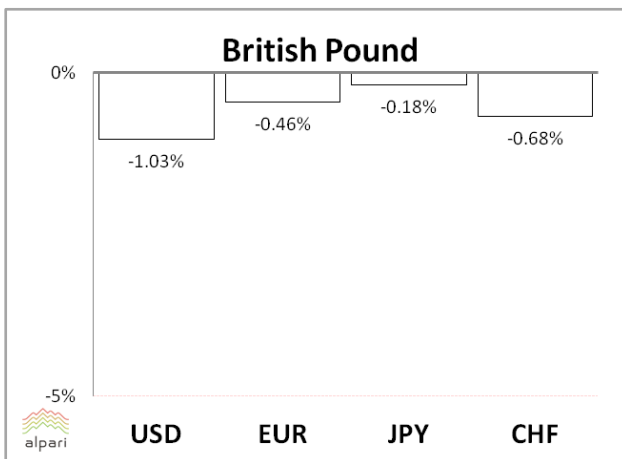
The clear focus for last week was the interest rate decision and the ECB's consequent statement. Although developments to the ECB's QE programme were a potential risk, no such developments materialised. The ECB kept interest rates on hold as expected and made no references to expanding/contracting/augmenting the current €60bn purchase scheme.

Lower retail sales figures (-0.4% vs. -0.1% exp.) failed to gain any traction with EUR

traders on Friday probably because of lower market participation in light of the US public holiday on the same day. Despite the lack of reaction, the lower figures should be noted nevertheless because the resilience of the European consumer may be crucial for EUR pairs in the medium-long term.

GBP

Sterling was unable to extend beyond consolidated ranges because of the risk-averse mood and fresh deterioration in the UK macro data-set. The big surprise was much lower than expected GDP for Q2 (-2.4% vs. -2.0%) which drove GBP lower across the board. Sterling was under severe pressure as the large downward revision put back hopes of an imminent recovery. The fall in output was the largest since the 1950's as UK recovery hopes and recent claims of an end to the recession were both blown away. Also, lower GDP growth implies that recovery from the unprecedented levels of debt taken on by UK authorities will take longer to repay due to lower tax receipts in the coming years.



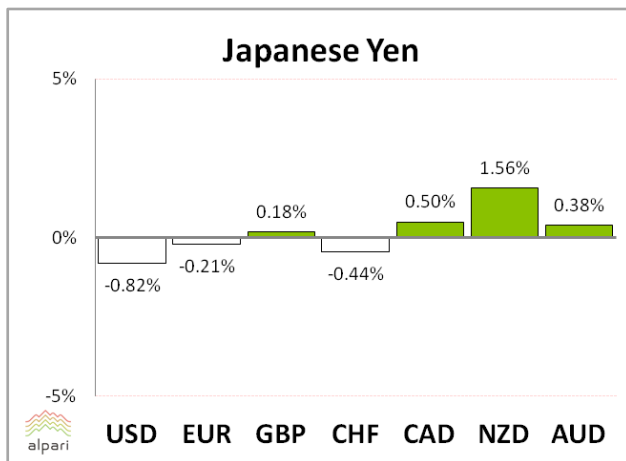
Despite the macro shock and other less significant data releases (wider current account and less lending to individuals) Sterling was able to keep a sure footing, falling most against USD (-1.09%) and least against JPY (-0.18%). The scale of depreciation is surprising considering the large downward revision to growth; it is possible that more GBP weakness will be priced in as other indicators reflect the fragility expressed by the GDP figure. An economic recovery before the end of 2009

is looking increasingly unlikely and yet GBP pairs have barely moved away from their recent highs against other majors.

Also, a BoE credit conditions survey showed that financial institutions are making credit more readily available but the problem is more on the demand side - demand for new loans is weak as consumers find it unjustifiable to take on new credit given current conditions and current lending rates (stubbornly high due to wide banking margins). On the contrary, consumers are paying back more debt than ever before in order to avoid the negative consequences of default. The propensity to save is also rising despite record low interest rates. The news briefly boosted GBP because more ample availability of credit is usually taken as a good sign for the UK although worries of excess liquidity and lacklustre demand restrained the seemingly upbeat news that credit market conditions are easing in the UK.

JPY

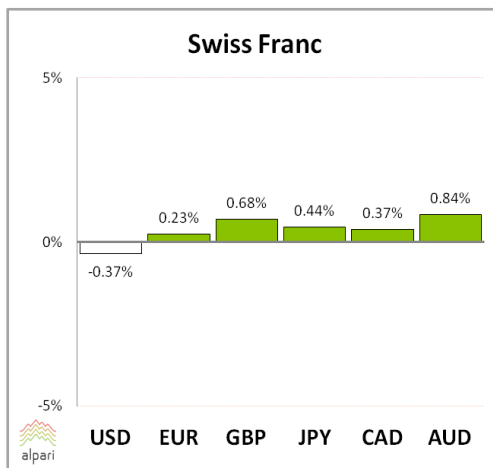
Price action was very mixed in JPY pairs as risk-averse sentiment was countered by disappointing Japanese data. The main event was the Tankan survey which measures the health of the Japanese



manufacturing (-48 vs. -43 exp.) and services (-29 vs. -26 exp.) sectors; both showed less than expected improvements although Japanese manufacturing continues to contract most. Economic stimulus measures were cited as having a positive impact on sentiment but concerns that stimulus measures are unsustainable and that any improvement will occur only in the long-term pushed the Yen lower immediately after the announcement. The changing tide of opinion, expectations and

speculation pulled the Yen away from protracted moves – when added to the risk-aversion factor, the Yen gained against the most cyclical currencies (CAD, NZD, AUD, GBP) and fell against USD, CHF and EUR.

CHF



The Swiss Franc was largely range-bound last week as pronounced moves failed to occur in any currency pair. Apart from a marginally better CPI estimate (0.2% vs. 0.1% exp.) and a slightly better PMI reading (41.8 vs. 41.1 exp.) there were no other macro events. According to Swiss purchasing managers, the country's manufacturing and service sectors remain in contraction but the deterioration is diminishing. Overall, CHF was stronger against every currency in the G10 with the exception of USD (-0.37%). In the absence of country specific themes and interventionist actions by the SNB, the risk-negative bias is an arguable contributor to Swissie appreciation last week, however small it was.

Preview: 6th July – 12th July 2009



Looking ahead

- Two interest rate decisions (UK and Australia) scheduled; BoE statement carries risk of expanding QE while RBoA could surprise with a cut
- G8 meetings commence this week - positioning of the US Dollar as a reserve currency is a likely topic for discussion and commentary
- Q2 earnings continue; Alcoa due to report with financials commencing next week

Looking forward to this week, plenty of events threaten to drive asset values. Interest rate decisions from UK and Australian central banks have the potential to be influential if the quantitative easing theme is revisited. In addition, a key G8 meeting in Italy could have particular significance for FX traders as Chinese officials are already pushing for a debate on an alternative reserve currency (Fri-Mon). We are also keenly anticipating Euro zone GDP figures as an indicator of European resilience amidst tough economic conditions. The next few weeks will see Q2 earnings results, some of which will be reported this week. Investors are likely to focus on large bellwether stocks as an indicator of performance in the broader economy – again attention remains on the validity of improving economic conditions. Financial stocks are likely to grab the headlines for obvious reasons although most market participants are demanding a broader recovery in corporate profitability to justify further optimism. A banking sector led recovery can only take us so far.

The G8 meeting could impact FX rates depending on what is said by participating officials. Attention will focus on Brazil, Russia, India and China because they hold the largest reserves of US Dollars in the world. Indications that one of these nations may abandon USD as their prime reserve currency could weaken the Dollar substantially. Despite this risk, we feel it is rather unlikely for clearly USD negative commentary to occur; it is more probable that fairly ambiguous comments are overtaken by speculators waiting for a development. In this scenario, FX rates are likely to fluctuate rapidly but without direction.

Aside from the rather eventful economic calendar, July marks the heaviest month for US debt issuance in history. The US Treasury is expecting to auction \$37bn of 3yr debt on Tuesday (7th), \$19bn of 10yr debt on Wednesday (8th) and \$11bn of 30yr debt on Thursday. The record for debt issuance was set last month at \$104bn and looks like being broken this month. This could possibly weigh on USD and Treasuries if the auctions are undersubscribed. Yield levels will also be key because they influence mortgage rates – if key yield resistance levels are breached, further rumours and speculation regarding USD viability would continue. Investors are becoming increasingly worried that the rising level of debt in the US could lead to a crisis in confidence and a run on the Dollar – these worries are premature to the extent that USD weakness from higher debt issuance is being offset by rising issuance overseas so more Treasury supply by itself is not enough to drive prices lower in our opinion.

A major event risk this week will be the BoE interest rate decision and the accompanying statement on monetary policy. Interest rates are almost certain to remain unchanged although the chances of BoE's QE policy being changed are relatively high. At the moment the BoE has

planned to conduct £125bn of asset purchases by September 2009 with a provision to go as high as £150bn if needed. The downside risk to GBP comes from the possibility of purchases being expanded beyond the maximum amount which would be immensely negative for Sterling as fears over hyperinflation, devaluation and capital flight are re-invigorated after a 3 month hiatus. The BoE could also go through the motions and assert their intention of utilising the whole £150bn instead of the currently confirmed £125bn. The flip side to this scenario is the BoE announcing a cessation of QE and introducing plans for removing added liquidity over a period of time – we feel this scenario is unlikely although if it occurs, GBP reaction should be very positive.

Also this week, an IMF report on China is due for the first time in 3 years. The language and tone of the report could be important to currency markets, especially if commentary is critical of China's exchange rate policy.

FX Sensitive Calendar Events

<u>Monday 6th July</u> (GBP) Halifax House Price Index (USD) ISM Non-Manufacturing PMI	<u>Tuesday 7th July</u> (AUD) Interest Rate Decision + Statement (GBP) Manufacturing Production (GBP) Industrial Production
<u>Wednesday 8th July</u> G8 Meetings Begin (8-10 th July) (GBP) Nationwide Consumer Confidence (JPY) Core Machinery Orders (JPY) Current Account (CHF) Unemployment Rate (EUR) Final GDP	<u>Thursday 9th July</u> G8 Meetings Continue (8-10 th July) (AUD) Employment Change & Unemployment Rate (EUR) German CPI (JPY) Preliminary Machine Tool Orders (GBP) Trade Balance (GBP) Interest Rate Decision + Statement (USD) Unemployment Claims
<u>Friday 10th July</u> G8 Meeting Finishes (8-10 th July) (GBP) Producer Price Index (CAD) Unemployment Rate (CAD) Trade Balance (USD) Trade Balance (USD) Import Prices (USD) University of Michigan Consumer Sentiment & Inflation Expectations	

Q2 Earnings Calendar (US)

30 June 2009	Sealy Corp
07 July 2009	Pepsi Bottling Group Inc
08 July 2009	Family Dollar Stores Inc Alcoa Inc
09 July 2009	3Com Corp
13 July 2009	CSX Corp Goldman Sachs
14 July 2009	Altera Corp Intel Corp Yum! Brands Inc Johnson & Johnson
15 July 2009	Abbott Laboratories Crown Holdings Inc Eaton Corp
16 July 2009	Harley-Davidson Inc JPMorgan Chase & Co International Business Machines (IBM) PPG Industries Inc Google Inc Wells Fargo & Co Charles Schwab Alliance Data Systems
17 July 2009	Mattel Inc Citigroup Baxter International General Electric Merrill Lynch & Co Inc Advanced Micro Devices (AMD) Fairchild Semiconductor International BlackRock Bank of New York Mellon Johnson Controls Morgan Stanley Bank of America
20 July 2009	Texas Instruments Halliburton Lexmark International

Financial services companies marked in red

Source: Bloomberg, J.P Morgan

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