

FX Weekly

Review: 6th – 12th July 2009

Recap

- Moves away from risk intensified as recovery scepticism predominated
- G8 meeting failed to introduce anything new although existing themes were developed
- Yen strength seen across the board; exposure to risk FX was cut substantially in response to a growing tide of cynicism over the recovery
- Commodity prices tracked lower; crude futures below \$60 on expectations of faltering demand for energy
- Q2 earnings were upbeat although the bulk of results will be released in the week commencing July 13th



Market Research

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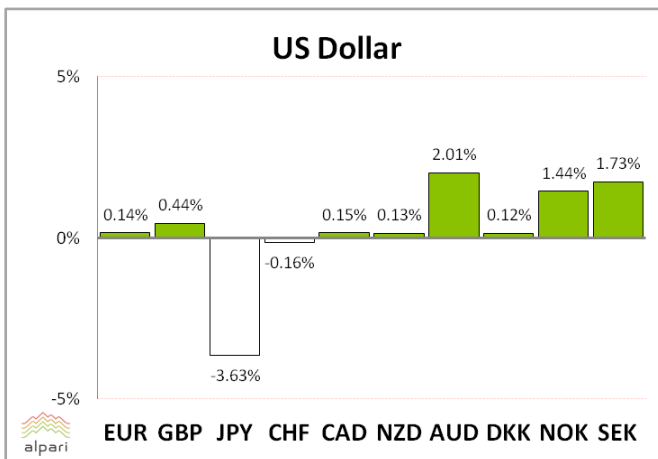
Currency pair	At Open on July 6 th	At Close on July 10 th	Nominal Change	% Change	Volatility
EUR/USD	1.3955	1.3935	-0.0020	-0.14%	1.72%
GBP/USD	1.6281	1.6209	-0.0072	-0.44%	2.44%
USD/JPY	96.04	92.55	-3.49	-3.63%	4.47%
USD/CHF	1.0879	1.0862	-0.0017	-0.16%	1.90%
EUR/GBP	0.8569	0.8594	0.0025	0.29%	1.58%
EUR/CHF	1.5184	1.5138	-0.0046	-0.30%	0.66%
GBP/CHF	1.7713	1.7604	-0.0109	-0.62%	1.60%
GBP/JPY	156.37	150.02	-6.35	-4.06%	6.22%
EUR/JPY	134.04	128.97	-5.07	-3.78%	5.26%
CHF/JPY	88.24	85.15	-3.09	-3.50%	4.91%
AUD/USD	0.7945	0.7785	-0.0160	-2.01%	3.98%
NZD/USD	0.6279	0.6271	-0.0008	-0.13%	3.17%
USD/CAD	1.1619	1.1636	0.0017	0.15%	1.57%

| Source: Alpari (UK)

Economic recovery sceptics had reason to cheer last week as moves away from risk intensified – highlighted by sharp moves lower in most indices (S&P, FTSE, DAX), commodities (crude below \$60) and risk FX. Several measures of volatility (VIX, QQQ) were also elevated indicating anxiety and renewed fears of severe weakness in economic conditions in the near future. There were no standout data releases and very little from the G8 summit although talk of a second stimulus package in the US, more QE in the UK and a dismissal of removing stimulus measures in the G8 (for now), weighed on near-term recovery hopes. Expansionary policies tend to lift optimism and asset prices but in the current environment, prospects of extra stimulus measures are having the opposite effect because they are sending a message that aggregate demand is unable to grow in its own right and that the green shoots were never green enough.

USD

Risk preferences as an FX theme made a strong comeback following several weeks of consolidation and stalemate. Since March, cyclical currencies have dominated supported by government financing, optimism for a worldwide recovery in aggregate demand, higher commodity prices and recovering fundamentals. However, over the course of June/early July, market participants have found themselves more divided and more open to questions regarding the validity of any recovery taking into account the multitude of indicators that are continuing to deteriorate almost unabated e.g. unemployment, housing and consumer spending (all supposedly key to economic prosperity). The events of last week indicate an adjustment in favour of the sceptics despite the mixed performance in USD pairs. In a risk-averse environment, we would have expected to see more USD strength than there actually was especially when compared to



JPY performance. The disparity could be explained by overhanging risks; rising government debt, weak fiscal position, QE, inflation expectations and persistent pot-shots at the Dollar by Chinese and Russian officials and policymakers. Overall the Dollar performed best against AUD (+2.01%) and SEK (+1.73%) but weakened against JPY (-3.63%) and CHF (-0.16%).

From a data perspective, the Dollar had positive influences - better than expected ISM non-manufacturing PMI figures (47 vs. 45.9 exp.) showed the slowest contraction in US services for 9 months. USD was very mixed after the figure with no clear direction as some market participants interpreted the news as USD negative (via positive risk theme) while some as USD positive (improving conditions for aggregate demand and recovery).

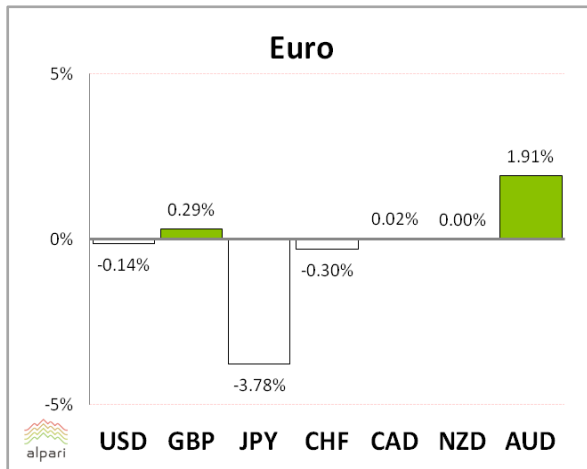
Last week's planned Treasury auctions were closely watched for signs of diminishing demand for US debt as worries over widening fiscal deficits continued to weigh. Demand for 3yr Treasuries was reasonably good on Tuesday whereas demand for 30yr Treasury bonds was heavily oversubscribed (3.38 bid-to-cover) with indirect bidders bolstering demand. The comparative preference for long-term debt may suggest investor uneasiness about long-term inflation although by the same token, willingness to lend to the US remains strong implying a solid level of confidence in the long-term viability of the US economy.

There was no mention of currencies in the official G8 draft and Chinese absence from the meetings was also a letdown as FX market participants expected some kind of stance on the Dollar. If the G8 meetings failed to provide a clear driver for FX, there were at secondary developments which are likely to persist over the next few months. The door to a 2nd stimulus package was opened to some extent as Obama reiterated the possibility of a new round of support from the current administration – the effect this could have on the Dollar is so far unclear because supportive measures are arguably as bad for the Dollar as they are good. Stimulus measures weaken the US fiscal position but act as a support for aggregate demand. In addition,

the counter-intuitive nature of USD trade makes this theme likely to create uncertainty and indecision.



EUR

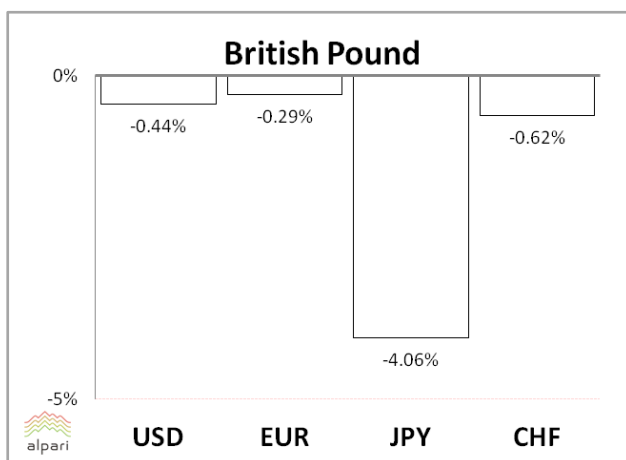


EUR pairs were subdued in the absence of any surprises from the G8 and a flat economic calendar. The only meaningful data was the final estimate for GDP growth in Q2 (-2.5% vs. -2.5% exp.) which was as expected thus having no immediate impact on EUR value. Most EUR pairs simply moved sideways although AUD (+1.91%) and JPY (-3.78%) were the exceptions. The Yen appreciated strongly against EUR on the back of the risk-aversion theme as was the case in other pairs while AUD was the worst performing currency in

several crosses as central bank comments failed to rule out further interest rate cuts despite keeping rates on hold for now. AUD value is to a large extent driven by yield differentials which would be eroded if rates fall closer to zero.

GBP

Sterling edged lower against USD, CHF and EUR but plummeted against JPY (-4.06%) as its risk-positive collar limited any potential upside. The major event of last week was the highly anticipated BoE interest rate meeting. Market participants began selling into GBP several days in advance of Thursday's announcement as an expansion to UK's QE policy looked to be on the cards. The consensus was for a £25bn increase in asset purchases, adding to the £125bn already being enacted – the actual result was a disappointment as both rates and QE parameters were left unchanged. GBP pairs spiked higher on the news as GBP sellers exited their speculative positions although in our opinion, the prospects for a £25bn increase have not diminished but have simply been postponed. The MPC stated that QE would once again be reviewed at the August 6th meeting which is likely to weigh on GBP in the preceding few days.



A set back in UK's manufacturing sector played a part in driving GBP/USD to its weekly low of 1.5982 before Thursday's bounce. Manufacturing production (-0.5% vs. 0.1% exp.) figures were very disappointing because a trend of continued improvement since March was broken. Most market participants have not yet given up on the 'positive growth in 2009' story purely because several sectors have shown a continuous slowing in deterioration while PMI's have continued

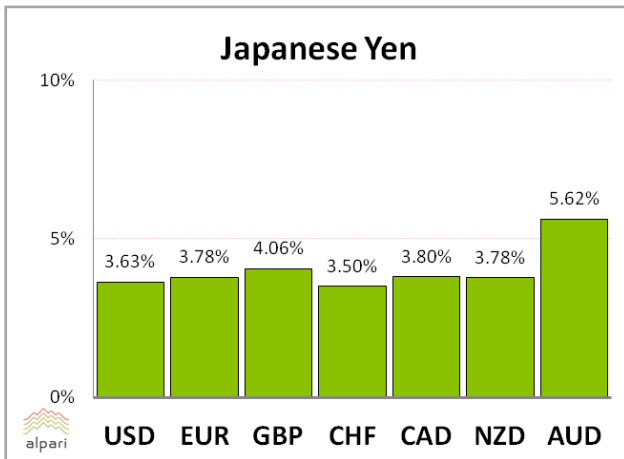
to creep towards 50 (the threshold for expansion) leading to expectations that actual growth/expansion would occur soon.

House price figures from Halifax showed a 0.5% decline in June, again weighing on recovery hopes and GBP in similar fashion to manufacturing. The first rise in house prices since March 09 was registered last month (+2.6%) so a fresh decline suggests any kind of recovery will be slow, protracted and uncertain in its evolution.



JPY

Not for the first time, highest volatility was in Yen pairs last week as recovery doubts intensified and risk appetite suffered. The Yen has been a reliable safe haven for investors over the past 18 months, give or take odd occasions of JPY weakness when macro data has been so bad that it has trumped the risk theme e.g. -13% GDP in Q1.

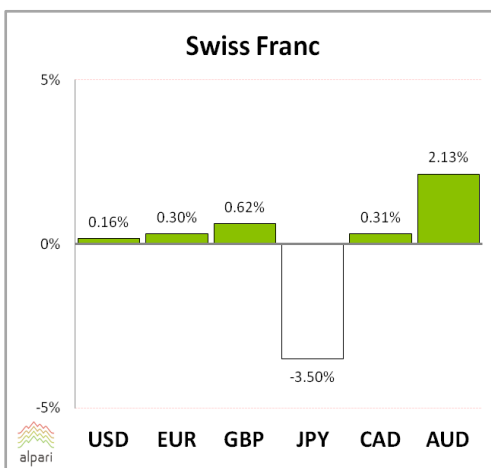


A large fall in machinery orders (-3% vs. 2.3% exp.) was unexpected and contrary to last week's headlines that the Japanese economy is beginning to stabilise. Market participants were expecting healthy progress in economic activity only to be disappointed by another large fall. The constantly swaying data sets worldwide do not necessarily suggest that recent recovery expectations weren't valid but they do indicate significant rebalancing and readjustment occurring in several

countries which are acting as a barrier for confidence and preventing a build-up of momentum.

A highlight for intra-day traders last week were the massive moves higher in JPY and USD on Wednesday afternoon in the London trading session – there were 2-3% moves in several pairs as JPY rose 3% against USD in less than thirty minutes. All currency pairs moved significantly – with risk-positive currencies being sold aggressively. Interestingly, AUD fell against its commodity counterparts (NZD, CAD) very sharply also. If we assume the explanation for these moves as being risk preference then AUD weakness indicates a comparatively higher risk premium in AUD as opposed to CAD or NZD. Also, Scandinavian currencies were unchanged during this time which is peculiar considering their cyclical nature and investor risk preferences towards them.

CHF



A light economic calendar and no SNB intervention meant fairly subdued range trade in CHF pairs but they still managed to finish mildly stronger against all other majors. CHF/JPY and CHF/AUD were the only pairs to make moves of $\pm 1\%$ - in similar fashion to the Euro. As previously mentioned in our *FX Weekly* publication, we are seeing the Swissie's risk profile drift from risk-negative to risk-neutral; most likely because of SNB intervention in EUR/CHF and USD/CHF and introducing QE. Investors are more tentative about holding the currency thus removing

natural support in a risk-averse environment.

The only notable data release was the unexpected rise in unemployment from 3.5% to 3.8%. The immediate effect on price action was negligible although the psychological aspect is important because it increases the likelihood of the SNB continuing their interventionist stance in a bid to counter deflation risks. Unemployment in Switzerland has risen in every month since September 2008.



USD/IND (+2.34%)

Indian equities had their worst weekly performance for 8 months (falling by almost 10%) as a disappointing annual budget induced capital outflows by foreign investors. Concerns that monsoon rains will be insufficient also weighed. Under the risk-averse conditions, USD strengthened against the Rupee, reaching 49.44 at its high. Unconfirmed reports suggested the Reserve Bank of India (RBI) was intervening in the FX market on Friday to support the falling INR.

G8

The G8 meeting underlined the importance of a stronger, more sustainable recovery before any stimulus is removed. This development is intriguing because once stimulus is removed, this will indicate what policymakers actually classify as a "sustainable recovery" and could even be used to gauge what is acceptable as a recovery and what can be discounted as a green shoot. Also, by vocally conditioning the removal of stimulus packages on a sustainable recovery, the G8 have potentially created a tough situation because if recovery falters soon after stimulative measures have been removed, then the onus will be back on central banks to re-introduce asset purchases seeing as they are so crucial to a recovery. Another possibility is QE having a pronounced inflation effect without growth i.e. stagflation. This would be a big problem if removing QE is conditional on sustainable growth.

Preview: 13th – 19th July



Looking ahead

- Recovery story continues to look fragile as several macro risks approach
- Very eventful week expected as overweight calendar threatens to increase volatility
- Q2 earnings season reaches its peak with 29 firms expected to report
- Inflation figures will be all important for ongoing inflation expectations

Looking at this week, several key indicators are due – most attention will go on US, EU and UK inflation figures considering the added importance inflation expectations are taking of late. Equities are likely to remain volatile due to ongoing uncertainty over Q2 earnings; several bellwethers are due to report although it's unlikely that financials will take such a pre-eminent role as they did in Q1. An economic recovery is likely to require strength amongst financials whilst a broad recovery must include other sectors. Due to the large number of market drivers threatening to affect currencies, consolidated ranges may be under severe threat.

The most decisive factor could be the 29 earnings reports due from the US (*Earnings calendar attached*). Equity moves have been well reflected in FX pairs over the course of the financial crisis – moves higher in equities have come alongside upward moves in cyclical currencies (at the expense of majors such as USD, JPY and CHF) and vice versa. If we see another quarter of strong results, there is a real possibility of the recovery story gaining renewed traction as investors regain their appetite for risk FX, equities and commodities. In Q2 the focus is not on financials as was the case in Q1 because a much higher degree of certainty now surrounds the financial sector, especially in the US where billions have gone into supporting banks. Investors are largely aware that profitability amongst banks is rising backed by record low funding rates and sticky lending rates offered to customers. Now, the question is whether a broad recovery can occur whereby several sectors show improvement simultaneously, thus supporting the case for a turnaround in demand, unemployment and investment nationwide.

From a macro perspective, our opinion is that this week's multiple CPI releases have the best chance of driving FX values extensively. With all eyes on inflation and inflation expectations going forward, the release of CPI's from so many territories could reveal a nasty surprise. The focus will be on the US, UK and EU because they are currently implementing various degrees of QE policy which risk pushing inflation beyond central bank targets. Signs of this scenario occurring is likely to be severely negative for the relevant currency.

Also this week, FOMC minutes and Retail Sales figures will be focused on. Market participants are interested in finding out whether the Fed plans to switch their planned purchases from mortgage backed assets to Treasuries – this issue could be resolved by commentary from their meeting on June 23rd. US retail sales have shown a modest recovery since April and are expected to have grown by 0.4% in June. The viability of the US consumer as a driver for US growth is in severe doubt with rising unemployment and falling house prices depressing disposable incomes in addition to contraction in several key industries and sectors. A downside surprise here is likely to be USD positive as risk preferences globally continue to overshadow local factors.

FX Sensitive Calendar Events

<u>Monday 13th July</u>	<u>Tuesday 14th July</u>
(CHF) PPI (CAD) Bank of Canada Outlook Survey (USD) Federal Budget	(GBP) CPI (GBP) RPI (EUR) ZEW Economic Sentiment (EUR) Industrial Production (USD) Retail Sales (USD) PPI
<u>Wednesday 15th July</u>	<u>Thursday 16th July</u>
(JPY) Interest Rate Decision + Statement (CHF) Retail Sales (GBP) Claimant Count (GBP) Unemployment Rate (EUR) CPI (USD) CPI (USD) Industrial Production (USD) Fed (FOMC) Meeting Minutes (NZD) CPI	(CHF) ZEW Economic Expectations (USD) TIC Long-term Purchases (USD) Philly Fed Manufacturing Index
<u>Friday 17th July</u>	
(EUR) Trade Balance (CAD) CPI	

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
14 July 2009	Altera Corp Intel Corp Yum! Brands Inc Johnson & Johnson Goldman Sachs
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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