

# FX Weekly

## Review: 3<sup>rd</sup> – 9<sup>th</sup> August 2009

### Recap

- Bank of England shocks recovery theorists with unexpected QE expansion beyond set limit of £150bn; GBP pairs suffered across the board
- US Dollar shook off its risk sentiment trade logic following good employment report. Dollar index bounced off late 2008 lows.
- Traditional safe havens (CHF, JPY) sold again. Strong up trends against JPY continuing for most currencies
- Q2 earnings almost at an end as investors scour for new positives that could drive the ongoing risk rally higher



### Market Research

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Currency pair	At Open on August 3 <sup>rd</sup>	At Close on August 7 <sup>th</sup>	Nominal Change	% Change	Volatility
EUR/USD	1.4268	1.4182	-0.0086	-0.60%	2.06%
GBP/USD	1.6719	1.6682	-0.0037	-0.22%	2.34%
USD/JPY	94.76	97.55	2.79	2.94%	3.62%
USD/CHF	1.0674	1.0808	0.0134	1.26%	2.66%
EUR/GBP	0.8533	0.8498	-0.0035	-0.41%	1.62%
EUR/CHF	1.5233	1.5330	0.0097	0.64%	0.92%
GBP/CHF	1.7849	1.8030	0.0181	1.01%	1.80%
GBP/JPY	158.41	162.73	4.32	2.73%	3.16%
EUR/JPY	135.22	138.36	3.14	2.32%	3.06%
CHF/JPY	88.72	90.20	1.48	1.67%	2.68%
AUD/USD	0.8352	0.8369	0.0017	0.20%	1.56%
NZD/USD	0.6599	0.6713	0.0114	1.73%	3.30%
USD/CAD	1.0770	1.0810	0.0040	0.37%	2.19%

| Source: Alpari (UK)

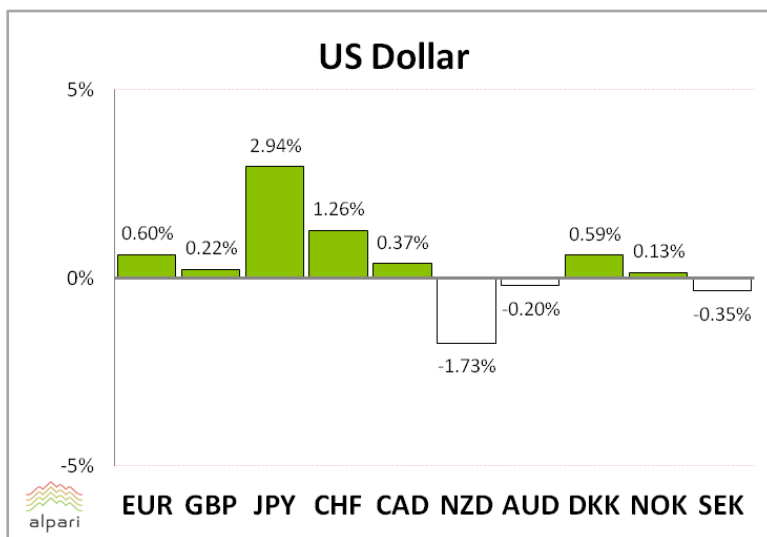
Multiple asset classes put an end to several months of range trading this week as investors began to tip over into the belief that broad macroeconomic conditions are improving worldwide and not just in particular regions – in essence, confirmation of a burgeoning recovery became more concrete which gave market participants the green light to take on risk in search of higher returns. Equities, commodities and cyclical currencies all made strong rallies although the highly anticipated US employment report last Friday burned USD shorts that were too slow to notice a suddenly diminishing safe-haven theme for the Dollar. The pattern over the course of the crisis has been a USD bid on negative surprises and a USD sell-off on positive ones – quite consistent with risk-aversion logic.

Given the gradually improving data flow out of the G20, investors are hoping to see signs of recovery in the labour sector for the recovery story to make sense. The big news of the week was the decision by the Bank of England to increase their QE policy by £50bn, way beyond all dovish expectations whilst keeping interest rates on hold.

Broad confidence is still fragile and is likely to remain so for a considerable amount of time until macro data flow shows a trend of improvement; something which is still not occurring despite all the improvements in sentiment indicators. Next week, inflation data from the UK and US is unlikely to surprise so focus is likely to be on US monetary policy and German GDP estimates – a good indicator of GDP for the Euro zone overall.

## USD

The story of the week for the US Dollar was its strong reconnection with normality after months of safe-haven preferences i.e. strong macro-data from the US is finally beginning to have a positive effect on the Dollar as opposed to a negative one. The Dollar has been sold aggressively on good news from the US because of a more global risk tolerance theme which has proved very counterintuitive and problematic for market participants. Last Friday, eager USD shorts were squeezed as the employment situation in the US was seen to be getting worse at a decreasing rate (-247,000 vs. -320,000 exp.). Less than 100,000 fewer jobs lost was enough to stoke confidence-led buying of the Dollar – this was not completely unexpected however because the data flow up until Friday was broadly good including improvement in ISM manufacturing, pending home sales, personal spending and factory orders. Investors are in good spirits with regards to the US economy; a story which has been gaining support as various indicators point to an ongoing



recovery. The timing and voracity of USD buying caught many by surprise because the employment report was very close to expectations and yet this was enough to erase all USD losses over the course of the week.

The Dollar's largest loss was against NZD (-1.73%) by Friday's close but early on Friday afternoon the Dollar was over 3% lower against

NZD and weaker against every currency in the G20 apart from JPY. The sharp turnaround could be a sign of things to come in terms of how Dollar pairs trade in the future so we'll be watching how USD pairs react to macro data this week for further confirmation. Incidentally, NZD/USD was the 3<sup>rd</sup> most volatile currency pair last week, behind AUD/JPY and NZD/JPY.

EUR/USD broke beyond the highs of early June that were rejected at that stage. GBP/USD has also broken out. Several currency pairs have done the same indicating a renewed surge of confidence. Since May, FX pairs have run into severe congestion as investors questioned future prospects for the global economy. Talk of double-dip recessions around the globe ensured apprehension with many market participants preferring to sit on their hands instead of gambling on which way broad trends would go. It seems that the glass is half full rather than half empty for most investors at the current time.

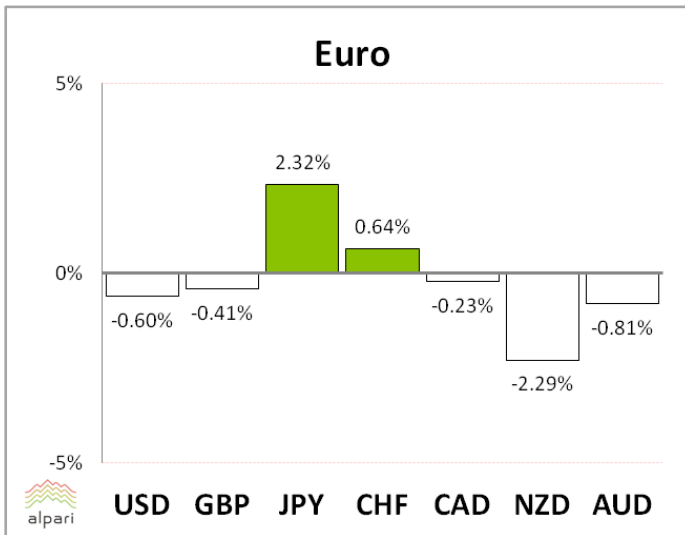
The Dollar index tested Dec 2008 lows (77.68). In December 2008, serious concerns regarding USD value were common and a sense of panic was prevailing – compared to now these conditions

have clearly improved which may suggest USD is oversold on the back of re-investment of USD stockpiles in response to extensive risk-aversion.



## EUR

An extremely low-key week for the Euro from a data point of view prevented significant moves in EUR pairs. Also, the risk tolerant environment gave the EUR inherent support against JPY and CHF. There was some weakness against cyclicals (-2.29% vs. NZD and -0.81% vs. AUD) but this was by no means on the back of EUR weakness or NZD strength. The largest moves against the EUR came



after non-farm payrolls which suggest more of a risk-preference theme predominating rather than any local ones.

From the data that was available, our focus was on much weaker than expected retail sector numbers in Germany and the EU overall. Weak German retail sales figures (-1.8% vs. 0.4% exp.) were reaffirmed by falling retail sales in the EU (-0.2% vs. 0.3% exp.) and proving that consumer demand is still incredibly fragile and

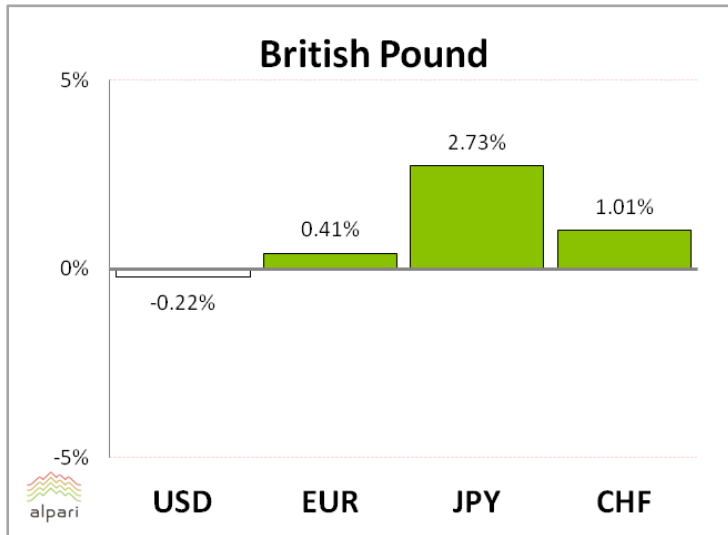
subject to large fluctuations within the fledgling recovery.

The prime risk of last week for EUR market participants was undoubtedly the ECB's interest rate decision on Wednesday. The base interest rate was left unchanged at 1%. Some investors were anxious that the ECB's bond purchase programme would be altered and/or expanded given the BoE's decision to expand QE by £50bn earlier in the day. BoE officials were quoted as saying that the current recession was "deeper than previously thought" – considering that almost every indicator over the past 2 months has been indicating an easing of recessionary conditions, investors took fright. The effect was mostly seen in GBP trade but the psychological effect has been extensive and far-reaching. Fears of the ECB following suit were immediately evident in addition to the Fed's interest rate decision this coming week providing speculators with more reason to question current expectations of no more stimulus measures for the time being. The Fed's announcement this Wednesday has taken on added significance as a result of BoE's decision because investors are concerned policymakers know more than what the market does i.e. the recovery will not be strong and will not occur as quickly as estimated. The fear is of a rather slow and gradual recovery thus requiring expansionary monetary measures.

## GBP

Sterling trade was dominated by the BoE interest rate decision and the accompanying statement. The base rate was left unchanged with another £50bn of asset purchases announced, bringing a total allocation of £175bn to be used for buying assets from UK banks before year end. The effect in real terms is estimated to be equivalent to a 1%-1.2% rate cut. GBP was sold heavily from 1.6980 down to 1.6830 within 10 minutes. Market participants were clear in their apprehension,

viewing the added QE with some disdain. UK stocks rose sharply however because of the assumed stimulatory effect for banks and UK businesses in the medium term. Long-term (10yr) yields fell 20 basis points within minutes. Most investors thought it impossible that the BoE would go beyond the allocated £150bn. With the announcement of a £175bn level, the market was spooked at the severity of the move considering the improving data being seen in manufacturing,



housing and retail sectors. One quote stood out most: "The recession is deeper than previously thought" which goes completely against the recovery story currently being sketched out.

UK house prices and UK manufacturing were both better than expected. In the case of house prices, this was the second week that house price estimates showed a rise. Two weeks ago we saw the Nationwide HPI rise and

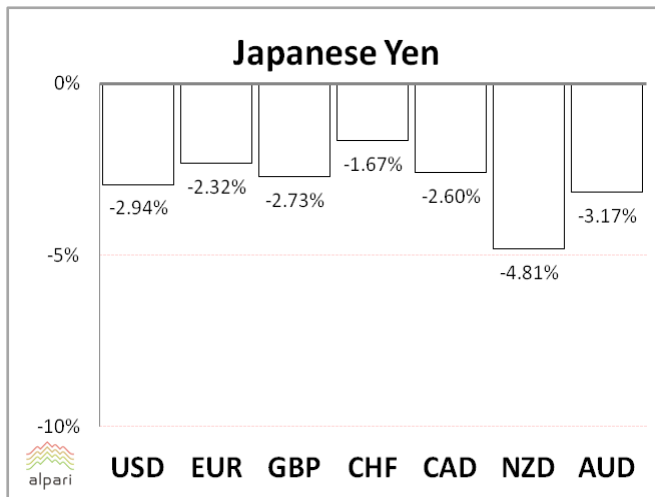
this week the Halifax index also showed a rise. Both of these numbers have given confidence to inward UK investors because house prices are considered crucial for a true economic recovery to be validated. In addition, speculators are viewing UK property prices as an indicator for GBP direction – and they've been right because UK house prices currently have a correlation of 0.90 with Sterling. On the whole, a solid week for Sterling with risk-rally momentum being kept if not increased. GBP performed best against JPY (+2.73%), and falling only 0.22% against the Dollar. The US employment report clawed back all the gains made prior in the week.

Sterling strength may begin to cause negative effects on the UK economy in the medium-term just as British exporters begin to see improvements in trade conditions. Sterling has appreciated very strongly over the past few months because of its risk-positive status, the strong recovery of the banking sector and a broad improvement in aggregate demand expectations going forward.

### JPY

And so for another week the Yen suffered in line with improving economic conditions and a risk tolerant environment which induced higher equity and commodity prices. The Yen fell across the board as worrying comments from the Bank of Japan added weight to an already downbeat mood for risk-negative, safe-havens. Japanese authorities said they expected Japan to have deflation until 2011/2012 - a revisit of the 1990's scenario whereby consumers held back spending, investment and luxury purchases in the expectation of lower prices in the future. It took Japan a whole decade to even begin to climb out of this self-perpetuating downward spiral; the prospect of this spiral re-engaging has been a bitter pill to swallow for many long-term JPY investors.

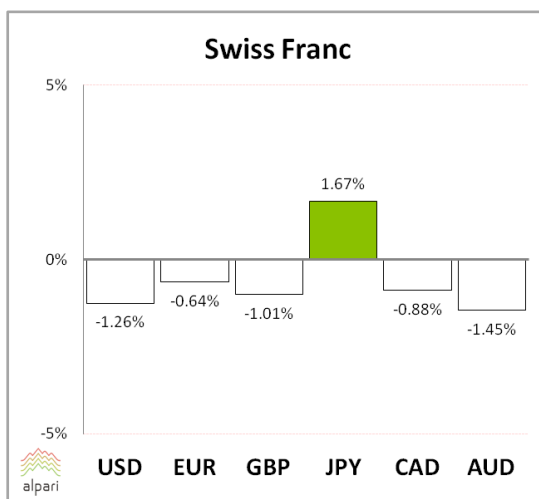
JPY buyers have disappeared off the radar in recent months as persistently disappointing fundamentals have been exacerbated by JPY being used as a funding currency for carry trades and



reallocation of JPY holdings abroad in similar fashion to how hoarded USD deposits have been re-invested into higher yielding assets. The USD and JPY have been the two weakest currencies in the G20 over the past few months due to such capital flow preferences. Last week, the largest falls were expectedly against cyclical currencies such as NZD (-4.81%), AUD (-3.17%) and CAD (-2.60%) which have been increasingly bullish alongside a return of risk-appetite and their relatively better

yields. In the case of Canada, Australia and New Zealand, exposure to the sub-prime debt market in the US has been limited. Most of the negative impact has been via the fall in international trade and commodity prices which have already begun to recover.

## CHF



The Swiss Franc bore the brunt of a risk-tolerant mindset and improving conditions in Europe and the US, leading to broad sell-off. The Franc was the 2<sup>nd</sup> weakest currency in the G20 as safe-havens were snubbed in favour of higher yielding currencies. The fact that no Swiss macroeconomic data was available made it all the more likely that CHF would follow the lead of the Dollar, Euro and Yen.

## Others

The RBoA left interest rates unchanged with a slight hint of rates only being able to rise from the current level of 3%. This had a supportive effect for the Aussie Dollar. In addition, better than expected labour market conditions (5.8% unemployment vs. 6% exp. and 32.2k jobs created vs. 18.8k jobs lost exp.) also helped to boost AUD. Market participants were given reason to believe that the economic recovery in Australia is further down the line compared to other nations which encouraged AUD buying not only from a returns perspective but also a security perspective seeing as other developed countries are still struggling to rule out another dip in economic conditions and aggregate demand.

NZD underperformed as unemployment rose sharply in July (6% vs. 5.6% exp.). Compared to the Aussie Dollar and a stark comparison with Australia where unemployment is falling, the Kiwi looked very weak before recovering well before Friday's close.

# Preview: 10<sup>th</sup> – 16<sup>th</sup> August 2009



## Looking ahead

- Central banks take centre stage as Fed, BoJ and Norges Bank announce policy decisions
- End of Q2 earnings could create a temporary vacuum whereby investors struggle to find impetus to drive the recovery story further
- Very important to watch for a pause in confidence with opportunities for taking profits being realised
- USD price action could reveal a firm psychological shift following last week's strong rally following better than expected macro data in the US

Market participants are likely to be left in a bit of a quandary this week as clear cut catalysts for the recovery story become ever scarcer. For the past 4 weeks or so, Q2 earnings reports in the US and Europe were seen as good indicators of economic conditions in the developed world. Investors were able to gauge how recovery from the effects of the financial crisis was getting on. Large banks were the first port of call seeing as the financial crisis was initially and primarily a banking phenomenon. With Q1 and Q2 results having been priced in, investors are likely to be tempted to pause for breath and potentially take profits on extensive moves in equities, commodities and risk FX.

Macro data is on the thin side this week so attention is likely to fall on a few key releases: the Fed, European GDP estimates and US retail sales. Inflation figures from the US and Europe are unlikely to surprise because almost all indications point to inflation being kept under control for now. Also this week, the Norwegian central bank (Norges Bank) will convene to decide their policy rate which currently stands at 1.25%. It is very unlikely for rates to be cut by any of the reporting banks this week (Fed, BoJ, Norges) because policy rates are already at all time lows. One possible nuance could be a hint of policy rates going higher in the near future (Norges) because aggregate demand conditions in Norway are more or less stable at the moment. Being seen as one of the first to recover from the crisis has its benefits in the form of inward investment, capital flows, more trade and lower unemployment so it is arguably beneficial for countries to pursue this collar.

Macroeconomic indicators are also improving, some more than others but a broad improvement is becoming more evident nevertheless so adding stimulus, either in the form of lower policy rates and/or QE does seem more unlikely than likely. This illustrates the surprise created by last week's decision to expand QE by the Bank of England – seemingly improving conditions were not reason enough to prevent more easing so the risk of the same happening in the US have to be acknowledged. Regardless of the actions by UK policymakers, we see very little chance of the Fed following suit. The political backlash is likely to be strong if the Fed decides to expand QE and the pressure on the Dollar is likely to be immense which again, politicians would have to answer for. The other factor is that most of the stimulus measures in the US have not been conducted in full as of yet whereas QE in the UK is (was) coming to the end of its track. Minutes from the BoE meeting could be explosive when they are released in 2 weeks time.

Last but not least, and possibly the most important theme likely to be developed this week is how the Dollar will react to positive/negative macro data going forward. Following last Friday's good employment report, the US Dollar was in heavy demand which is logical although this hasn't been the case over the course of the financial crisis. A reconnect of traditional, intuitive USD price

action must occur at some stage because it is almost impossible for good US fundamentals to send USD lower and vice versa. At some point, a return to normality must occur with last Friday's events potentially being the first example. We will be watching US announcements with this in mind this week.



- End -

#### **FX Sensitive Calendar Events**

<u>Monday 10<sup>th</sup> August</u>	<u>Tuesday 11<sup>th</sup> August</u>
(JPY) Core Machinery Orders (JPY) Current Account	(JPY) Interest Rate Decision + Statement (GBP) Trade Balance
<u>Wednesday 12<sup>th</sup> August</u>	<u>Thursday 13<sup>th</sup> August</u>
(GBP) Unemployment Rate (EUR) Industrial Production (GBP) BoE Inflation Report (NOK) Interest Rate Decision + Statement (CAD) Trade Balance (USD) Trade Balance (USD) Interest Rate Decision + Statement	(EUR) German Preliminary GDP (EUR) French Preliminary GDP (CHF) PPI (EUR) Preliminary GDP (USD) Retail Sales (NZD) Retail Sales
<u>Friday 14<sup>th</sup> August</u>	
(JPY) Monetary Policy Meeting Minutes (EUR) CPI (USD) CPI (USD) Capacity Utilisation Rate (USD) University of Michigan Sentiment	

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