Fundamental | FX

17th August 2009

FX Weekly

Review: 10th – 16th August 2009

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Market Research

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Recap

- US Dollar continued its move closer to a positive correlation with macro data
- Central bank meetings expose a growing likelihood of divergence in monetary policy in the G20 as recovery estimates vary across the G20
- Emphasis on potential QE exit strategies intensifies as timetable for QE removal is set by the Fed
- Recovery rates in the UK appear to be lagging behind others (Germany, France, Japan, US); this could provide a negative tone to GBP pairs going forward

Currency pair	At Open on August 10th	At Close on August 14th	Nominal Change	% Change	Volatility
EUR/USD	1.4175	1.4202	0.0027	**0.19%**	1.70%
GBP/USD	1.6670	1.6541	-0.0129	**-0.77%**	1.97%
USD/JPY	97.66	94.91	-2.75	**-2.81%**	3.38%
USD/CHF	1.0821	1.0718	-0.0103	**-0.95%**	1.98%
EUR/GBP	0.8501	0.8582	0.0081	**0.95%**	1.91%
EUR/CHF	1.5341	1.5223	-0.0118	**-0.77%**	0.95%
GBP/CHF	1.8040	1.7729	-0.0311	**-1.72%**	2.22%
GBP/JPY	162.79	157.00	-5.79	**-3.56%**	**4.28%**
EUR/JPY	138.47	134.81	-3.66	**-2.64%**	3.27%
CHF/JPY	90.20	88.50	-1.70	**-1.88%**	2.85%
AUD/USD	0.8337	0.8323	-0.0014	**-0.17%**	**3.57%**
NZD/USD	0.6689	0.6776	0.0087	**1.30%**	**4.31%**
USD/CAD	1.0826	1.0979	0.0153	**1.41%**	2.62%

| Source: Alpari (UK)

Last week was relatively uneventful as the holiday season sunk in. The dominant themes were the upbeat Fed meeting which signalled a winding down of stimulus measures as early as October as well as highly upbeat GDP figures from France and Germany which gave investors added confidence that the two largest EU members can lead Europe out of its economic malaise. In the absence of fresh confidence catalysts investors took profits following strong rallies in equities and commodities over the past few weeks. In FX, focus was on whether the US Dollar would continue to trade in line with traditional trade logic following an upbeat employment report last week. The answer looks to be a yes as disappointing retail sales numbers helped to push the Dollar lower over the week. The US retail sector remains fragile and erratic despite positive signs elsewhere.

This week, macro data is quite thin on the ground, not helped by the holiday exodus. Nevertheless, financial markets will still price in macro developments; focus will be on Bank of England minutes, UK inflation figures and a fresh bout of EU PMI's. Another factor that could sway sentiment is the continuing decline of Chinese equities – the SSE

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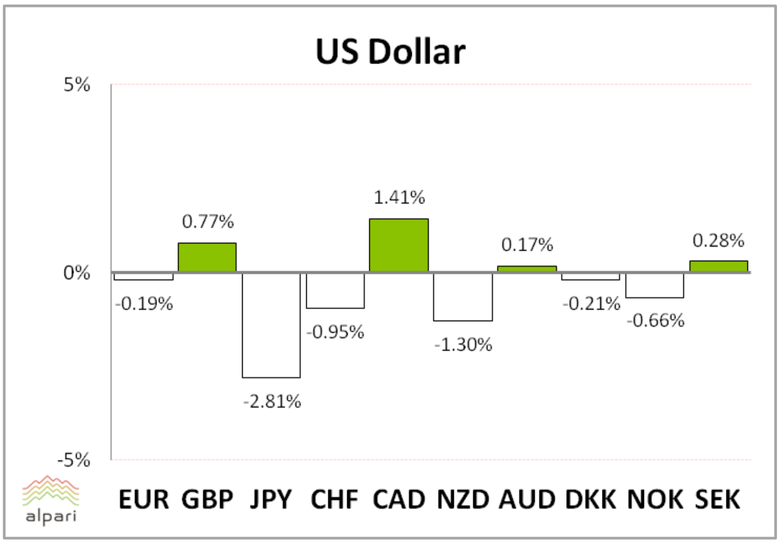
Index has fallen by over 10% since the start of August and is creating anxiety regarding a Chinese-led global recovery. These themes are likely to influence FX rates in addition to the usual speculative moves that pre-empt macro data. With FX pairs likely to see thinner trade than usual, extended intra-day moves alongside higher volatility are probable.

USD

The Dollar had a see-saw week with two main factors dominating sentiment towards the Dollar. A hawkish FOMC meeting led to sharp USD strength on news that unprecedented stimulus measures are about to be wound down. This also increased the chances of US rates going higher sooner rather than later. The Fed now sees a diminishing need for asset purchases and considers the current allocation of $1 Trillion as more than ample. The added stimulus measures are scheduled to be mothballed as early as this October which is clearly USD positive in the short-term as the recovery is sustained. Investors are coming round to the possibility that the ongoing recovery will continue to gather momentum; once stimulus measures are removed the expectation is that the recovery will continue on its own merits thus requiring higher interest rates over the medium-long term – this is the assumption most market participants were willing to subscribe to following the Fed policy statement on Wednesday last week.

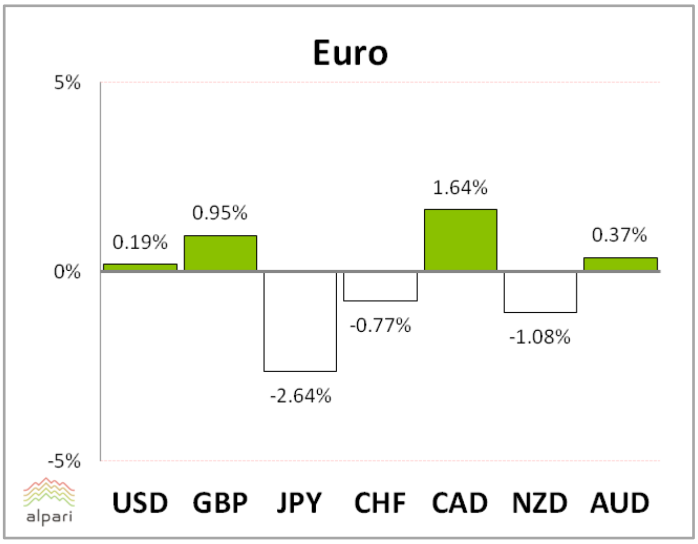
Despite the cheer coming from central bankers, USD spiked 3% before giving up its gains and closing lower in most pairs by the end of the week. This was largely due to disappointing retail sales figures (core: -0.6% vs. 0.2% exp. & headline: -0.1% vs. 0.8% exp.). Macro data was once again able to slap optimists in the face, underlining that any recovery will not be smooth and serene. The US consumer is considered as one of the more important elements in a US recovery so a lack of synchronisation between Fed policy/comments and other data flow such as retail sales has given investors a bitter taste in an otherwise sweet recovery story. From a broader, longer-term perspective we saw further evidence of USD re-syncing with traditional trade logic last week; we were watching for whether the Dollar would continue in this vein following the employment report on August 7th – the answer for now is a 'yes', the Dollar is now trading with a positive correlation to the US macro data set.



Aside from the Fed, two other central banks had policy meetings last week – the Bank of England and Norges Bank. Contrasting the three meetings together, the most striking development is the divergence between central bank policy in the three respective regions. Three banks but three slightly different monetary policy views: US (hawkish and positive for the future - asset purchases being wound down), Norges (very positive, interest rates may rise faster than expected) and BoE (most dovish because anti-growth comments continue to seep out of BoE members leaving the potential of a downside surprise on the table). Governor King reiterated that growth will be slow and protracted despite improvements in macroeconomic indicators and sentiment – emphasis was on the fact that it would take time to utilise spare capacity. UK growth projections are also lagging behind other nations, this is partly due to the UK going into the recession later than other nations and also because the UK is so highly dependent on the banking sector which has been the worst affected sector of all (approx. 20-30% of UK GDP derived from financial services).

EUR

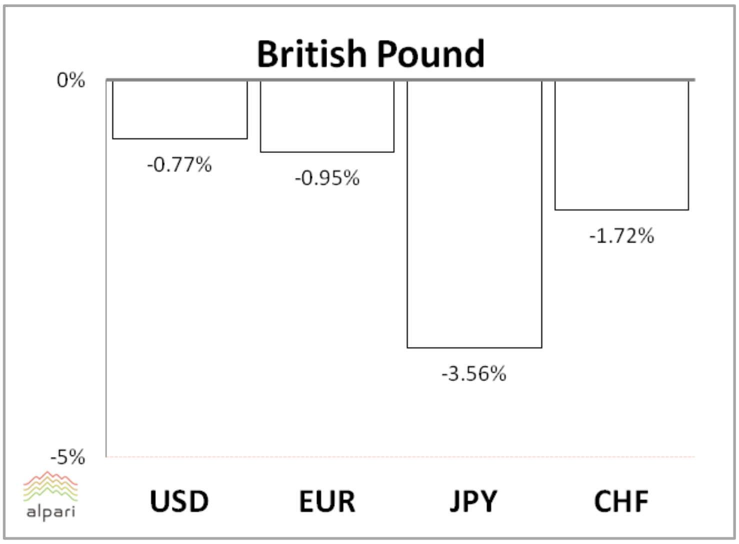
Euro zone factors were limited so when combined with a fairly subdued trading week ranging trade predominated in EUR pairs. The largest loss was against JPY (-2.64%) whereas the largest gain was against CAD (+1.64%). Overall, from a risk preferences perspective, risk-aversion was common although in our opinion, the lack of new upward momentum due to a lack of positive factors meant many investors decided to trim positions by taking profits. The breakout trade looked to be on offer in several pairs over recent weeks as a sparkling Q2 earnings season gave confidence to market participants. Since then, very few positive indicators have paused the spurt higher leaving late risk-rally longs in a squeeze.



The headline grabbing, EUR boosting news was of German and French GDP figures beating even the most optimistic estimates (+0.3% vs. -0.2-0.3% exp.). The return to growth story was taken up by news agencies, investors and politicians. Rhetoric was ratcheted higher and calls trumpeting the European economic model were widespread. The effect on the Euro was predictable – EUR made decent gains against cyclical currencies (AUD, CAD, GBP) and was stable against other majors (USD, GBP, JPY). Interestingly, overall EZ GDP was in line at -0.1% but the psychological lift from German/French results was evident. The consensus was that EZ GDP is back on the road to recovery, led by its two major economies. The other member states are expected to show improvement later in 2009 and 2010.

GBP

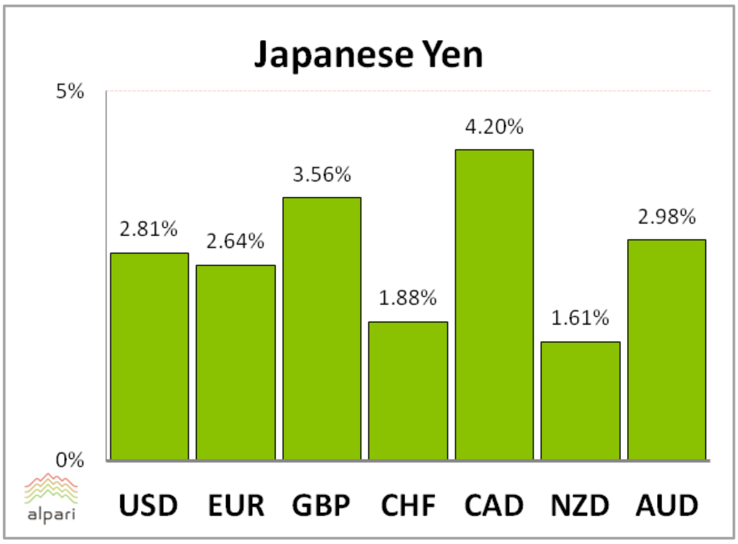
Aside from a dovish inflation report by the BoE with growth targets being put into question and references to a "slow" recovery ensured GBP pairs sold off on speculative flows. The risk-averse bias in FX combined with clear indications that UK interest rates would stay low for a considerable amount of time (given the added QE measures recently announced) has forced Sterling pairs to pull back on their recent breakout of May-July ranges – a good example of this is GBP/USD which broke through its topside range barrier at 1.6650 very confidently at the end of July only to break back into it on August 10th. Last week, we saw an attempt to break above 1.6650 once more, but this attempt was rejected leaving Sterling around 1.63 in early trade this morning. As previously mentioned, there is high risk of future monetary policy diverging between G20 nations. The UK has a very dovish approach and is actually increasing easing measures. This is in stark contrast to the US which is reigning back on stimulating its economy. The Norges Bank is clearly hawkish,



suggesting interest rates will rise soon. The USD/NOK pair sold off by 2.5% after the statement was released suggesting that market participants were greatly surprised. Very few people would have expected higher rate expectations so soon after the biggest financial crisis since the 1930's and yet we are in exactly this position. Certain nations have enough fundamental support and seemingly enough of a recovery in demand to warrant higher rates – this theme is newly developed and is very likely to pressurise GBP over the coming months if the disparity between policy stances is maintained.

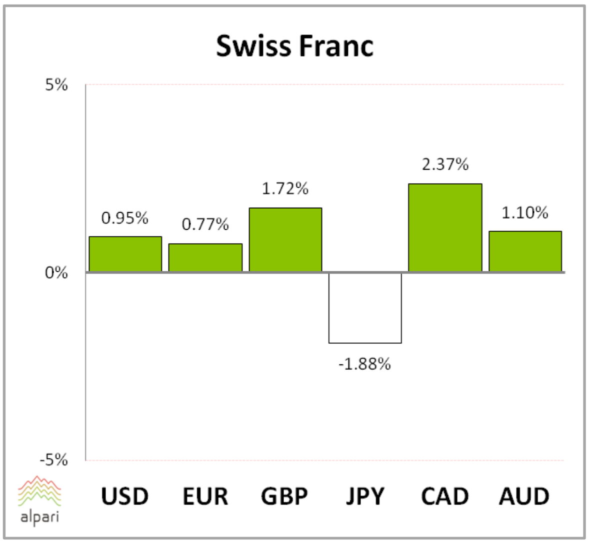
JPY

The Yen bounced back incredibly well from October 2008 lows (EUR/JPY, CAD/JPY, CHF/JPY as just a few examples) against a rising tide of bearishness towards Japan's future, overshadowed by prospects of deflation and anaemic growth. Only 2 weeks ago we heard BoJ comments expecting deflation in Japan until 2011/12 whereas today we've seen a return to positive growth in Japan's GDP in Q2 (+0.9%). The explanation for last week's across the board rally in JPY pairs could possibly be higher risk aversion but in our view, this explanation is too simplistic and can almost be considered an easy way out of a complicated set of dynamics. We put forward the theory that the profit taking motive on the back of a pause in upward momentum was a more likely cause for JPY buying. Holiday season trade could also have had an effect whereby a lack of volume prevented any pushes higher leaving the door open for retracements away from highs in cyclical and lows in safe-havens – this may be a better explanation for why JPY and CHF both had strong weeks.



The Dollar had a mixed performance, primarily because of its move towards a positive correlation with macro data. Usually, a risk-averse bias helps the US Dollar although this relationship was clearly lacking last week. Also, the risk-aversion connection that tied the Dollar to risk sentiment first and foremost could also be unravelling in the case of the Yen. Now that market participants (and markets overall) have calmed down, panic propensities are at pre-crisis levels so it stands to reason that currencies should return to trading off local factors. If Japan has been insulated from a large proportion of the banking fallout and international trade is likely to recover then it also stands to reason that JPY pairs should begin to strengthen if the recovery story is sustained and we see improvements in key indicators and demand conditions worldwide. Other positive influences included an eye watering jump in core machinery orders (9.7% vs. 2.8% exp.) suggesting Japanese manufacturing is on its way to recovery. Also, BoJ minutes had a hawkish but supportive tone as government backed supportive measures may be phased out in December 09 if conditions continue improving – this was music to the ears of JPY bulls who've been sidelined as JPY pairs have trended down from the start of the year.

CHF



The Swiss Franc had one data release for the whole week – month on month PPI which was in line with expectations. As a result, CHF pairs traded on the back of counterpart factors and the arguable risk aversion theme. We hold the view that this is a disguise for an actual trimming of profits, as in the case of JPY. By market close on Friday, the Swissie was the 2nd strongest currency in the G20. SNB intervention has been off the table for the last few weeks as the 'line in the sand' has remained in the distance – we are of course referring to the 1.50 level in EUR/CHF and 1.05-1.06 level in USD/CHF.

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Preview: 17th – 23rd August 2009

Looking ahead

- Quiet week expected as the holiday season in Europe and the US takes hold
- European PMI numbers are a focus for Europe while housing is the hot topic in the US
- BoE meeting minutes and UK retail sales figures stand out as the prime risks for GBP pairs

The focus this week is likely to centre on only a few indicators. The most likely to cause a reaction in FX rates are BoE minutes, UK retail sales and European PMI's. Following last week's excellent GDP figures from Germany and France, we are expecting to see good sentiment indicators from Europe thus helping the Euro higher across the board. FX rates could also react to risk preferences – looking at this morning's open in equities it is evident that a sharp sell-off is in progress across all indices in Europe, US and Asia. The retracement in European and US equities from October 08 highs is occurring unabated after key resistance levels held at the end of last week. In addition we are seeing a lack of upward momentum as positive factors are thin on the ground. Asian weakness is flowing over into European/US equities due to diminishing confidence in recent expectations that Asian demand would sustain a global risk-rally. The Chinese SSE index is 5% lower today, posting a 17% fall from early August.

If this trend continues for the rest of the week, we may see further upside in JPY, CHF and USD pairs at the expense of cyclical currencies; most at risk are commodity currencies (NZD, CAD, AUD and NOK).

At FX open in the early hours of this morning Japanese GDP figures showed a return to growth in the 2nd quarter. It wasn't long ago that Japan was expecting <-10% fall in GDP so quick recovery expectations are likely to be cemented. This news added to the Yen's good performance last week, extending its broad rally against every other currency. We are also seeing some pessimistic news reports regarding risk-rally overextension which is boosting low-yielders like USD, JPY and CHF against risk positive currencies.

The Bank of England minutes could be interesting because the decision to expand QE beyond the pre-set limit of £150bn was widely unexpected. Market participants are anticipating a variety of possibilities as to why BoE members decided to go so far in their policy decision despite so many indicators showing modest improvements. While other central banks are thinking of QE exit strategies and talking about tightening monetary policy, the UK seems to be lagging behind. The key question is what has the BoE so spooked so as to warrant an aggressive expansion of QE? The reasons behind why could be explosive with both downside and upside risks for GBP pairs looking as likely as each other. We expect higher volatility in Sterling pairs surrounding the release of the minutes on Wednesday.

FX Sensitive Calendar Events	
Monday 17th August (JPY) Preliminary GDP (CHF) Retail Sales (EUR) Trade Balance (USD) TIC Long-Term Purchases	*Tuesday 18th August* (AUD) Monetary Policy Meeting Minutes (GBP) CPI (EUR) German ZEW Sentiment (USD) PPI
Wednesday 19th August (EUR) Current Account (GBP) Monetary Policy Meeting Minutes (CAD) CPI	*Thursday 20th August* (GBP) Retail Sales (GBP) Public Sector Net Borrowing (CHF) ZEW Economic Expectations (USD) Philly Fed Manufacturing Index
Friday 21st August (EUR) French & German Flash Manufacturing PMI (EUR) French & German Flash Services PMI (EUR) Euro-zone Flash Manufacturing PMI (EUR) Euro-zone Flash Services PMI (USD) Existing Home Sales	