

# FX Weekly

## Review: 17<sup>th</sup> – 23<sup>rd</sup> August

### Recap

- Holiday season curbed volumes but failed to restrict intra-day volatility
- Oil prices made a new 2009 high alongside equities which also overcame resistance to break higher
- Heavyweight week for Sterling as several macro surprises influenced GBP pairs
- Commodity currencies prevailed and had the best performance; supported by stronger commodity prices and the fresh march higher in equities



### Market Research

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Currency pair	At Open on August 17 <sup>th</sup>	At Close on August 21 <sup>st</sup>	Nominal Change	% Change	Volatility
EUR/USD	1.4188	1.4324	0.0136	0.96%	2.33%
GBP/USD	1.6504	1.6507	0.0003	0.02%	2.11%
USD/JPY	94.75	94.37	-0.38	-0.40%	1.97%
USD/CHF	1.0732	1.0582	-0.0150	-1.40%	2.63%
EUR/GBP	0.8593	0.8675	0.0082	0.95%	2.06%
EUR/CHF	1.5228	1.5160	-0.0068	-0.45%	0.70%
GBP/CHF	1.7711	1.7470	-0.0241	-1.36%	2.38%
GBP/JPY	156.35	155.78	-0.57	-0.36%	2.58%
EUR/JPY	134.45	135.19	0.74	0.55%	2.44%
CHF/JPY	88.24	89.14	0.90	1.02%	2.53%
AUD/USD	0.8296	0.8346	0.0050	0.60%	2.93%
NZD/USD	0.6742	0.6820	0.0078	1.16%	3.34%
USD/CAD	1.0994	1.0807	-0.0187	-1.70%	3.29%

| Source: Alpari (UK)

Trading volumes were subdued last week with the holiday season in full swing. Despite a reduced number of market participants, there wasn't a lack of development in ongoing themes. Most intriguing was the raft of UK data; Bank of England minutes carved out a path for more QE increases thus underlining a diverging path of monetary policy between the UK and other G20 economies such as the US where stimulus measures are close to being phased out. Further deterioration in UK's public finances and stubbornly high inflation also weighed on UK markets. Over the course of the week, FX pairs were stuck in ranges but remained volatile. An important barometer of the recovery has been the performance of Chinese equities – steep losses at the start of the week were retraced to an extent but still left the SSE index 20% lower from early August highs. Overall, all currency crosses within the G20 were very subdued with no significant moves occurring.

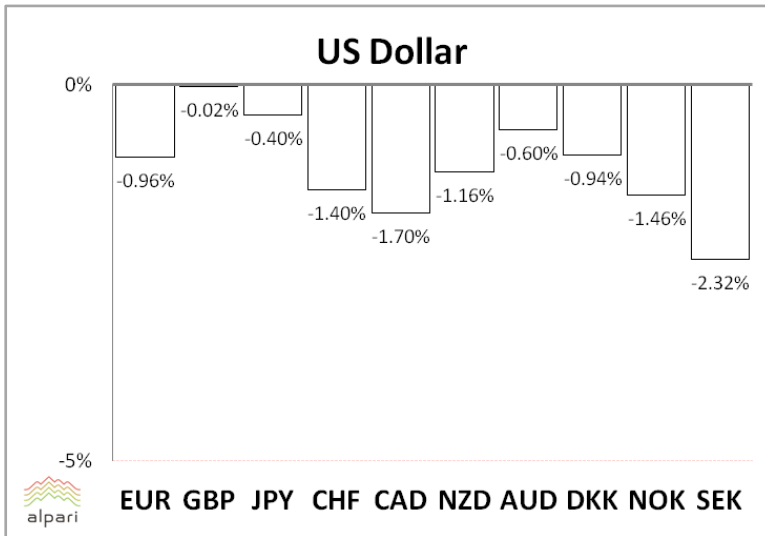
Next week, attention will turn to fresh GDP estimates from the US and the UK with upside surprises seeming more likely at this stage considering the upbeat growth numbers coming out of the Euro zone and Japan recently. Range breaking news could well come from the array of central bank speakers scheduled, especially because monetary policy is beginning to take on hawkish tones in several regions. Speculators are likely to concentrate on future interest rate

paths over the coming weeks as contrasting monetary policies exert an influence on FX rates, bond yields and recovery prospects.



## USD

The US Dollar traded off several themes last week which added to volatility in USD pairs. Although it finished lower in all pairs, news regarding the US wasn't all bad. In fact, the really important indicators were actually showing improvements. Existing home sales (5.24M vs. 5.03M) and an upbeat speech by Fed Chairman Ben Bernanke boosted USD sentiment late in the week but this wasn't enough to reverse the sharp Dollar losses mid-week. USD pairs were under pressure because risk-sentiment was again called into question on the back of rapidly weakening Chinese equity prices and continued qualifications by central bankers that tough conditions have not yet passed. Despite our initial thoughts that US dollar trade is becoming more positively correlated to US data, the events of last week made a contrary argument.



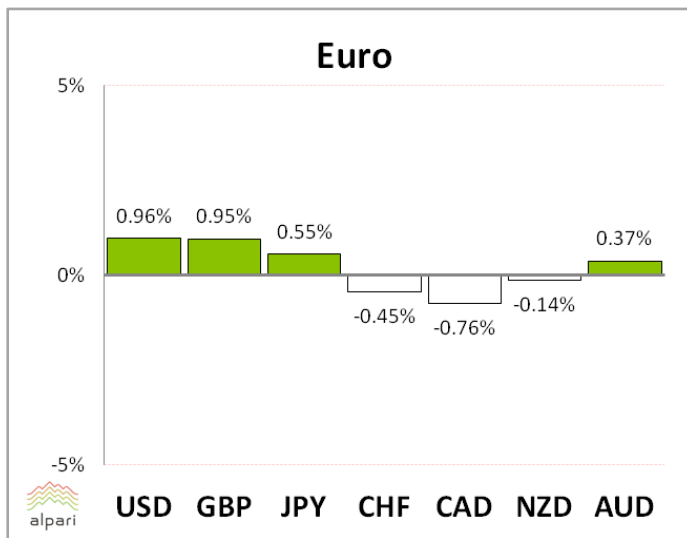
Despite a continuation in economic improvement, the Dollar fell because of a larger, more encompassing theme of risk avoidance resurfacing. Either this transition is still occurring with last week being an odd relapse towards safe-haven demand or the safe-haven theme for the Dollar is still predominating, regardless of any other local factors that suggest otherwise. Also, the lack of significant volumes (our estimates suggest a 40-50% reduction in FX volume as

a result of the ongoing holiday period) ensured FX moves were more pronounced and possibly more exaggerated. On the positive side, demand for long-term securities in the US rose very sharply in July (\$90bn vs. \$8bn exp.) which boosted USD demand and confirmed a slow return back to normality for the US Dollar as increasing doubts over its long-term viability now seem to have peaked.

## EUR

Good improvements in sentiment indicators across Europe allowed the EUR to stay well supported amidst a tentative, anxious environment, created by recovery doubts emanating from China. European PMI's were all better than expected - the EUR was stronger in most pairs although the majority of gains were against other majors rather than cyclical, pro-risk currencies. There was no reaction whatsoever in EUR/CHF.

Flash PMI readings	Previous	Expected	Actual
<b>French Manufacturing</b>	48.1	49.1	<b>50.2</b>
<b>French Services</b>	45.5	46.6	<b>48.9</b>
<b>German Manufacturing</b>	45.7	47.1	<b>49.0</b>
<b>German Services</b>	48.1	48.8	<b>54.1</b>
<b>EU Manufacturing</b>	46.3	47.8	<b>47.9</b>
<b>EU Services</b>	45.7	46.6	<b>49.5</b>



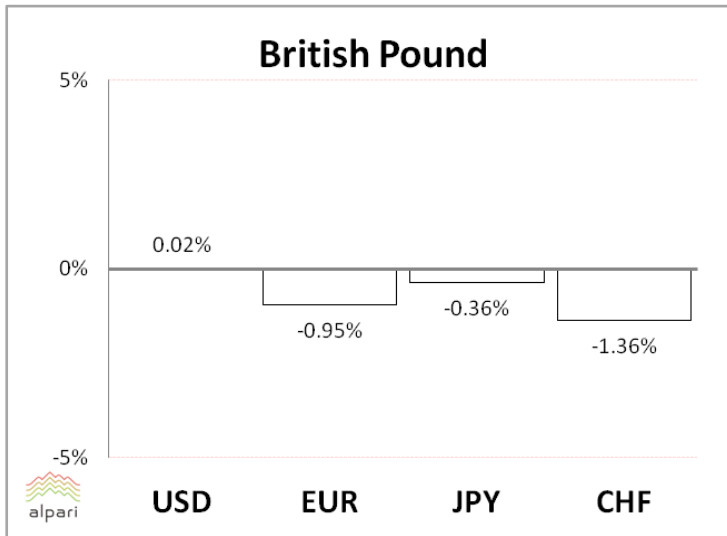
Adding to improving confidence from last week when Euro zone GDP figures showed a return to growth and PMI numbers beginning to breach the key 50 barrier (above 50 reading signifies perceived expansion), German ZEW figures measuring confidence made a huge jump higher (56.1 vs. 45.2 exp). The unexpected improvement instigated a short-term bid in EUR pairs although as the week went on, the EUR displayed a tendency to trend higher against other majors.

## GBP

Sterling pairs were stuck in the ranges for most of the week – 1.6590 to 1.6390 was the approximate range in GBP/USD with a similar pattern evident in GBP/JPY. Against the Swiss Franc, the Pound trended lower, closing 1.36% in the red. As already mentioned, the most intriguing news last week came from the UK bringing about higher GBP volatility and sharp changes in expectations with regards to the UK economy, future interest rates and the ongoing recovery. At the current time, estimates are immensely varied about the long-term future of the UK as a whole – public finances, QE and anaemic growth suggest a slower than expected recovery whereas upbeat sentiment, healthier banks and improving PMI's suggest the UK can recover in line with optimistic expectations. Uncertainties relating to this particular point were dominating sentiment amongst market participants which exacerbated the reaction in GBP trade once market moving influences occurred.

UK CPI had a large impact, with a big surprise to the upside - GBP traded higher in all pairs. The 1.8% inflation number took many by surprise because it went against the expectation that UK inflation is falling thus increasing the likelihood of higher interest rates. Speculation is still rife regarding the potential inflationary impact of QE upon the UK. The fact that headline inflation is remaining stable rather than falling is stimulating doubts whether the BoE can cap inflation at around 2%. So far, QE has not had an inflationary impact so this issue has not gained traction in real terms but in psychological terms, when you have a stubbornly high inflation reading at almost the same time as more QE is announced (2 weeks ago) and even stronger stimulus measures are being openly left on the table – inflation fears were always likely to be raised; even if this is just an anxiety at the moment, further signs of upward inflation before the current QE

programme has ceased is likely to spark concerns over the Pound. The other factor that is leaning on GBP value is the prospect of several central banks beginning policy tightening (Norway, US, Australia) in the near future whereas UK policy is likely to stay where it is well into 2010.

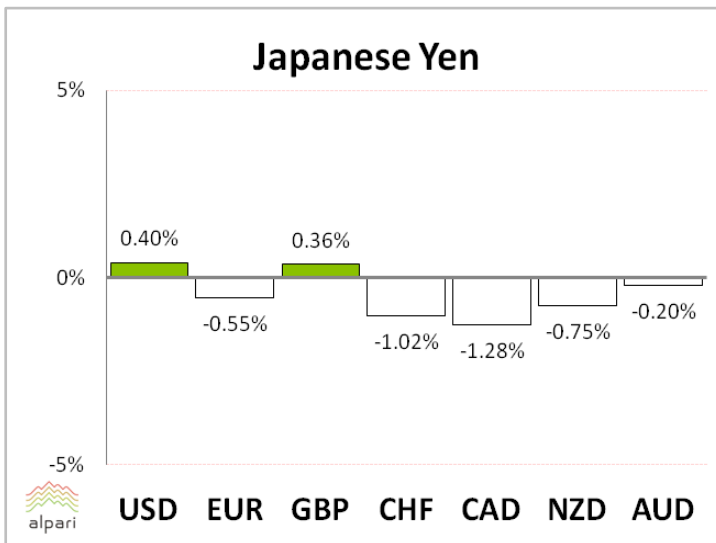


Despite the 'risk-off' tendencies, the benchmark UK index (FTSE 100) made new highs last week, trading at its highest level since October 2008 when uncertainty was incredibly high and the financial crisis was unravelling on almost a daily basis. Commodity prices also made strong rallies; crude oil touched a yearly high of \$74 per barrel.

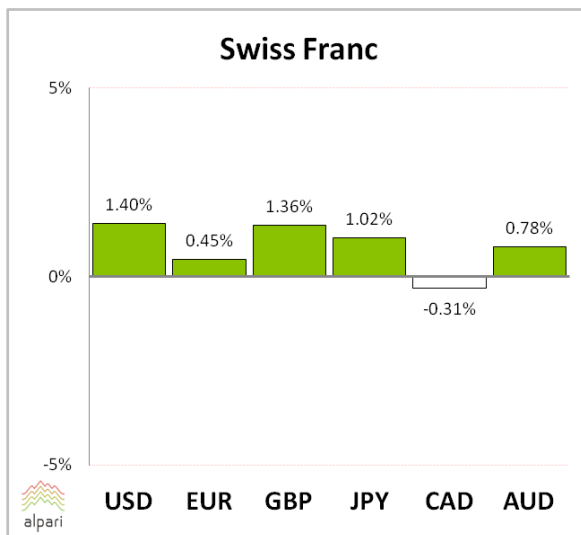
Last but not least, the BoE minutes from their August 6<sup>th</sup> meeting were released last week. In line with our opinion that the minutes could be explosive because of internal divisions

regarding QE expansion, we saw a 6-3 vote amongst BoE members to increase QE by £50bn. Lets recall that the £50bn increase announced 2 weeks ago was heavily Sterling negative because only a £25bn number was expected. The fact that 3 board members voted for a £75bn increase (even higher than the surprise), including Mervyn King, the Governor. In other words, the lead decision maker was outvoted by the rest of the committee which sent out a signal not only of potentially higher levels of QE in the future but also a sense of desperation regarding the internal workings of the BoE. Sterling was sharply weaker after the minutes were released, one comment which stood out for us was: "need for substantial further asset purchases" which clearly indicates a diverging policy approach between the BoE and other central banks. This could prove very GBP negative over the course of the next few months if policy decisions meet expectations being priced in at the moment.

On a negative note and a factor which has consistently plagued GBP bulls is UK public spending. UK retail sales were better than hoped (0.4% vs. 0.3%) which boosted Sterling but market participants concentrated on other data/themes which were stronger price drivers i.e. UK public finances. Higher than expected increase in public debt highlighted UK's fiscal problems and induced GBP shorts. Figures out last week showed a £8bn shortfall for the month of July alone, contrary to an expected £500m shortfall. The downward effect on GBP was made worse because July is traditionally a positive month because of incoming tax receipts which made the -£8bn number all the more shocking.

**JPY**

The major news from Japan last week was the return to growth for the Japanese economy in the month of July (0.9% vs. 1.1% exp.). Even though the improvement wasn't as good as expected, any improvement at all was good enough to push up confidence considering the amount of bad news that has been priced into JPY over the past year. Overall, the Yen was flat in almost every pair; the largest gain came against the Dollar (+0.4%) whereas the largest loss was against CAD (-1.28%).

**CHF**

The combination of low volumes, no macro data and a holiday atmosphere, the Swiss Franc also traded in subdued fashion. Over the course of the week, the Franc was the strongest major currency, only falling against CAD (-0.31%) by Friday's close. We don't see any great significance in the fact that CHF was the strongest major rather than the Euro or Sterling for example because of the thinned out trade. We would have expected GBP to outperform CHF in a week where stocks/commodities were sharply higher alongside a broadly risk supportive week regardless of where Chinese equities are.

**Others**

Potentially important news for the future of AUD was made available last week. Although not picked up by the major news agencies, the fact that the Australian government plans to remove a 10% tax levied on foreign investors of Australian Government Bonds (AGB's) may induce higher demand for the asset from foreign market participants. The added demand is also likely to boost demand for AUD. Overall, Australia is looking fundamentally strong - Gross debt is 15% of GDP - compared to EU (90%) and US (100%) the comparable difference should provide support for capital flows into Australia. Investors are likely to discount the risk-correlation (and risk-sensitivity) of the Australian Dollar if global macro indicators sour because the base fundamental position is relatively sound compared to other countries. The standard understanding of 'where is risk-free' may change if government expenditures continue deteriorating. The US Dollar is considered the most reliable currency and yet fiscal/monetary policy decisions are threatening its long-term value. Australia currently has the opposite assumptions attached to it: risk-positive and risk-sensitive, investors are worried that capital invested in Australia is under threat if risk conditions deteriorate.

## Preview: 24<sup>th</sup> – 30<sup>th</sup> August



### Looking ahead

- Quite economic calendar as holiday season puts a drag on volume
- Three GDP estimates from Germany, US and UK could force adjustment in recovery expectations
- Large amount of speakers from several central banks could clarify ongoing shifts in monetary policy expectations around the G20
- Markets lacking in direction could concentrate on one particular issue – over the past few weeks this has tended to be Chinese equities and the how they will impact the global recovery overall

With markets lacking direction and volume we are expecting volatile intra-day moves again this week. Macro data could focus on the fresh GDP numbers scheduled from Germany, UK and US. Either one surprising could cause a shift in risk sentiment further afield because of the ongoing race-to-recovery between the developed nations. Another focus could be housing numbers. This week we are expecting to see UK house price estimates as well as US new home sales which could add complexity to recovery expectations. House price correlations with FX rates have always been dubious and have fluctuated depending on other macro factors. However, in the current environment, UK house prices are very highly correlated to GBP so market participants are likely to react if the housing sector makes the headlines and dominates attention. Long-term investors are keenly watching for house price stabilisation as a firm confirmation of a broader recovery because many of problems linked to the financial crisis began with sub-prime loans. As the crisis unravelled, the consumer was hit hard by rising unemployment which put further pressure on mortgage providers/banks because people were struggling to repay atmospheric levels of debt linked to house prices. With the recovery story gaining momentum and support over the past few months, house prices have shown some semblance of stabilisation in that they have stopped falling. When it comes to house price recovery that has not begun to occur in the UK, US or Europe whereas it has begun to occur in other nations. If investors see this effect spreading to the countries hit hardest by the crisis (US, UK) it could have a major effect on currency rates because housing is intrinsically linked to how much consumers can afford to spend i.e. rising house prices tend to promote more spending and vice versa because many people choose to borrow against the value of their property. The flip side is that falling house prices tend to destroy the value of the single most valuable asset consumers own thus leading to higher savings rates, less discretionary spending and higher default rates.

Overall, we expect a continuation of the previous week's trend mainly because of limited volume during the holiday period combining with limited calendar. One key factor could be the large amount of central bank speakers scheduled. Throughout the week we are expecting to see comments relating to monetary policy across several regions including Canada, Switzerland and the US.

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**FX Sensitive Calendar Events**


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<u>Monday 24<sup>th</sup> August</u> (CAD) Retail Sales	<u>Tuesday 25<sup>th</sup> August</u> (EUR) German Final GDP (GBP) Nationwide HPI (CHF) Employment Level (GBP) Mortgage Approvals
<u>Wednesday 26<sup>th</sup> August</u> (EUR) German IFO Business Climate (USD) Durable Goods Orders (USD) New Home Sales (NZD) Trade Balance	<u>Thursday 27<sup>th</sup> August</u> (USD) Preliminary GDP (USD) Unemployment Claims
<u>Friday 28<sup>th</sup> August</u> (JPY) Manufacturing PMI (JPY) CPI (JPY) Unemployment Rate (GBP) Revised GDP (CHF) KOF Economic Barometer (USD) Core PCE Price Index	

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