

FX Weekly

Review: 17th – 23rd August

Recap

- Lacklustre week on the back of thin volume and limited macro data
- Range trading predominated again amidst the holiday mood; technical support/resistance levels restricted price action
- Equity markets reached new highs alongside crude oil which tested \$75 for the first time this year
- Chinese equities found support and arrested their recent slide. Fresh wave of selling came in on Monday 31st – SSE composite was down 7% on the day



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Currency pair	At Open on August 17 th	At Close on August 21 st	Nominal Change	% Change	Volatility
EUR/USD	1.4344	1.4301	-0.0043	-0.30%	1.39%
GBP/USD	1.6501	1.6265	-0.0236	-1.43%	2.37%
USD/JPY	94.36	93.57	-0.79	-0.84%	1.96%
USD/CHF	1.0564	1.0595	0.0031	0.29%	1.78%
EUR/GBP	0.8688	0.8789	0.0101	1.16%	2.08%
EUR/CHF	1.5147	1.5154	0.0007	0.05%	0.64%
GBP/CHF	1.7424	1.7236	-0.0188	-1.08%	2.15%
GBP/JPY	155.72	152.20	-3.52	-2.26%	3.69%
EUR/JPY	135.36	133.84	-1.52	-1.12%	2.33%
CHF/JPY	89.16	88.28	-0.88	-0.99%	2.60%
AUD/USD	0.8376	0.8397	0.0021	0.25%	2.77%
NZD/USD	0.6851	0.6835	-0.0016	-0.23%	1.81%
USD/CAD	1.0790	1.0911	0.0121	1.12%	2.80%

| Source: Alpari (UK)

See-sawing risk attitudes led to sharp intra-day fluctuations in G20 FX; meanwhile equity markets pushed higher on thinner trade. Most of the market moves this week should be taken in context because of light trading volumes across the board. Significant developments are only likely to be fully priced in once financial sector activity gathers momentum this coming week.

Over the course of the week, the holiday season mood lived up to its reputation of creating seemingly random price moves - up until Thursday, stocks rallied to fresh highs without positive data surprises whereas on Thursday when good US GDP and better UK house prices were announced - stocks sold off, although not substantially. Less liquid markets could be the reason why i.e. markets have been dragged around without solid consensus.

In commodities, crude oil prices consolidated their push beyond \$72 - the yearly high, suggesting better demand conditions are here to stay, at least for now as investors

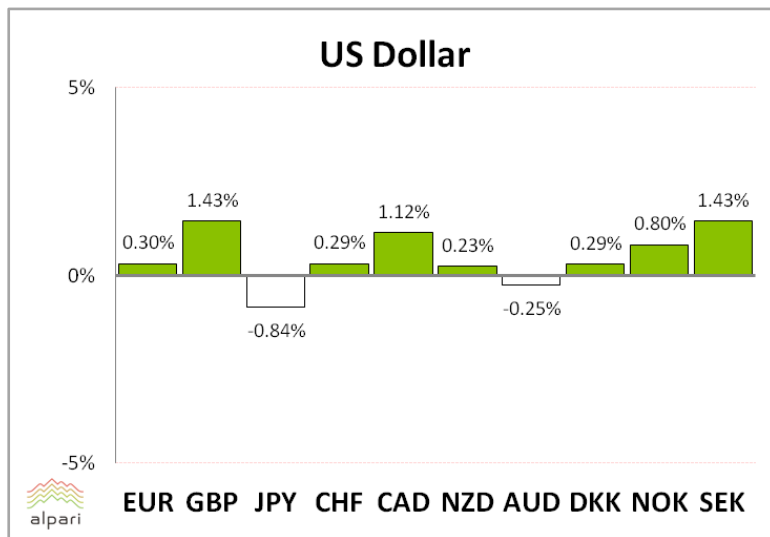
fight to maintain their good spirits. This coming week should see volumes return and thus a sense of normality could be restored to intra-day FX trade.



USD

A mixed data set combined with thin volumes led to erratic price action in USD pairs. Strong Canadian retail sales (1% vs. 0.2% exp) led to weakness in USD/CAD in addition to CAD strength in other pairs. Very strong US economic confidence on Tuesday pushed stocks higher and bonds lower. Despite the risk positive connotations, there was a limited impact on FX rates.

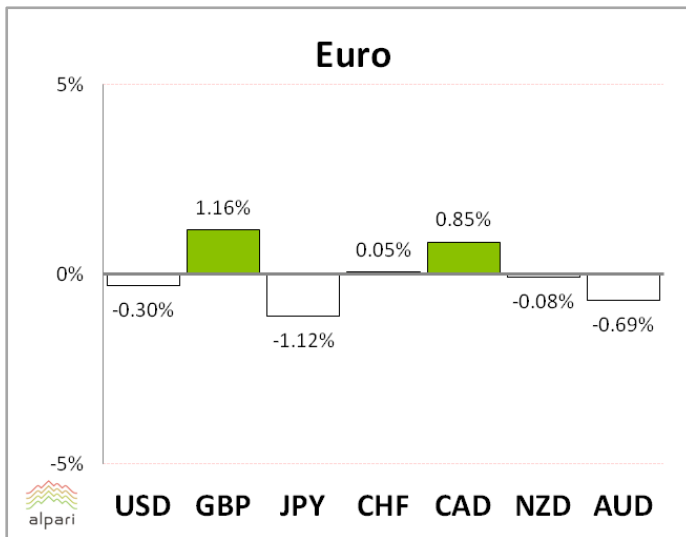
By market close on Friday, USD strengthened against all other currencies with the exception of JPY and AUD. USD seems to be trading more and more in line with local US factors rather than



global risk sentiment. At times however, sudden bouts of risk aversion/USD safe-haven interest occurred because USD is perceived the safest currency. Despite the fact that USD has begun to react more traditionally to macro data, spurts of Dollar buying despite negative US data will occur because not all market participants feel as safe as others. US Dollar price action has become more difficult to

gauge because more emphasis has been put on intangible drivers such as sentiment, psychology and perception of safety. Another factor creating difficulties is the fact that opinions over FX rates are diverging so with USD being the most liquid, most traded currency it's understandable that the current indecision and uncertainty will induce changes as to what theme predominates.

Potentially the most important macro event was the improvement in growth estimates in the US. Quarter on quarter GDP was better than expected (-1% vs. -1.4% exp.) which intensified expectations that the Fed will be on a tightening spree sooner rather than later. Policymakers in the US have been insistent that interest rates will only be allowed to rise if signs of recovery continue to become brighter. A quicker return to positive GDP growth is likely to induce a quicker change of stance by the Fed in terms of removing unconventional stimulus measures (QE) and tightening monetary policy (higher interest rates).

EUR

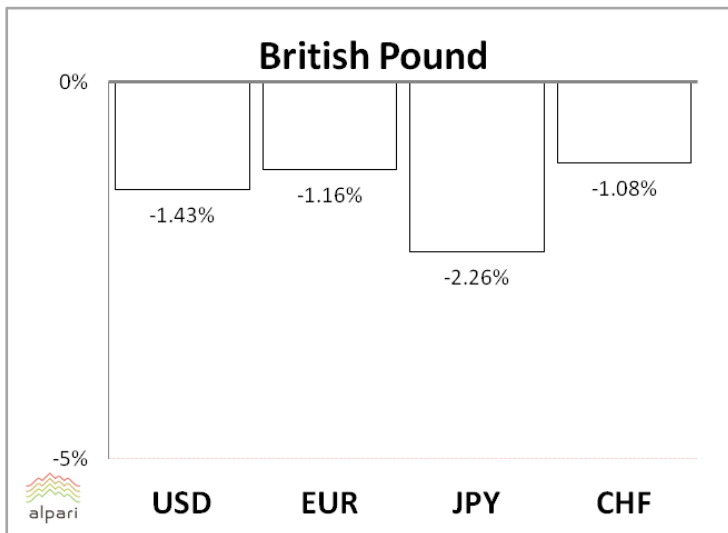
The Euro was caught up in ranges as light volumes and a light calendar left little room for manoeuvre. Generally speaking, speculators were the primary market participants last week - waiting for surprises that didn't arrive. The only significant macro event was the marginally better than expected German IFO number (90.5 vs. 89.1 exp.). The figure helped to maintain medium-long term EUR up trends in several pairs. July's improvement in sentiment was the fifth consecutive increase in line with



improving economic conditions and risk tolerance – these two factors have been a great support for the Euro over the past 6 months.

GBP

Contrary to performances in other majors, GBP traded down in most pairs. In fact, quite clear downtrends can be seen in Sterling's performance against CHF, JPY and USD over the course of last week. Sterling weakness was unexpected seeing as all the macro data from the UK was

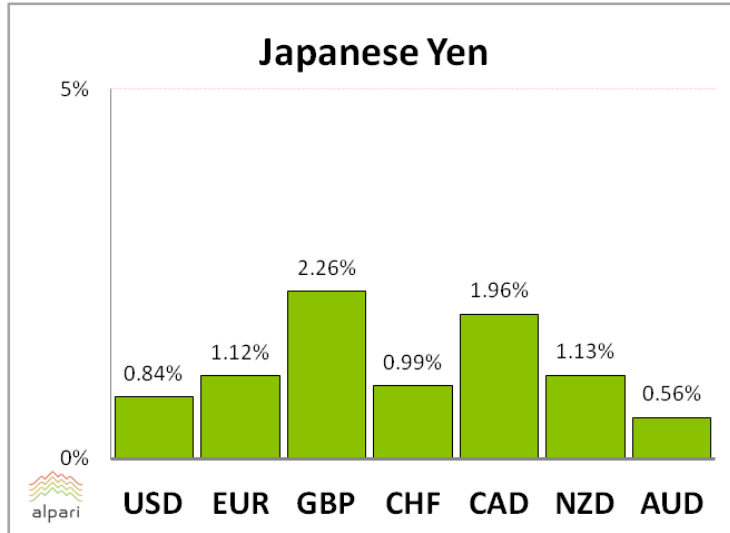


positive (house price index, GDP). Slight revision of UK GDP from -0.8% to -0.7%, helped GBP recover some of the losses made earlier in the week. Despite the Sterling weakness (or maybe even because of it), UK equities rallied to new 2009 highs. Tuesday was the 6th straight up day for the FTSE despite the worries of overextension permeating the mindsets of even the staunchest bulls. Another factor worrying recovery bulls is severe equity

market weakness in China. At the beginning of last week, the SSE composite index was down almost 20% from early August highs so market participants were wary of a failure in the recovery story seeing as so much of it has been attributed to Chinese economic resilience. And today, the same index fell a further 7% in a day which is likely to get people's attention going into Tuesday's European open.

JPY

The Yen had a strong week overall but not because for risk-aversion reasons. The broad equity and commodity strength last week may have led some to assume the Yen would weaken but in reality, positive news from Japan combined with mounting speculation that the DPJ party would win the Japanese election. The net effect was positive because the DPJ party is considered pro-



business and has plans to reform the Japanese economy for the better. As with most elections, as long as the election result is known quickly and no other unexpected delays occur, markets tend to either ignore elections or give domestic assets a boost if particularly positive reforms are planned. The sentiment factor is also important; many Japanese investors are seeing the election result as the start of a new era for Japan, leaving old habits behind in

favour of a new approach which is likely to be more growth supportive. At market open on Monday, the election result was clearly JPY positive.

A factor that may play a significant role in any future JPY price moves is Yen repatriation. We could be seeing strong demand for Yen in late Aug/early Sep because Japanese firms are likely to repatriate billions back to Japan from abroad. Many Japanese businesses prefer to keep funds abroad to avoid paying more in tax. This is largely related to the current tax exemption on dividends being offered by Japanese authorities. A concentrated influx in September, which marks the end of the fiscal second quarter for many Japanese firms, could push JPY higher against other currencies.

On the negative side, Japanese inflation (-2.2% vs. -2.1% exp.) and unemployment figures (5.7% vs. 5.5% exp.) suggested sharper declines in prices and a sharper rise in unemployment compared to previous estimates. The effect on the JPY was negative but not substantial as all losses were recovered later in the day.

Preview: 31st August – 6th September



Looking ahead

- Three interest rate decisions (Sweden, Australia and Euro zone) – focus likely to be on scale and timing of future tightening
- Japanese election result could have a persisting effect, at least in the short-term while the goodwill factor remains
- Volumes should begin to return to normal as we go into September; economic calendar is very eventful this week
- Employment situation in the US is likely to grab headlines; volatility is expected to be very high considering the wide range of assumptions over how the Dollar will react

This coming week could be explosive as a large amount of data is due for release (See next page). In addition, the end of the holiday season should bring volumes back to the table. Most FX rates have been adhering to ranges over the past few months which has only increased speculation as to which direction the next twist will take us. The recovery story seems intact for now as several indicators show improvements. Although on the flip side we are seeing continued weakness in the labour and retail sectors. The countries that are seriously considering appropriate policy responses in the near future (Australia, Norway, New Zealand, US) seem odds on to claim an interest rate bias and thus attract capital flows over time at the expense of those that are maintaining dovish policy (UK, Japan, Euro zone). Investors are taking on the exit strategy theme more and more because central bankers have been commenting on the subject extensively. As a result, this week's interest rate decisions (Riksbank, ECB and Euro zone) as well Fed minutes will be watched with much anticipation. The minutes from the August FOMC meeting should clarify the decision to slow asset purchases by the Fed and the consequent removal of stimulus measures in October. We expect the phrase "low rates for an extended period" to be included in the Fed's press conference after the interest decision; otherwise, rate expectations will rise significantly and thus give strong support to the US Dollar.

In the case of the ECB, there is almost a zero chance of an interest rate change so all attention will be on the press conference. The ECB could transmit a very upbeat tone in light of better GDP and PMI estimates released recently and thus encourage market participants to price in a rate hike sooner rather than later.

One factor worth watching closely this week is performance of Chinese equities. A significant part of the recovery story was attributed to Chinese resilience and quick recovery. However, over the past few weeks the benchmark Chinese index (SSE Composite) has fallen almost 25% while US, European and other Asian markets have trawled higher. How investors react to the idea that everything may not be so rosy in the Chinese economy may be important, especially if other leading countries falter alongside.

The Japanese election result proved positive for Japanese equities and the Yen because of its historic significance and hopes of expansionary policies that may be put forward as a result. The election may have a lasting effect if it is considered as pivotal for the Japanese economy in terms of facilitating better economic policies for years to come.

The US employment report is always a highlight for traders and this week is no different. Most estimates are looking for another improvement in the amount of jobs lost since last month. Unemployment is still rising in the US but at a slower rate; unemployment is expected to peak at 10m in 2010. An upside surprise would probably have less of an effect than a downside surprise because almost everyone is assuming that conditions are improving month on month. Considering that most market participants are very jumpy these days, it's reasonable to assume that knee-jerk reactions will occur regardless of the number. One other aspect will be how the US Dollar reacts – at the previous non-farm payrolls release the Dollar unexpectedly re-synced with US data i.e. a stronger headline number led to a stronger Dollar. This was a surprise because the past 18 months have seen risk preferences dominate FX trade. Since then the Dollar has more or less maintained this positive correlation but there have been instances of a disconnection when people's propensity for safe-havens has risen beyond a critical mass. This aspect has made trading USD pairs incredibly tricky on an intra-day basis.

Preliminary G20 meetings in London at the end of this week (in preparation for the main event in Pittsburgh on September 24th) could lead to comments on FX by the G20 delegates. Media sources as well as policymakers have confirmed that currencies will be discussed including what potential (if any) a new reserve currency has. Talk of a new reserve currency have faded since July but the potential for them to resurface tends to rise when the US Dollar underperforms.

FX Sensitive Calendar Events

<u>Monday 31st August</u> (JPY) Preliminary Industrial Production (JPY) Retail Sales (GBP) Bank Holiday (CAD) GDP	<u>Tuesday 1st September</u> (AUD) Interest Rate Decision + Statement (CHF) GDP (EUR) German Retail Sales (EUR) Final Manufacturing PMI (GBP) Halifax HPI (GBP) Manufacturing PMI (GBP) Net Lending to Individuals (GBP) Mortgage Approvals (EUR) Unemployment Rate (USD) ISM Manufacturing PMI (USD) Pending Home Sales
<u>Wednesday 2nd September</u> (AUD) GDP (EUR) Revised GDP (USD) ADP Employment Report (USD) Fed Monetary Policy Meeting Minutes	<u>Thursday 3rd September</u> (AUD) Trade Balance (EUR) Final Services PMI (GBP) Services PMI (EUR) Retail Sales (EUR) Interest Rate Decision + Statement (SEK) Interest Rate Decision + Statement (USD) ISM Non-Manufacturing PMI
<u>Friday 4th September</u> (CHF) CPI (CAD) Unemployment Rate (USD) Non-farm Employment Report (USD) Unemployment Rate G20 Meetings	<u>Saturday 5th September</u> G20 Meetings

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