

FX Weekly

Review: 31st August – 6th September 2009

Recap

- Trading volumes began to track higher after a slow holiday period
- Volatility measures spiked higher alongside heightened risk-aversion
- Equities and commodities were broadly lower in line with renewed doubts regarding economic recovery
- Risk sentiment lower although commodity and cyclical currencies performed well; AUD, NZD, CAD, GBP finished strongly despite unfavourable conditions early on



Market Research

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Currency pair	At Open on August 31 st	At Close on Sep 4 th	Nominal Change	% Change	Volatility
EUR/USD	1.4305	1.4293	-0.0012	-0.08%	1.40%
GBP/USD	1.6261	1.6389	0.0128	0.79%	1.85%
USD/JPY	93.48	92.99	-0.49	-0.52%	1.73%
USD/CHF	1.0599	1.0605	0.0006	0.06%	1.54%
EUR/GBP	0.8791	0.8719	-0.0072	-0.82%	1.48%
EUR/CHF	1.5165	1.5161	-0.0004	-0.03%	0.43%
GBP/CHF	1.7241	1.7382	0.0141	0.82%	1.64%
GBP/JPY	152.05	152.41	0.36	0.24%	2.45%
EUR/JPY	133.74	131.01	-2.73	-2.04%	2.33%
CHF/JPY	88.14	87.64	-0.50	-0.57%	2.28%
AUD/USD	0.8420	0.8503	0.0083	0.99%	3.50%
NZD/USD	0.6839	0.6866	0.0027	0.39%	3.09%
USD/CAD	1.0911	1.0883	-0.0028	-0.26%	2.56%

| Source: Alpari (UK)

Trading volumes rose this week as the holiday season wound down. As a result, a serious case of the holiday blues was evident as equities, commodities and cyclical currencies suffered sharp retracements from recent highs. Equity markets across the G20 have made rapid gains in the second half of this year, reaching 12 month highs at the end of August on the back of an appetising recovery story that refuses to lose momentum. Rumours of a new round of bank failures combined with a sense of overextension across multiple asset classes ensured investors stayed subdued and tentative despite upbeat macro indicators in the US and EU. A key employment report from the US was very ambiguous and failed to answer some of the questions aimed at the validity of the recovery in the US.

Looking forward to next week, trading volumes should continue recovering with the help of a bumper week for data. Three interest rate decisions should dominate focus because rates of recovery and thus monetary policy responses are beginning to diverge following two years of extreme easing worldwide. Diminishing levels of support provide a psychological boost; on the other hand, the past six months have

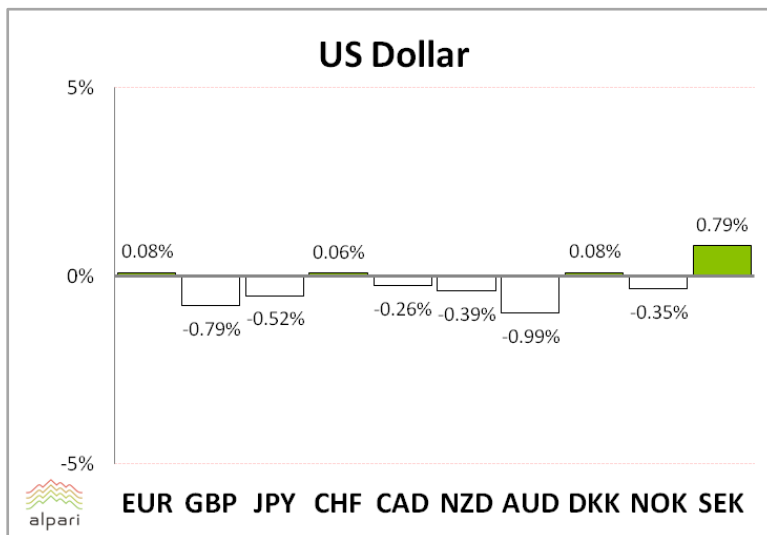
been largely risk positive but with stimulus measures on the verge of being withdrawn, the fear of economic lethargy in the absence of government-backed initiatives is gaining some support.



USD

The US Dollar was one of the most volatile currencies last week under the strain of a surge in trading volume, mixed macroeconomic data and mixed commentary from Fed members. Fed minutes released on Wednesday were not highly market moving so all attention (and headlines) focused on the employment report.

An inconclusive non-farms employment report raised some positives and some negatives. Positive in that job losses are still increasing but at decreasing rates, a sign that the effects of the financial crisis are ebbing away. On the negative, the economic recovery, which many people are relying on, seems to be flatter and less enthusiastic than first hoped. The fact that job losses are continuing to rise underscores the possibility of unemployment increasing for many more months still thus undermining a consumer-led recovery.



Very strong development of the recovery in manufacturing in the US (52.9 vs. 50.6 exp.) - the prices paid component was higher than expected which can sometimes have a negative effect on the currency if fears of inflation circulate. This was not the case in this instance because investors see the US handling of monetary policy as adequate and robust enough to avoid excessive inflation.

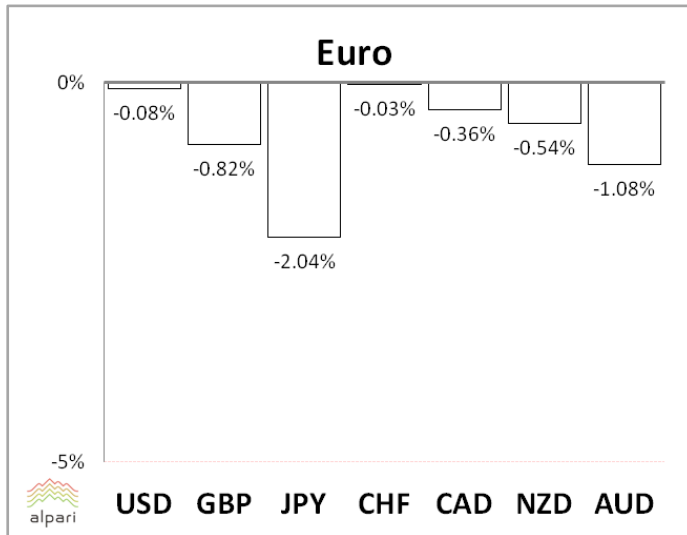
US pending home sales were higher (3.2% vs. 1.7% exp.); housing has been a hot topic in the recovery story so an improvement was taken well, adding support for the Dollar. US equities traded lower however.

Risk aversion, anxiety came back into financial markets on Tue/Wed as rumours of a new bank failure and perceptions of overextension influenced market behaviour. The heady levels in G20 equity markets gave investors a signal to take profits which added to the risk-off mood.

EUR

Despite the added volumes, the Euro remained range bound against most pairs but ended the week lower in most pairs. The interest rate decision to keep rates on hold was followed by a very appeasing statement designed to calm the Euro bears as much as the Euro bulls. Expectations of an early exit strategy from the ECB's 'QE-lite' programme were assuaged at the same time as positive elements of the recovery were underlined. The overall effect on the Euro was negative as speculative longs ran for cover.

Elsewhere, stronger German retail sales lifted spirits early in the week, only to be reversed as



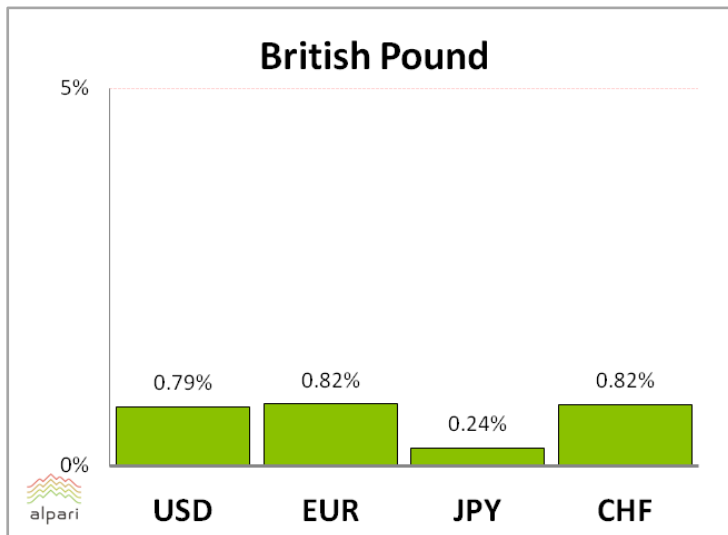
retail sales for the Euro zone showed a month-on-month decline. On numerous occasions certain indicators have shown positive signs only to disappoint the next month. Our take on last week's (and the past few months in general) developments is that the data element of the recovery is likely to remain volatile even if economic conditions are improving in real terms. The volatility within macro-data should increase intra-day price volatility thus making longer term



trading strategies harder to implement.

GBP

Some unexpectedly weak economic figures failed to dent appetite for Sterling last week. Sterling suffered after consumer credit and net lending fell unexpectedly, amidst claims from the media and political circles that the recovery was well under way. The keenly awaited manufacturing data was also disappointing (49.7 vs. 51.5 exp.) – even though the reading was only just lower than 50, the psychological impact of seeing contraction rather than expansion, amidst expectations of an ongoing recovery, did not bode well for Sterling early on in the week.



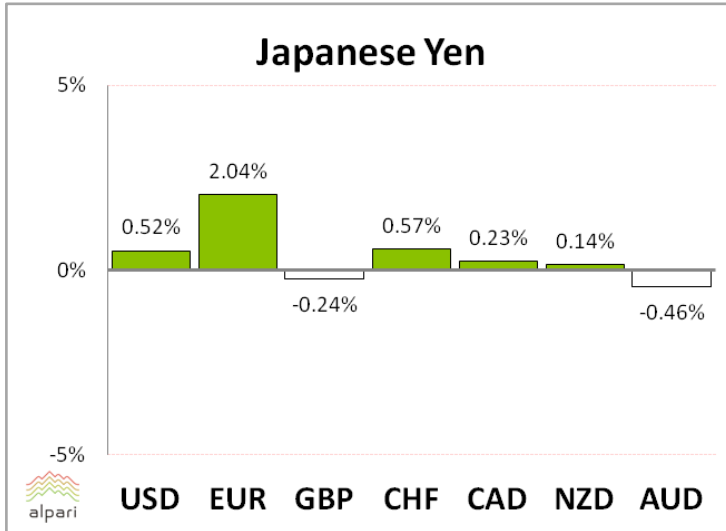
Market analysts were surprised to see these types of numbers considering the QE being done by the BoE and upbeat performance in house prices, business confidence, GDP forecasts and sentiment. Lower levels of lending are good in many ways because it shows people/businesses are deleveraging and becoming more prudent which is good for the long-term. In the short term however, lower levels of consumption/lending could lead

to a stagnant economy, drowning in liquidity with no one having the desire to utilise it. The former scenario was clearly more tantalising than the latter, at least in the minds of speculators who were more than willing to buy the rumour.

JPY

The Yen was range-bound against most pairs, ending the week more or less at the same levels as it started. The largest gain/loss was in EUR/JPY (-2.04%) which failed to claw back losses made early on following a sharp change of preference towards safe-haven currencies.

The Yen was also helped by a fresh round of optimistic data which boosted its value even more when risk-tolerance was low, and kept it well supported when risk-tolerance was high – Retail



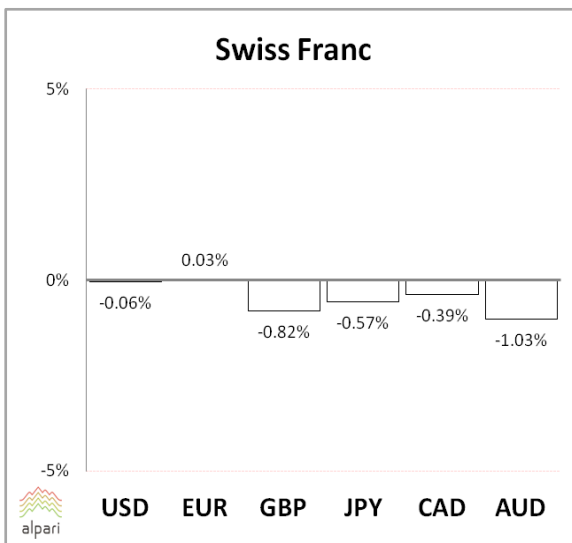
Sales (-2.5% vs. -3.3% exp.) and Industrial Production (1.9% vs. 1.4% exp.) numbers were the pick of the macro data but despite this positive driver, the Yen ended the week lower against GBP (-0.24%) and AUD (-0.46%).

The economic situation in Japan remains fragile as economic growth is restricted by anaemic consumer demand and lethargic investment from businesses. A

prevalent savings culture is not helping either. FX market participants continue to regard the Yen as a safe-haven despite Japan's troubles which has helped the Yen to recover ground as risk-appetite occasionally ebbs away. As with other currencies, the schedule and scale of the central banks' exit strategy will be important for future Yen value; due to persistent inflation, the market is expecting a rate hike only in 2010 at the earliest.

CHF

The Swiss Franc was in strong demand following a -0.3% GDP figure – a very good number considering most expectations were for a -1% fall. The prospect for Switzerland returning to actual growth in Q3 has gotten closer thus confirming and boosting recovery expectations.



Despite the cheer, the levels seen in CHF pairs were as good as it got – CHF pairs reversed their positive bias mid-week and were sold. The increase in risk-tolerance combined with a lack of Swiss specific data ensured Swissie pairs traded off other themes. A weaker CPI number late in the week was not taken well (0.1% vs. 0.3%), adding further pressure as investors were reminded that a deflationary reading is almost certain at the next reading in October. The SNB has been vociferous in their support for a weaker CHF which has created a bias in that speculators are now more inclined to sell CHF if weaker numbers are seen. Also, the 1.50

level in EUR/CHF has been taken on board, not only by the SNB but by traders as well. The result is heavy buying of EUR/CHF around 1.50-1.52 in the belief that intervention will occur.

Others

Australia kept interest rates on hold at 3% as expected. By staying neutral in their press statement, the RBoA disappointed market participants because a hawkish statement, signalling a shift of stance with a bias for tightening, was expected. As risk sentiment recovered from early week holiday trade, cyclical currencies regained their ground with the Aussie being a prime example. Another factor in play was strong manufacturing figures from China which boosted confidence after a rough week for Chinese equity investors. The news boosted AUD due to close trade links. AUD finished the week higher across the board. The Australian Dollar is maintaining its uptrend against USD, JPY, GBP, EUR back from February 2009 – the less risk attached to a currency, the stronger the uptrend has been.



Preview: 7th – 13th September 2009



Looking ahead

- Three interest rate decisions likely to dominate focus – UK, Canada & New Zealand
- QE exit and monetary tightening strategies are fast becoming the trigger themes
- The validity of the recovery debate is being replaced by a 'race to the top' debate. Who will recover first and strongest?
- North American public holiday on Monday should see lighter volumes at the start of the week

This coming week, trading volumes should continue recovering with the help of a bumper week for data. Three interest rate decisions should dominate focus because rates of recovery and thus monetary policy responses are beginning to diverge following two years of extreme easing worldwide. Diminishing levels of support provide a psychological boost; on the other hand, the past six months have been largely risk positive but with stimulus measures on the verge of being withdrawn, the fear of economic lethargy in the absence of government-backed initiatives is gaining some support.

First it was a question of whether the recovery was valid in the first place. Was it really green shoots or grey weeds? Now that signs of recovery have been priced into expectations, some positive surprises are even being taken for granted. The question has quickly changed from if, to what type and then to how fast in terms of the recovery. The next theme seems to be if and how quickly stimulus measures will be removed considering how much impact has been attributed to them. The consensus is that stimulus measures have been a great help to all economies utilising such measures – as the crisis has faded away and with the recovery bobbling along the seafloor, investors are beginning to ask whether current economic realities can handle a withdrawal of support. How this issue plays out is likely to decide how risk tolerance will be affected and thus have an effect on currency values.

The three interest rate decisions scheduled for this week will be anticipated because Australia and New Zealand are supposedly the front-runners to recover and thus raise interest rates. Even last week, hawkish rate expectations precipitated a large fall in AUD as RBoA officials resisted calls to switch to a tightening bias. This week has the same scenario; speculators are likely to favour hawkish comments so whether the RBoA responds will be important. Also, it is worthwhile to consider the timing of these interest rate decisions. Last week's G20 dress-rehearsal will be followed up by the real thing at the end of September so any radical shifts in policy stance may not be advisable at this stage if a broader, globally coordinated policy is agreed at the G20. AUD and NZD have been appreciating very strongly over the past 9 months so more upward momentum is undesirable from an export-led growth perspective. Australia and New Zealand are highly dependent on export revenue so a sharply stronger currency is not so beneficial.

In the case of the Bank of England, we have been surprised by their actions time and time again this year so another surprise is not so unlikely. After unexpectedly raising the level of QE, the BoE has brazenly diverged from many other central banks. Whereas most others are thinking about pausing or reducing QE and stimulus measures, BoE officials are increasing them. The effect has not been as negative as it could have been because of the risk-positive mood but if this changes

with investors looking to diversify away from perceivably risky currencies, GBP could suffer dramatically. The 1.60-1.70 zone in GBP/USD has rarely been under threat over the past 6 months but some kind of finalisation as to how much QE the BoE will do could change that. On the other hand, if QE scenarios are left open suggesting even more asset purchases, Sterling would be under severe pressure. Going into the decision expectations are for no change and continuation of planned asset purchases.

FX Sensitive Calendar Events

<u>Monday 7th September</u> (EUR) German Factory Orders <i>US and Canada Bank Holiday</i>	<u>Tuesday 8th September</u> (CHF) Unemployment Rate (EUR) German Trade Balance (GBP) Halifax HPI (GBP) Manufacturing Production
<u>Wednesday 9th September</u> (AUD) Retail Sales (EUR) German Final CPI (GBP) Trade Balance (USD) Beige Book (NZD) Interest Rate Decision + Statement	<u>Thursday 10th September</u> (AUD) Unemployment Rate (GBP) Interest Rate Decision + Statement (CAD) Trade Balance (USD) Trade Balance (CAD) Interest Rate Decision + Statement
<u>Friday 11th September</u> (JPY) Final GDP (China) CPI, Retail Sales & Industrial Production (USD) University of Michigan Consumer Sentiment (USD) Federal Budget Balance	

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