21st September 2009

FX Weekly

Review: 14th – 20th September 2009

Recap

- The emergence of a new policy move frightened Sterling bulls and pushed GBP significantly lower
- Commodities, equities and risk-FX were all well supported; several equity indices worldwide made fresh highs
- US Dollar and Japanese Yen bore the brunt of the risk-on mood; Dollar Index hit a 12 month low of 76.00
- Pronounced strength seen in the Euro as macro data showed upside surprises

Market Research

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Currency pair	At Open on Sep 14th	At Close on Sep 18th	Nominal Change	% Change	Volatility
EUR/USD	1.4592	1.4710	0.0118	**0.81%**	1.73%
GBP/USD	1.6683	1.6268	-0.0415	**-2.49%**	2.73%
USD/JPY	90.40	91.28	0.88	**0.97%**	1.68%
USD/CHF	1.0362	1.0294	-0.0068	**-0.66%**	1.43%
EUR/GBP	0.8745	0.9039	0.0294	**3.36%**	**3.62%**
EUR/CHF	1.5124	1.5144	0.0020	**0.13%**	0.80%
GBP/CHF	1.7286	1.6748	-0.0538	**-3.11%**	**3.38%**
GBP/JPY	150.83	148.50	-2.33	**-1.54%**	2.33%
EUR/JPY	131.95	134.29	2.34	**1.77%**	2.64%
CHF/JPY	87.22	88.64	1.42	**1.63%**	2.29%
AUD/USD	0.8622	0.8672	0.0050	**0.58%**	2.69%
NZD/USD	0.7053	0.7091	0.0038	**0.54%**	2.75%
USD/CAD	1.0768	1.0688	-0.0080	**-0.74%**	**3.11%**

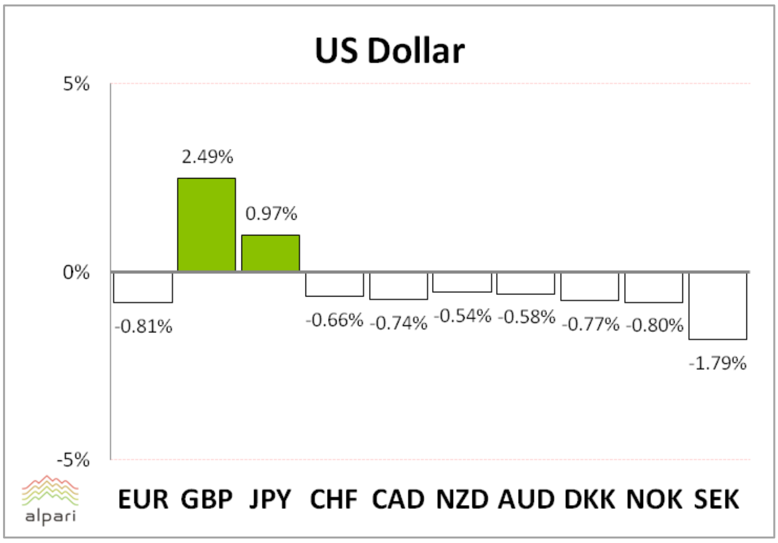
| Source: Alpari (UK)

It was a positively 'risk-on' week for most asset classes last week. Equities pushed higher as dips were bought into very aggressively. The FTSE Index eased past 5,100 and held onto its gains without trouble in similar fashion to equities across Europe and the US. Broad confidence in the ongoing recovery remained strong – at the expense of the US Dollar which printed new lows for yet another week. A weakening Dollar was a catalyst for strength in commodities including Gold prices which hit highs not seen since early 2008. One of the major highlights was a hint from the Bank of England that central bank reserves would be squeezed in order to induce lending.

Next week, the focus will probably be the G20 meeting in Pittsburgh, European PMI's and the Fed's decision on interest rates. Once again, more so the statement rather than the decision itself is likely to be most market moving. MPC (BoE) minutes due next Wednesday will be important as investors try to clear up the recent confusion and inconsistency regarding future policy, both in terms of QE but more interestingly, how prominent the idea of adjusting remuneration rates on bank reserves is amongst Committee members.

USD

The US Dollar was lower in most pairs as risk-tolerant trade dominated. Sidelined Dollar reserves coming from investors as well as reserve diversification from central banks ensured the Dollar was under pressure throughout the week. The risk-rally gained pace on Wednesday following up-lifting comments from several central bankers and prominent business leaders, saying that economic conditions are improving and growth is finally occurring. It seems that any bullish remarks are being picked up by speculators very easily at the moment whereas contrarian views are having less impact. Downside surprises in macro data continue have the biggest potential to reverse sharp moves higher in equities, commodities and risk-FX. Despite this anti-Dollar environment, USD gained strongly against GBP (+2.49%) due to UK specific factors - more specifically, news of a possible change to remuneration rates at the Bank of England. GBP sold off over 200 points over the course of the day after the news of possible BoE reserve remuneration broke.

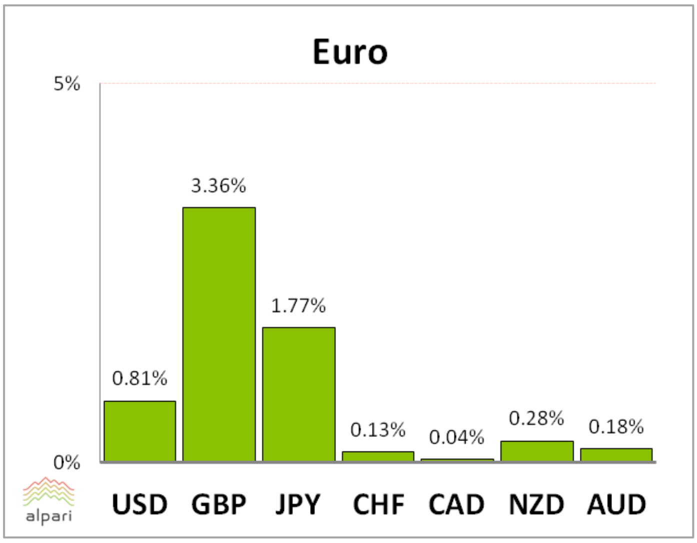


Falls in the Dollar could have been worse if not for several positive indicators which helped to turn the tide. US retail sales figures (+2.7% vs. 1.9% exp.) and PPI (+1.7% vs. 0.9% exp.) were helpful in alleviating deflation fears in addition to lifting optimism regarding a consumer led recovery in the US. In recent months, market participants have been focused on consumers and their actions in the current economic climate. Persistent increases in job losses added to subdued spending habits have worried investors because the US economy is so reliant on consumer-led economic growth. In its absence, it is difficult to imaging a strong, vibrant recovery – last week's positive surprise provided a semblance of calm and confirmation of a broad recovery.

Interestingly, the Dollar reverted to trading with an inverse relationship to US data last week. Although this occurred only occasionally e.g. USD fell despite good housing, permits and unemployment data on Thursday, we are of the opinion that this occurrence was not representative of the overall relationship – with various reasons as a possible explanation. We still see Dollar reconnection with US data as inevitable in the medium-long term as the sidelined Dollars issue fades away post-crisis. Over the past few weeks, the Dollar has been reacting 'traditionally' more frequently so last week's occasional disconnect is unlikely to be representative of a broader shift.

From a political angle, particular comments stood out as potentially important for FX rates over the next few months. A key adviser to President Obama (Summers) said that he is "confident of the farthest reaching financial reforms to be implemented since the Great Depression in the near future". Disclosure of such reforms could be significant for all asset classes, including FX. Most at risk from such reforms would be the banking sector because of its close proximity to the financial crisis. Also likely to be affected are exchanges and financial derivative participants. It is of course of little use to speculate without knowing exactly what the reforms will entail – the G20 meetings this week may be useful in this regard. Comments on FX rates could also make an impact although these have largely stayed off the menu at previous G20 meetings, possibly for fear of creating instability seeing as markets are so nervous and jittery already.

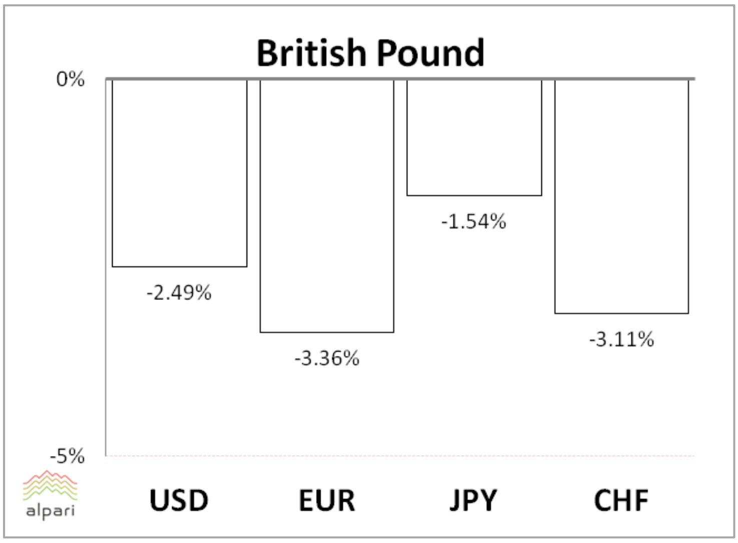
EUR



European indicators on the whole had a positive effect on the Euro as CPI (-0.2% vs. -0.2% exp.), ZEW (59.6 vs. 57.8 exp.) and Trade Balance (€6.8bn vs. €1.2bn exp.) figures all helped to boost confidence. The risk friendly environment prevented extended gains against cyclical currencies (CAD, NZD, AUD) but did add momentum to gains against the US Dollar, Sterling and Yen. Strongest gains came against GBP (+3.56%) due to comments from Governor King at the Treasury Select Committee on Tuesday. The bearish sentiment towards GBP ensured it was the weakest currency last week - EUR/GBP broke confidently out of the 0.8837 - 0.8700 range, touching 0.9000 before market close on Friday.

GBP

The headline news for Sterling was the possibility of the Bank of England reducing remuneration rates on funds held at the central bank by financial institutions; effectively this is another 'unconventional' monetary policy move designed to stimulate lending and in turn spending by consumers. The idea is that if banks will receive less for keeping funds at the Bank of England, they will be persuaded to allocate those funds to lending to businesses and consumers. The effect on equities was extremely positive because this news increases the chances of a consumer-led demand recovery. In FX only Sterling pairs were affected i.e. a very sharp downward move in GBP in all pairs because the rate of compensation banks receive for keeping excess funds at the BoE is likely to fall. This was considered an easing measure and thus negative for GBP.

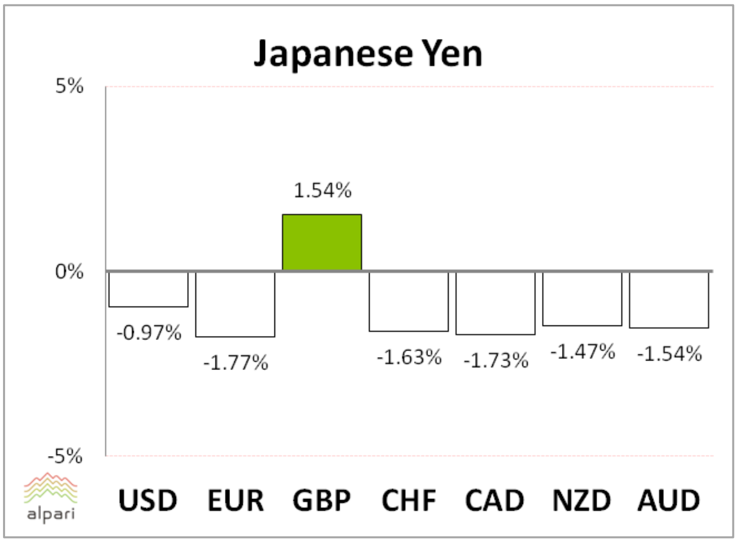


In our view, the level of downside in Sterling pairs was unexpectedly high considering that it was barely even a comment that initiated the surprise. Governor King simply refused to expunge the possibility of such a measure which was enough to force GBP bulls into a 180. There is now a clear opportunity for Sterling losses to be reversed if a clear denial is presented to investors. If these measures are confirmed then more GBP downside is likely. From an ideological perspective, the BoE is clearly struggling to come up with new ideas as to how economic activity can be stimulated seeing as QE has not had a clear tangible effect on the UK economy. This could of course change but so far, even the policymakers are not convinced. By penalising banks for not lending the BoE is trying to solve UK's financial problems via the supply of capital whereas in actual fact, it is the demand for capital that is the problem. Despite the bounce in activity, sentiment and equity prices since March of this year, people still feel beleaguered and threatened by what could potentially be around the corner. The result is higher savings rates and a lower inclination to borrow, especially if borrowing rates remain elevated by cash-hungry banks. Later this week, we may see some developments with this issue as BoE minutes from their September 6th meeting are released. Any mention of remuneration rates could give speculators more reason to believe in their imminent decrease and thus lead to further GBP selling. On the other hand an absence (or better yet) a dismissal of such plans would be severely GBP positive.

Aside from central bank commentary, other data releases were mixed. Higher than expected inflation (1.6% vs. 1.4% exp.) wasn't considered alarming as some QE sceptics had predicted while retail sales (0.0% vs. 0.2% exp.) were disappointing because of the anticipated improvement in consumer spending in line with improvements in other indicators such as house prices, rate of job losses, sentiment and manufacturing.

JPY

Very few data releases and a straightforward interest rate decision (held as expected at 0.10%) made sure that no new price drivers influenced Yen pairs. With the first 3 days of this week being a Japanese bank holiday, Yen pairs are once again likely to be subdued, both in the European and Asian trading sessions.



Last week's broad Yen weakness was primarily because of the risk-on environment and carry trade positioning seeing as Japanese monetary policy is unlikely to switch bias anytime soon. The carry trade (borrowing cheaply in a low funding currency and investing in a high yielding currency) is slowly coming back to the fore alongside decreasing volatility in FX rates.

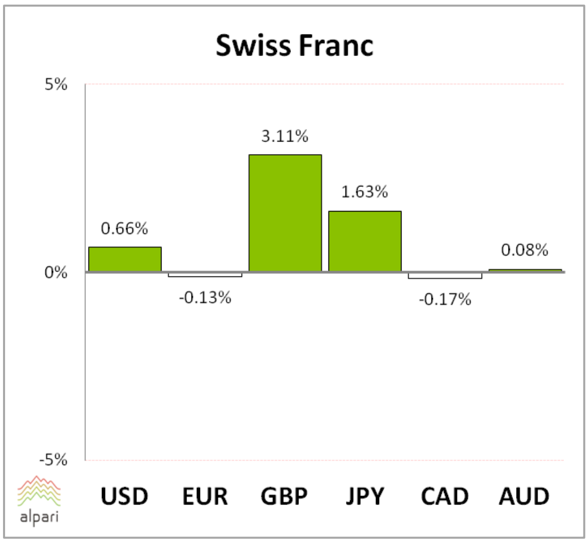
Japan's Finance Minister Fujii said that he is averse to intervening in the Yen if market trends were gradual. Investors picked up the story as a signal of lower government intervention in the Yen going forward due to a new stance from the new government. The comments and subsequent news story supported the Yen from Wednesday onwards but were not strong enough to reverse losses. Further hints at a break in policy would be JPY beneficial but the problem of believability is likely to remain unless market participants see continued Yen weakness back towards 1994 lows of around 80.00 in USD/JPY for example.

The outlook for the Yen continues to look bearish from a risk-preferences perspective and with policy frameworks around the G20 looking as if they will diverge within the context of the recovery, investors are beginning to see the carry trade as a viable trading strategy after its sabbatical during the crisis. Out of all the developed countries, Japan's interest rates are expected to rise more slowly than the rest which implies a widening yield differential over time. If this scenario plays out, the Yen is likely to be a funding currency for carry trades and thus have a tendency to weaken against the higher yielders.

CHF

Weaker industrial production figures released early in the week pushed CHF lower in most pairs but this effect was not sustained through to market close.

The SNB decided to keep interest rates unchanged (as was widely expected) and expressed an intention to continue buying bonds, if required, as well as countering an appreciation of CHF. The soft, dovish monetary policy being employed by the SNB does not seem to be on any verge of change, so policy rates are likely to stay suppressed at least until Q1 2010. The reaction in CHF pairs was very positive - EUR/CHF fell throughout the duration of Thursday afternoon reaching a low of 1.5144, almost as if speculators wanted to call the SNB's bluff. The 1.50-1.51 zone remains the likely area where SNB would be buying EUR against CHF. Also, the SNB's upward revision of growth rates and inflation expectations eased fears over deflation and thus the relief effect made CHF a preferred buy for speculators. Over the course of last week, largest gains were against GBP (+3.11%) and JPY (+1.63%) whereas performance against cyclical currencies and the Dollar was flat.



Preview: 21st – 27th September 2009

Looking ahead

- Fed and Norges Bank announce interest rate decisions; focus is likely to be on exit strategies
- G20 meetings commence on Thursday; FX rates will probably be left out of any communiqués but draconian regulation of financial markets could be announced
- Japanese public holiday on Monday through to Wednesday – JPY volumes could be thin
- Fresh European PMI's will clarify developing economic conditions in the Euro zone
- Bank of England minutes may clarify ongoing confusion regarding remuneration rates

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The G20 meetings scheduled for this week is unlikely to contain FX-sensitive comments – previous meetings have played out without FX rates being mentioned for various political reasons so we have little reason to believe this will change. However, there is a fairly strong possibility of new regulations (designed to regulate financial markets) being announced. Regulations are often good for the long-term viability of any particular market but that doesn't mean that anyone actually likes them. If tangible new measures are enforced, financial markets are likely to react negatively because profitability is usually affected. Large-scale failures by several regulatory bodies worldwide as well as disproportionate risk taking by banks has helped to create a financial crisis which is still affecting businesses and individuals. The pressure is on politicians to come out of this looking like stern correctors of wrongs by taking a stand against such exuberant practices. The G20 may well be an opportunity and a platform for policymakers to enforce new regulation that will limit risk taking, reduce counterparty risk and most importantly, measures that will reduce the significance of any one company on its economy (and the world e.g. Lehman Brothers). With the anniversary of the Lehman collapse only just behind us and refreshed in the memory, we may see action regarding 'too big to fail' banks. Any new regulation is likely to be a hindrance to current business practices and thus could be detrimental to bank balance sheets and cost base.

European PMI's are again on the menu – investors have been paying attention to European sentiment indicators as a way of gauging the European recovery. More so as other macro data has been volatile and inconsistent month on month. This week's dose will develop this theme further so beware of negative surprises seeing as the market mood is an optimistic one with most expectations set for a subdued but reasonable recovery over the next 12 months. Upside surprises would add weight to the recovery story but an upside surprise is arguably less shocking amidst the current set of expectations.

One potentially huge theme for this week is a continuation of one of last week's themes – the possible change to remuneration rates on funds held at the Bank of England. The veracity of last week's sell off in Sterling pairs caught many by surprise considering that no actual policy statement was made. Governor King refused to bury the possibility by ruling it out which was enough for speculative selling to ensue. This week's minutes may shed some light on this issue i.e. if such a policy move was discussed at the BoE's last meeting for example then GBP pairs are likely to be under further pressure. Even if the minutes fail to provide more clarity, the chance of this issue being raised (and commented on) by a BoE member at some stage this week is also high. EUR/GBP and GBP/CHF were particularly volatile last week, primarily because of the remuneration theme; this is likely to be the case again if this theme develops further.

FX Sensitive Calendar Events

Monday 21st September (JPY) Bank Holiday (GBP) Rightmove HPI (NZD) Current Account	*Tuesday 22nd September* (JPY) Bank Holiday (CHF) Trade Balance (CAD) Retail Sales (USD) HPI (NZD) GDP
Wednesday 23rd September (JPY) Bank Holiday (EUR) French Manufacturing & Services PMI (EUR) German Manufacturing & Services PMI (EUR) Euro zone Manufacturing & Services PMI (GBP) BoE Meeting Minutes (GBP) BBA Mortgage Approvals (EUR) Industrial New Orders (USD) Interest Rate Decision + Statement	*Thursday 24th September* (JPY) Trade Balance (EUR) German IFO Business Climate (NOK) Interest Rate Decision + Statement (USD) Existing Home Sales (NZD) Trade Balance G20 Meetings
Friday 25th September (JPY) BoJ Meeting Minutes (USD) Durable Goods Orders (USD) New Home Sales G20 Meetings	