

1st June 2010

FX Weekly

Review: 24th – 30th May 2010



Market Research

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Recap

- Volatile, nervy week sees divergence in risk preferences – EUR continues its steady decline but global risk tolerance recovers. JPY pairs suffered in the tentative risk-on environment
- US Dollar held onto early gains; Dollar Index touched a new high (87.452)
- Commodity currencies and cyclical finding support despite continued headwinds from European sovereign crisis and Chinese growth concerns
- Equity indices had a weak start to last week, confirming a serious test of the bull run since March 09. Indices around the globe were largely mixed; emerging market indices well supported.
- Geopolitical risk in Korea grows and could become a major theme over the coming weeks. Tension in the Middle-East not a factor so far
- The German 10yr benchmark hit its lowest yield (2.55%) for over 20 years.
- Proposed regulatory changes in the US on the horizon – new regulation is likely to fundamentally change the banking sector and how it operates

Currency pair	At Open on May 24 th	At Close on May 28 th	% Change	Week High	Week Low	Volatility
EUR/USD	1.2546	1.2270	-2.20%	1.2562	1.2153	3.26%
GBP/USD	1.4465	1.4453	-0.08%	1.4610	1.4258	2.43%
USD/JPY	90.16	91.04	0.98%	91.40	89.26	2.37%
USD/CHF	1.1501	1.1588	0.76%	1.1696	1.1480	1.88%
EUR/GBP	0.8669	0.8486	-2.11%	0.8671	0.8422	2.87%
EUR/CHF	1.4431	1.4221	-1.46%	1.4443	1.4110	2.31%
GBP/CHF	1.6638	1.6751	0.68%	1.6838	1.6586	1.51%
GBP/JPY	130.44	131.59	0.88%	133.23	127.64	4.29%
EUR/JPY	113.15	111.72	-1.26%	113.68	108.83	4.29%
CHF/JPY	78.36	78.53	0.22%	79.46	76.40	3.91%
AUD/USD	0.8311	0.8470	1.91%	0.8550	0.8066	5.82%
NZD/USD	0.6761	0.6785	0.35%	0.6862	0.6560	4.47%
USD/CAD	1.0623	1.0543	-0.75%	1.0854	1.0443	3.87%

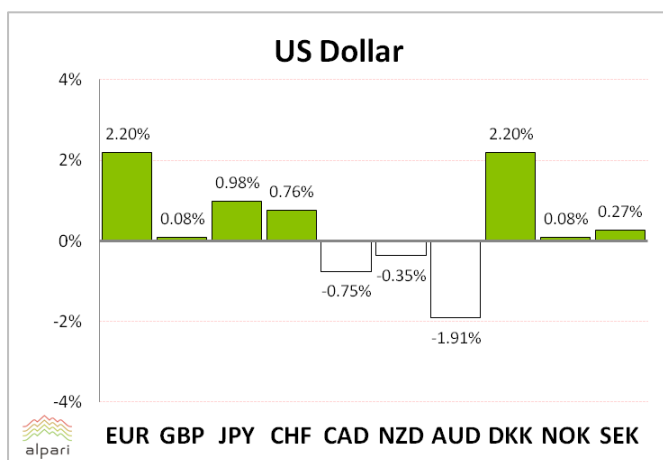
| Source: Alpari (UK)

USD

The Dollar was able to hold gains against the major currencies and only fall marginally against the commodity currencies (CAD, NZD, AUD) as fresh concerns in Greece and a delicate geopolitical issue in Korea pushed investors to fret once more. With so much bad news already priced into all asset classes, further escalation in the European sovereign crisis (Spanish downgrade) didn't induce the eye watering falls seen earlier in May.

North Korea announced that it will sever ties with the South and upgrade its military to combat readiness. The prospect of geo-political instability was supportive for USD. The

Euro had little or no support as a bailout of Spanish banks and fiscal deficits weighed in their own right. EUR/USD was caught in a storm of EUR weakness and USD strength at the same time – however, by week close EUR/USD recovered to close 2.2% lower.



An issue which has been worrying investors across the globe is the renewed rise in the US LIBOR rate after 18 months of persistent declines. The USD 3m LIBOR rate spiked as high as 4.5% in September 2008 but overwhelming central bank support ensured LIBOR rates fell to record lows over the course of 2009. In the past

few months, the European sovereign crisis has gained momentum leading to investor fears of contagion – not only to other sovereign states but even more importantly, back into the private sectors that were so heavily protected by central banks at the height of the crisis. It is estimated that US banks hold in excess of \$500bn of exposure to various European government debt. LIBOR rates can act as a barometer of confidence and counterparty trust; the fact that rates are creeping higher indicates a slow deterioration in trust amongst the large investment banks. In 2008, this led to extreme risk aversion and hoarding of cash in order to afford write downs that were inevitable. Today, we are not in the same situation because the risk of a sovereign default remains low but nevertheless, anxiety and tension are rising on the back of national and private default risk.

US macro data was downbeat over the course of the week. Particular highlights could prove significant – Q/Q GDP estimates were revised down substantially (3.0% vs. 3.5% exp.) and durable goods orders (-1.0% vs. 0.5% exp.) also disappointed. On the positive side, US housing data surprised to the upside and reinforced expectations of a recovery in the consumer sector (albeit a gradual one) in 2010. Existing home sales (5.77m vs. 5.62m exp.) and new home sales (504,000 vs. 425,000 exp.) were strong but the expiration of supportive measures for US homebuyers was a likely cause of the upbeat numbers – it will be incredibly intriguing and important to see next month's figures as it will be the first time that sales figures do not incorporate government support measures.

Regulatory changes in the US

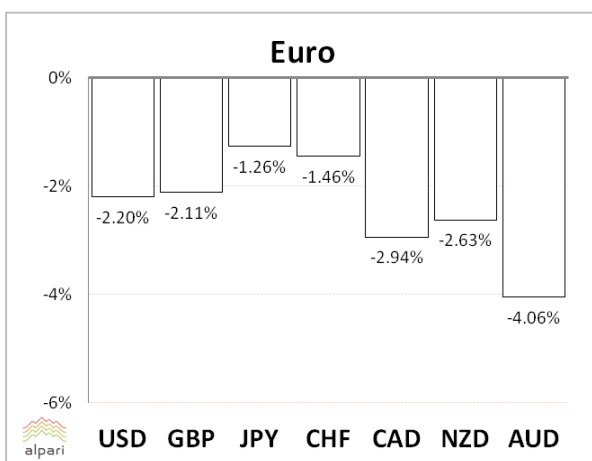
The proposed regulatory changes in US banking could have a market impact for years:

- Creation of 'Council of Regulators' to identify the build up of risks in the financial system
- Regulatory authorities will be given new powers to seize and conduct an orderly liquidation of large financial firms like Lehman/Citibank. A \$150bn fund, paid for by contributing banks will be used to support the orderly liquidation of a particular firm.

- Banks to be stripped of their leveraged trading arms – the exact extension of this rule is key. A full ban would be a serious detriment for the financial services industry and would likely lead to wider spreads on credit, derivatives and OTC products.
- Derivatives market totalling over \$2Trillion will have to clear through third parties in order to prevent huge liabilities with one party e.g. AIG, Lehman. This rule is likely to rebalance and redistribute business amongst the investment banks. Investors would benefit from the increased sense of security because counterparty risk would arguably be reduced if not eliminated – and banks would benefit because they could charge more fees, transaction costs and commission on the back of additional trades and transactions.
- Banks would be required to hive off their swaps businesses, in order to reduce their exposure to potential losses. Swaps are among the most profitable types of financial derivatives carried out by the banks. This rule would significantly weigh on bank profitability and as a result, huge lobbying efforts have been initiated by all the large US investment banks. The likelihood of this rule being implemented is rather low because of the horse-trading being done amongst US policymakers and the immensely powerful financial lobby in the US.

EUR

The Euro was sharply lower on Monday/Tuesday of last week but managed to recover some of its losses before week close. A downgrade of Spanish debt late on Friday after equity market close in Europe rattled some investors and caused volatility to rise across several asset classes although because a different ratings agency had already downgraded Spain, the actual effect on European asset classes was transitory.



Spanish banks are facing funding problems and adding to the tension surrounding Greece and Portugal. Investors fled all but the safest assets after four Spanish banks said they will consolidate as regulators and push lenders to merge with stronger partners.

CajaSur, a Spanish savings bank was given €550bn in emergency funding and taken over by the Bank of Spain. The Fund for Orderly Bank Restructuring (FROB) was

setup by the Spanish government last June after a forced takeover of another savings bank – the FROB has a funding capacity of €100bn. The bailout of CajaSur raised questions about the rest of the Spanish economy and Spanish banks in particular. The European banking sector is in full focus now and this coming week could have important developments for the sector.

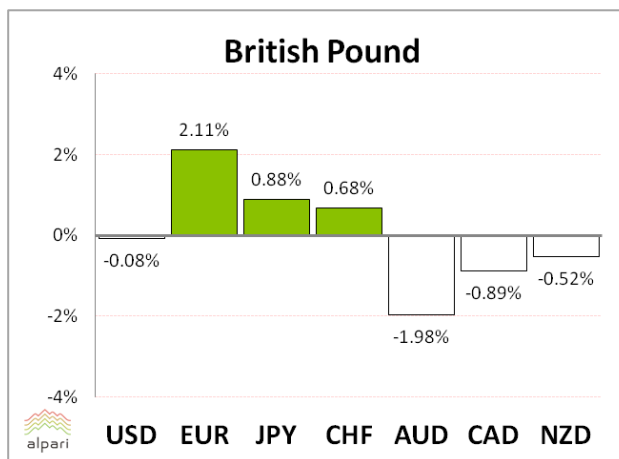
Italian authorities announced €25bn in budget cuts to try to reduce the ratio of debt to GDP. Austerity measures are being implemented by several European countries simultaneously – the long-term impact of such measures will be gauged by how quickly and how deeply the cuts

are. The adjustment in Italy will be smaller compared to most other EU nations because the debt-to-GDP ratio is much smaller in Italy compared to other countries.

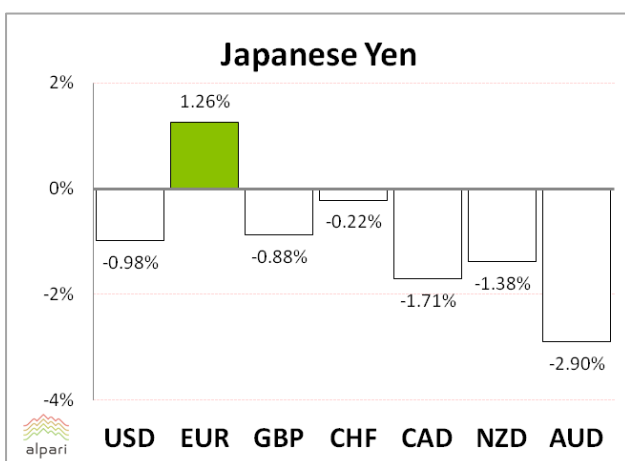
Speculation about Chinese EUR holdings was in the spotlight as a report indicating China was reviewing its central bank holdings of Euros pushed investors to sell EUR across the board in a bid to avoid significant further downside. EUR sentiment remains weak and various other rumours such as Germany banning non-hedging intended EUR shorts plus more stocks added to naked short ban have been doing the rounds. The myriad of sombre news kept Euro rallies suppressed. The Euro's largest losses were against AUD (-4.06%) and CAD (-2.94%). The interesting factor was that despite the sovereign crisis weighing on sentiment and risk-appetite, commodity currencies remained in favour as the Euro took the brunt of the negative price action.

GBP

The FTSE fell below 5,000 for the first time since Sep 2009 as the ongoing Greek situation continues to affect investors. The big focus for GBP traders was the highly anticipated revised GDP figure; all those expecting fireworks were disappointed as a revision wasn't forthcoming. The UK is continuing to attain economic growth but at a very slow rate. The prospect of public sector cuts, higher taxes and stimulus withdrawals are all factors that are likely to constrict the rate of growth and thus prevent a speedy recovery. Sterling was stable against the majors and was broadly down against cyclical pairs.



JPY



The Yen fell across the board except against the Euro with largest losses coming against AUD (-2.9%) and CAD (-1.71%). Global risk preferences improved towards the end of last week which encouraged market participants to shed the Yen in favour of riskier, higher yielding currencies. In addition to risk, other drivers were also important. A contraction in household spending (-0.7% vs. 2.5% exp.), higher than expected deflation (-1.6% vs. -1.5% exp.)

and a higher unemployment rate (5.1% vs. 5.0% exp.) were all pessimistic readings that increased the momentum in Yen selling.

Preview: 31st May – 6th June 2010



Looking ahead

- Extensive economic calendar has the potential to surprise somewhere along the line. Downside surprises would arguably have less impact given the amount of negativity already priced in
- RBA and BoC are due to announce their policy decisions; expectations are for no change in Australia and a 25pb hike in Canada – the BoC would be the first G7 nation to increase interest rates post-crisis
- US employment report(s) will probably be the focus for short-term traders as per usual
- G20 meetings next weekend could develop several active themes – European sovereign crisis, USD/Yuan exchange rate, global banking regulation and stimulus

The focus for this week is unlikely to change; the European sovereign crisis has metamorphosed into a possible counterparty crisis akin to Lehman Brothers and AIG. The other poignant issue is that private sector debt that was effectively nationalised by central banks and governments worldwide is slowly overlapping back onto the private sector. The ultimate fear is that private and public sector debt burdens combine to create a 'super-crisis' that cannot be supported by any entity or organisation. Back to this week – investors should be ready for more intra-day shocks in the form of further credit downgrades, negative commentary and write downs at financial institutions. Although many market participants are half-expecting such developments, scope still remains for more downside in EUR pairs, especially against the majors. Against commodity and cyclical currencies the Euro is likely to remain volatile and subject to substantial swings owing to swings in sentiment, risk preferences and confidence in how the sovereign uncertainty is laid to rest.

The economic calendar is packed and could re-engage market participants with macroeconomic and fundamental issues rather than sentiment-driven apprehension. We see a reasonable chance of equities and commodity currencies regaining some lost ground if macro data surprises even slightly to the upside. Market participants have felt clobbered by the emergence of sovereign default risk but considering the fact that fiscal issues will take years to resolve and that a default in the EMU has been averted (for now), investors may begin to gradually move back into riskier assets.

Aside from the bank holiday yesterday, financial markets should see plenty of volatility. Two interest rate decisions (BoC and RBA) will provide an insight into how countries that have largely avoided the strongest effects of the financial crisis (and are now ready to tighten monetary policy) are reacting to fiscal deterioration and excessive debt/leverage around the World.

On an intra-day basis, two employment reports (ADP & Non-Farm) will dominate attention. The US labour sector remains under pressure despite some upbeat signs over the past few months. Coming at the end of the week, some investors will choose to stay sidelined in advance of the number, but many others will which may lead to less liquidity.

The future development of LIBOR rates is crucial. In recent weeks, LIBOR rates have been rising very quickly as USD funding problems and counterparty risk encouraged investors to search for safety and ask questions about counterparty security. Essentially, LIBOR rates are a good indicator of how fearful banks are with each other so their development over the next few months will be important.

FX Sensitive Calendar Events

<u>Monday 31st May</u> (GBP) Bank Holiday (USD) Bank Holiday (JPY) Preliminary Industrial Production (AUD) Current Account (AUD) Private Sector Credit (NZD) NBNZ Business Confidence (EUR) CPI (CAD) GDP	<u>Tuesday 1st June</u> (CNY) Manufacturing PMI (AUD) Retail Sales (AUD) Interest Rate Decision + Statement (CHF) GDP (EUR) German Retail Sales (GBP) Halifax HPI (GBP) Manufacturing PMI (EUR) Unemployment Rate (CAD) Interest Rate Decision + Statement (USD) ISM Manufacturing PMI
<u>Wednesday 2nd June</u> (AUD) GDP (CHF) Retail Sales (GBP) Net Lending to Individuals (GBP) Final Mortgage Approvals (EUR) PPI (USD) Pending Home Sales	<u>Thursday 3rd June</u> (AUD) Trade Balance (GBP) Nationwide HPI (GBP) Services PMI (EUR) Retail Sales (USD) ADP Employment Report (USD) ISM Non-Manufacturing PMI
<u>Friday 4th June</u> G20 Meetings (EUR) Revised GDP (CAD) Unemployment Rate (USD) Non-Farm Employment (USD) Unemployment Rate (CAD) Ivey PMI	<u>Saturday 5th June</u> G20 Meetings
<u>Sunday 6th June</u> (NZD) Bank Holiday	

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