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Fundamental | FX

24th January 2011

# FX Weekly

## Review: 17th – 23rd January 2011

### Recap

- The Dow rose for an 8th straight week as stronger equities/weaker Dollar mantra continues. Positive USD/equities correlation at the beginning of the year has dissipated
- Strong earnings results from several bellwethers such as Apple, Intel and Google pushed indices across the globe higher
- Q4 earnings are proving robust – so far, approx 70% of all earnings reports have beat estimates
- Elevated inflation in the UK is gaining traction with hawkish elements of the BoE as well as market participants. Probability of policy tightening before year-end has increased substantially
- Oscillating sentiment towards future Chinese growth rates continues to cap short-term gains in global equity markets. Additional policy action by the PBOC is expected to weigh on global growth rates and AUD, NZD, CAD given their sensitivity to commodities

| Currency pair | At Open on 17th Jan. | At Close on 21st Jan. | % Change | Week High | Week Low | Volatility |
|---|---|---|---|---|---|---|
| EUR/USD | 1.3370 | 1.3619 | 1.86% | 1.3624 | 1.3244 | 2.84% |
| GBP/USD | 1.5871 | 1.5986 | 0.72% | 1.6059 | 1.5834 | 1.42% |
| USD/JPY | 82.88 | 82.55 | -0.40% | 83.12 | 81.84 | 1.54% |
| USD/CHF | 0.9635 | 0.9575 | -0.62% | 0.9686 | 0.9519 | 1.73% |
| EUR/GBP | 0.8421 | 0.8505 | 1.00% | 0.8529 | 0.8331 | 2.35% |
| EUR/CHF | 1.2882 | 1.3048 | 1.29% | 1.3068 | 1.2772 | 2.30% |
| GBP/CHF | 1.5287 | 1.5321 | 0.22% | 1.5426 | 1.5193 | 1.52% |
| GBP/JPY | 131.53 | 132.02 | 0.37% | 132.50 | 130.67 | 1.39% |
| EUR/JPY | 110.80 | 112.46 | 1.50% | 112.48 | 109.56 | 2.64% |
| CHF/JPY | 85.98 | 86.07 | 0.10% | 86.36 | 85.26 | 1.28% |
| AUD/USD | 0.9901 | 0.9884 | -0.17% | 1.0076 | 0.9831 | 2.47% |
| NZD/USD | 0.7678 | 0.7545 | -1.73% | 0.7786 | 0.7524 | 3.41% |
| USD/CAD | 0.9876 | 0.9925 | 0.50% | 1.0030 | 0.9837 | 1.95% |

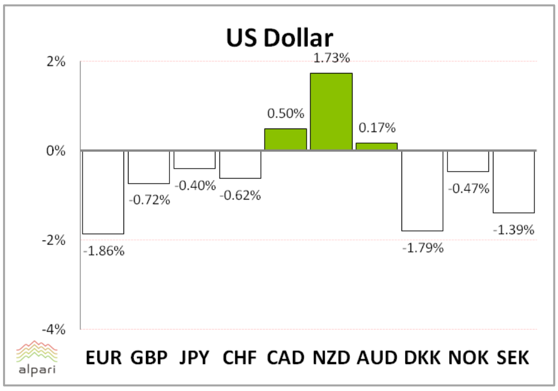
| Source: Alpari (UK)

The two big issues in FX since the start of 2011 have undoubtedly been sovereign European funding and inflationary pressures in the emerging markets, namely China. In January alone China, Poland, Brazil and Thailand have raised interest rates to temper inflationary pressures with Hungary (+25bp), Israel (+25bp) and India (+25/+50) all very likely to follow suit this week. According to our research, only one developed nation is currently posting above-target inflation: the UK.

Given these conditions, we would expect to see a fairly strong retracement (the S&P declined 10% in late 2010 alongside heightened policy tightening in China) in equities over the next few weeks as investors take risk off the table. Also, European funding issues have been tamed but not eradicated. Details of what measures European authorities will take at upcoming Ecofin meetings in February and March could be conclusive for the Euro. In our view, sovereign debt unease will linger for as long as there is excessive sovereign debt – in other words, until peripheral nations demonstrate a resolute ability to reduce the nominal amount of debt year-on-year thus shrinking debt-to-GDP ratios over the next 5 years.

**USD**

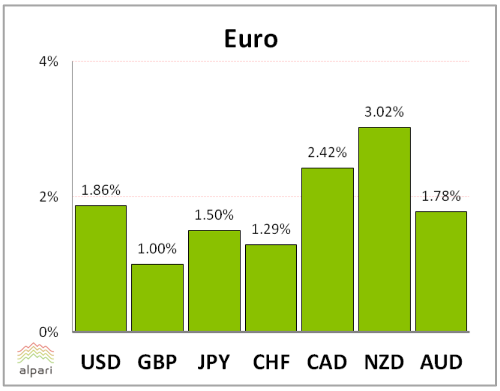
Risk-sensitive currencies took an unexpected dive last week as inflation concerns across the EM space continued to gain traction. The US Dollar declined against all its G20 counterparts with the exception of CAD (+0.50%), NZD (+1.73%) and AUD (+0.17%). Stronger equities usually put pressure on the Dollar as investors get out of cash and invest in better yielding assets – but rising commodity prices and strong economic performance in many emerging markets have steepened the rate of policy adjustment. Countries that are highly dependent on commodity exports (Australia, New Zealand, Canada) are ahead of other central banks in their policy response, but by the same token – risks to the recovery schedule in China and other EM countries tends to weigh severely on their currencies.




**EUR**

The Euro put in a very strong performance last week, closing the week as the strongest currency in the G20. Largest gains came against NZD (+3.02%), CAD (+2.42%) and AUD (+1.78%) as EM inflation rates and China in particular were the focus.

The European sovereign debt crisis looks like ebbing away at least for the near term as Chinese officials announced plans to buy securities from the region's most-indebted countries such as Greece, Ireland, Portugal. Japan has also confirmed that bonds issued by the EFSF would be viable investment vehicles. The positive sentiment generated by such re-assuring statements is likely to have been high because the amount of anxiety over the past few months has been elevated – taking EUR/USD down to 1.28. As Europe tightens fiscally and imposes supportive mechanisms to prevent defaults and debt restructuring – economic sentiment should increase, driven by the stronger, more populous nations. It is worth remembering that the US has done very little in its own right (let alone in comparison to Europe) to combat its huge budget deficit whereas Europe has. Over time, this should provide a premium for EUR against USD.



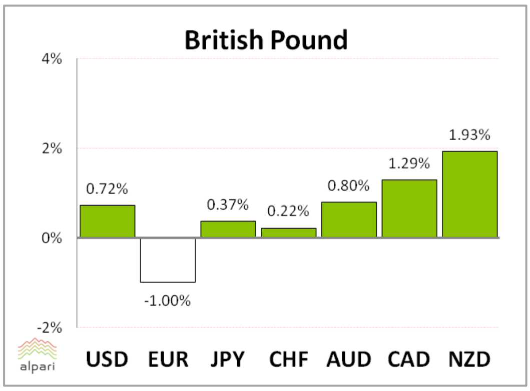

Last week, the Euro was buoyed not only by supportive commentary from various EU/ECB officials but also from the macro data that was available. Germany is proving to be a strong powerhouse for growth; enough to compensate for the lack of growth in the periphery – German ZEW economic sentiment (15.4 vs. 6.5 exp.) and German IFO business climate (110.3 vs. 110.0 exp.) indicated to market participants that the serious concerns being raised in the periphery are not severe enough to dampen the overall recovery path for Europe as a whole.

Bond auctions also played a small part last week. Germany auctioned €4.9bn of 2yr bonds last Wednesday - receiving strong demand at comparatively attractive yields. Yields on 2yr benchmark

German bonds rose to 12 month highs after hawkish commentary from Trichet gave warning of short-term inflation risks in the Euro-zone. Interest rate expectations have shifted higher as a result of his comments.

**GBP**

UK headlines were all inflation linked last week. An annual CPI reading of 3.7% - the highest level of inflation since April didn't go down well with UK market participants. Consumer price inflation jumped more than expected due to a surge in oil, food and utility prices. The reading immediately increased the pressure on the BoE to bring forward monetary policy tightening as a way to combat future inflation expectations.




In our view, the high CPI number is not a cause for alarm but it should most definitely be a cause for concern. We see the probability of an interest rate hike in 2011 as greatly increased as a result. Looking at the possible timing, the keenly awaited Inflation Report due to be published in May stands a good chance of being used as an opportunity by the BoE.

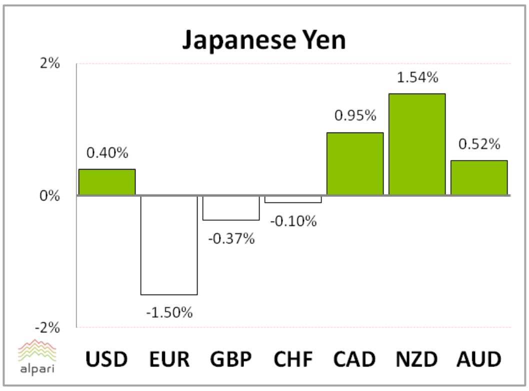
With fundamental factors like spare capacity, income and money growth all still pointing to considerably lower inflation in the medium-long term, we think the MPC will resist the temptation to provide a knee-jerk rate hike (at their next meeting on Feb 10th) to quell the media attention and remind market participants that the central bank is still focused on its prime remit of controlling inflation.

On a bright note, wage growth inflation remained very stable in November which indicates that higher inflation and rising inflation expectations are so far not percolating through to contract negotiations/wage inflation. This will be a particularly interesting indicator in future CPI/RPI releases.

The broad shift higher in rate expectations was the catalyst for GBP appreciation, making GBP the second strongest currency in the G20 last week.

**JPY**

The Yen had a mixed week with best gains coming against the commodity currencies. Macro data was very light. The Yen remains in a very precarious situation whereby Japan's status as a safe-haven is being seriously eroded by the >200% level of national debt. Although most of the debt is held domestically, the continued lack of significant GDP growth over the past 10 years is setting a stage for a spike in Japanese yields thus making the real debt burden larger and weakening the fundamental backdrop of Yen. Interesting comments over the weekend from Japan's new economy minister Yosano highlight this point – "long term rates could spike if new JGB issuance keeps topping tax revenue" and "Japan economy is at a standstill, facing hardships such as a high jobless rate".




**OTHERS**

The BoC held interest rates at 1% and raised its growth forecast for 2011 and 2012. We see the BoC on hold for a considerable time because of Canada's close proximity to the US and their desire to alleviate excessive CAD appreciation. In the accompanying commentary, the central bank stated that "any further reduction in monetary policy stimulus would need to be carefully considered."

New Zealand's annual inflation rate jumped to the highest level in more than 2 years in the fourth quarter because of an increase in sales tax, but underlying pressures were seen as contained, backing views that rates are unlikely to rise for months to come. CPI rose by 2.3% in Q4 2010 to stand 4% higher than a year ago. In Q3 2010, New Zealand's annual inflation was 1.5% indicating a *recent* sharp increase. This was the largest quarterly increase since a 3.5% rise in 1989 when sales tax rose to 12.5% from 10% - we think this underlines the unusual nature of the recent spike in CPI and something that should be watched very closely i.e. inflation in EM markets with particular focus on commodity-sensitive currencies.

# Preview: 24th – 30th January 2011

## Looking ahead

- Stock market volatility and extent of retracement could be very significant if perceptions of EM slowdown is confirmed through macro data
- About 20% of the S&P is due to report this coming week. Major sectors such as tech, aerospace, defence and consumer staples likely to be the prime focus
- Several EM interest rate decisions (Hungary, Israel, India) are due – all are expected to hike by 25bp. Yield/policy differentials between the developed and EM economies are widening with the topic itself becoming a prime theme
- Central bank meetings in the G20 are rife – RBNZ, Norges Bank, BoJ and the Fed are all scheduled to announce latest policy decisions – all are expected to stay on hold

This coming week has a large tranche of macro data. No less than seven interest rate meetings should take up most of the focus. Very interestingly, only developing economies are expected to hike rates this week (Hungary, Israel, India) whereas developed countries are expected to stay on hold (RBNZ, Norges Bank, BoJ, Fed).

Q4 earnings season continues this week with close to 20% of the S&P due to report. So far, approximately 70% of companies have beat consensus estimates. This level of performance from an aggregate view should help the up-trend in stock markets and add weight to the decline in the US Dollar. However, given the considerable volatility that is likely to linger in equity markets until the EM inflation story plays out, we could see fresh daily lows before seeing any further upside in global equity indices. The latest US rate cycle is still in its infancy so an intuitive reconnection between higher equity prices/better economy and a higher US Dollar is still some way off in our view.

Despite huge media attention on the BoE alongside some market participants calling for a pre-emptive move higher to appease all those losing faith in the BoE's ability to control inflation, the chances for a rate hike in the first half of 2011 remain pretty slim. Minutes from the December meeting will be published this week (Jan 26th) and the temptation is to assume someone from the committee was swayed to support Andrew Sentence in voting for a hike. The BoE will probably stick to its well versed story that the rise in inflation is temporary with the near-term growth outlook remaining uncertain which makes tighter policy now a very risky proposition. The logic at the BoE right now it seems is: better the devil you know than the devil you don't i.e. above-target inflation is preferable to a potential decline into negative growth, deflation and further tranches of bond purchases. Given the UK's precarious fiscal position, this avenue may simply be too daunting to think about for the coalition government and the BoE. Funnily enough, inflation dilutes the UK's real debt burden so seeing it at almost 4% is probably not the worst thing in the World if you work for HM Treasury.

The Fed is scheduled to announce its own policy decision this coming week. We think the Fed will leave rates and QE unchanged with the 'extended period' language also staying put. From previous commentary it appears the Fed is in macro-data analysis mode. We think the Fed will only remove ultra-loose policy once employment, housing and corporate indicators begin to exhibit consistent growth and improvement.

The Euro was the strongest currency in the G20 last week, rising 1.86% against USD. Some indications suggest that the rise in EUR/USD is rising due to fresh long positions being placed as a result of the newly found confidence surrounding Europe and its anemic periphery. However, by looking at open interest data (for FX futures) from the CFTC it appears last week's rise was more about short-covering rather than fresh longs being placed. As a result, we think investors remain incredibly cautious on the Euro with largescale outflows into USD, JPY and CHF a potential development subject to developments with the EU rescue fund/peripheral debt restructuring or even a default in adjacent Eastern Europe.

EUR/USD remains highly sensitive to peripheral CDS spreads with sensitivity being as high as it was during the peak of the debt crisis in June 2010. As a result, developments in the European periphery should be duly noted.

Most uncertainty is probably in Ireland. The exit of Green Party from the ruling coalition follows the resignation of Prime Minister Cowen as leader of the ruling Fianna Fail party over the weekend. A general election date of March 11th is now likely to be moved forward. The Greens will support the minority government long enough to pass the finance bills required for the release of bailout money from the EU and IMF. So while events over the weekend add to political uncertainty at the margin, they are unlikely to have a large impact on FX rates.

On the auction front, the EFSF sells €5bn of its inaugural 5-yr bond next week, Spain sells €3.5bn of t-bills Tuesday, and Portugal should sell €1.5bn of t-bills on Wednesday and Spain sell €4.0bn of bonds on Thursday.

| **FX Sensitive Calendar Events** | |
|---|---|
| *Monday 24th January*<br>(AUD) PPI<br>(EUR) French Manufacturing & Services PMI<br>(EUR) German Manufacturing & Services PMI<br>(EUR) European Manufacturing & Services PMI<br>(EUR) Industrial New Orders<br>(USD) Treasury Currency Report | *Tuesday 25th January*<br>*AUD Bank Holiday*<br>(AUD) CPI<br>(JPY) Interest Rate Decision + Statement<br>(INR) Interest Rate Decision + Statement<br>(GBP) GDP<br>(GBP) Public Sector Borrowing<br>(CAD) CPI<br>(USD) CB Consumer Confidence<br>(GBP) BoE Governor Mervyn King Speech |
| *Wednesday 26th January*<br>*WEF Annual Meetings*<br>(JPY) BoJ Monthly Report<br>(GBP) BoE Meeting Minutes<br>(GBP) BBA Mortgage Approvals<br>(NOK) Interest Rate Decision + Statement<br>(USD) New Home Sales<br>(USD) Interest Rate Decision + Statement<br>(JPY) Trade Balance | *Thursday 27th January*<br>*WEF Annual Meetings*<br>(GBP) Nationwide HPI<br>(EUR) German Prelim CPI<br>(USD) Durable Goods Orders<br>(USD) Unemployment Claims<br>(USD) Pending Home Sales<br>(NZD) Interest Rate Decision + Statement<br>(JPY) CPI<br>(JPY) BoJ Meeting Minutes<br>(JPY) Retail Sales |
| *Friday 28th January*<br>*WEF Annual Meetings*<br>(CHF) KOF Economic Barometer<br>(USD) GDP | *Saturday 29th January*<br>*WEF Annual Meetings* |
| *Sunday 30th January*<br>*WEF Annual Meetings*<br>(NZD) Trade Balance<br>(JPY) Manufacturing PMI<br>(JPY) Prelim Industrial Production | |

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