

31st January 2011

FX Weekly

Review: 24th - 30th January 2011



Recap

- The UK grabbed the headlines as a horror GDP estimator (-0.5% q/q) put a sword to any hawkish aspirations from the BoE. Forthcoming revision to Q4 UK GDP is crucial so UK macro data will take on added significance
- Credit rating downgrade from AA to AA- for Japan heightened risk-aversion across all asset classes
- Fed, RBNZ, Norges and BoJ all left interest rates unchanged as expected
- Soft US GDP estimate for Q4 gave the US Dollar added impetus going into the weekend
- Political instability in Egypt has allowed geo-political risk to emerge as an active theme in FX. USD, JPY and CHF gapped higher in all pairs to reflect the risk-averse sentiment at the start of this week.

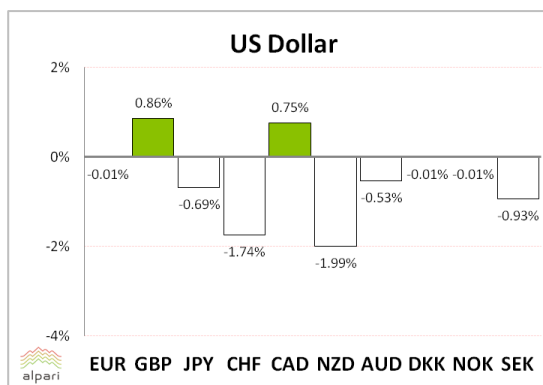
Currency pair	At Open on Jan 24 th	At Close on Jan 28 th	% Change	Week High	Week Low	Volatility
EUR/USD	1.3606	1.3608	0.01%	1.3757	1.3540	1.59%
GBP/USD	1.5993	1.5856	-0.86%	1.6016	1.5750	1.66%
USD/JPY	82.66	82.09	-0.69%	83.20	81.97	1.49%
USD/CHF	0.9582	0.9415	-1.74%	0.9622	0.9389	2.43%
EUR/GBP	0.8507	0.8579	0.85%	0.8671	0.8491	2.12%
EUR/CHF	1.3040	1.2816	-1.72%	1.3068	1.2804	2.02%
GBP/CHF	1.5324	1.4933	-2.55%	1.5365	1.4859	3.30%
GBP/JPY	132.20	130.16	-1.54%	132.66	129.51	2.38%
EUR/JPY	112.47	111.74	-0.65%	114.00	111.50	2.22%
CHF/JPY	86.25	87.12	1.01%	88.12	86.04	2.41%
AUD/USD	0.9885	0.9937	0.53%	1.0021	0.9862	1.61%
NZD/USD	0.7583	0.7734	1.99%	0.7792	0.7564	3.01%
USD/CAD	0.9936	1.0011	0.75%	1.0016	0.9110	9.12%

| Source: Alpari (UK)

USD

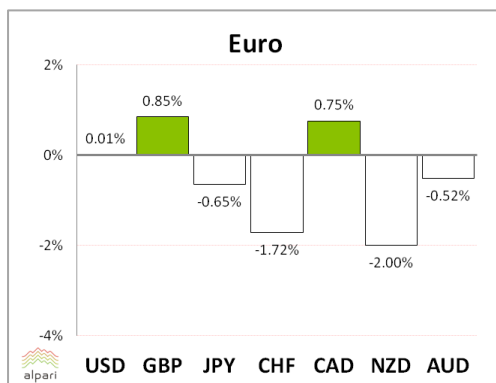
The US Dollar had a mixed week with several factors affecting USD pairs. Up until Thursday, the broad direction for Dollar pairs was down as continually strong earnings announcements supported a risk-on mood in all asset classes. Rising commodity prices were also a factor as the CRB Index made a fresh 2 year high. However, USD pairs changed course in the latter part of the week as a downgrade of Japanese government debt and a disappointing US GDP figure (3.2% vs. 3.5% exp.) induced strong flows into USD, JPY and CHF. The Japanese Yen and Swiss Franc were the two strongest currencies in the G20 last week – another factor worth mentioning was the developing geo-political issue in Egypt. Going into the weekend, the precarious situation in Egypt left most market participants very anxious about the very near term. At the open on Sunday night, USD was significantly higher although consensus opinion is drifting towards a peaceful and economically beneficial resolution which explains the gradual unwinding of risk-averse positions early in the London trading session.

USD made strongest gains against GBP (+0.86%) and CAD (+0.75%) given the abnormally weak data out of the UK and soft CPI data from Canada (-0.3% vs. -0.2% exp.). Although Canadian inflation data wasn't substantial enough to impact the ongoing schedule of policy normalisation by the BoC; it was sufficient to eradicate speculative CAD longs looking for pre-emptive action against rising commodity prices. In our view, the BoC's next rate hike is unlikely to occur sooner than the September 7th or October 25th meeting.



EUR

In our view, the recent strength seen in the Euro is most likely from short-covering rather than fresh longs being established i.e. we think there is much more anxiety to come for EUR pairs so investors are wary of placing significant new long positions in EUR pairs. Options pricing also suggests that EUR longs are very selective in that investors seem to prefer longs in EUR/CHF and EUR/JPY but prefer to be short in EUR/SEK and EUR/GBP. This phenomenon suggests a relief rally is ongoing in EUR/USD, EUR/JPY and EUR/CHF as peripheral Europe ebbs out of the limelight for the time being. European finance ministers plan to meet several times before a final announcement on the issue of how Europe will deal with the sovereign debt crisis is made in March.



Also, recent commentary from ECB members has been on the hawkish side. A Wall St Journal article and recent comments from several ECB members including Trichet have suggested a "ready to respond" approach by the ECB. So, as the SNB, BoJ and Fed are almost certain to stay on hold given their anaemic levels of GDP growth and inflation - in Europe however, inflation is starting to tick higher, fuelled and supported by

commodity prices. An important point to mention is that while the Fed focuses on core inflation, the ECB tends to focus on headline inflation – this makes a strong case for oil price changes having a relatively larger impact on the ECB's policy stance compared to the Fed's. Considering the developments in Egypt over the weekend, we could see oil prices spike significantly higher on the back of supply concerns.

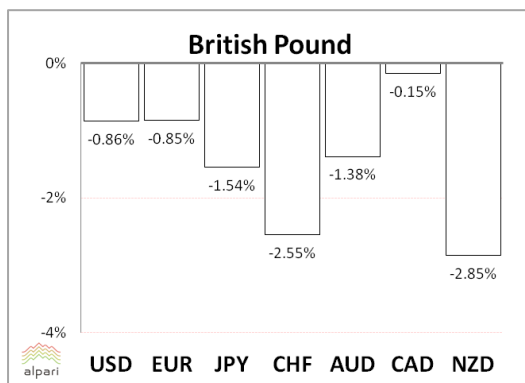
GBP

Sterling pairs suffered across the board and ended last week down against all other G20 currencies. Largest losses were against CHF (-2.55%) and NZD (-2.85%) as Q4 GDP (-0.5% vs. +0.5% exp.) came in lower than any analyst estimate on record. In fact, the lowest estimate was for a rise of 0.0% q/q. The sombre GDP figure was a full percentage point below consensus and prompted similar reactions. The decline was attributed to December's abnormally cold weather so even if this factor was ignored, growth would probably have been flat in Q4.

UK GDP numbers were very pessimistic indeed and pushed GBP lower. On the bright side is the fact that the number is grossly outside of all expectations which is leading many to assume a

large revision to the numbers will be forthcoming on Feb 25th (date of revision announcement). Also, the cause of the large fall in GDP has been largely attributed to weather related effects which are usually temporary.

Most weakness came from the services sector such as hotels and restaurants, transport industries and recreation, according to the ONS. Manufacturing was buoyant despite the severe weather while construction declined 3.3%.



From here, there are several scenarios – one is of course a severe worsening for GBP and the UK as inflation rises/growth slows but on the other hand, the UK is just as likely to maintain a slow path of recovery if Q4 GDP proves to be a blip. For the moment, it is very difficult to pin point where the effects of December's cold weather begin and end – the way investor consensus forms around this issue should decide GBP developments in the short-term.

BoE action is unlikely in the short term as the central bank is tied down – inflation is too high to ease policy but GDP/employment/activity is too anaemic for higher rates. All eyes are now on UK macro data – inflation, PMI's and employment data will take on greater significance prior to further GDP/inflation data being released as people try to establish whether a -0.5% GDP reading is a sign of an imminent double-dip or just a transitory statistical anomaly.

Since the initial blip lower in most GBP pairs after the release of the Q4 GDP estimate, Sterling pairs have recovered very well indeed. Prior to its release, GBP/USD was trading close to 1.59 – while in today's early trade the pair rose up to 1.6046 – almost a 2011 high as market participant seem to be considering the low Q4 GDP estimate as a good buying opportunity.

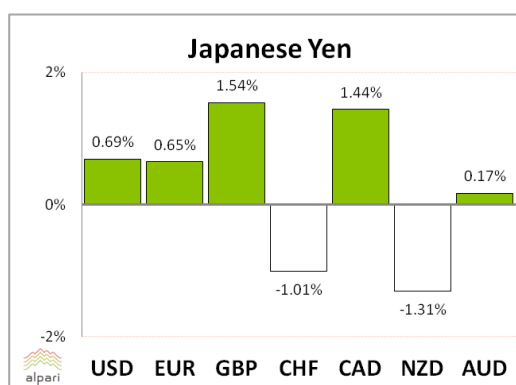
JPY

The BoJ left interest rates unchanged at 0.10% with a unanimous policy decision and maintained its previous economic assessment. The BoJ re-iterated its view that Japan's economy will gradually overcome its slowing pace of improvement.

The BoJ repeated the view expressed at its 4-5 November meeting that "Japan's economy still shows signs of a moderate recovery, but the recovery seems to be pausing". In terms of inflation the BoJ stated "The CPI (excluding fresh food) is declining on a year-on-year basis due to the substantial slack in the economy as a whole, but the slowing trend in the pace of decline has continued."

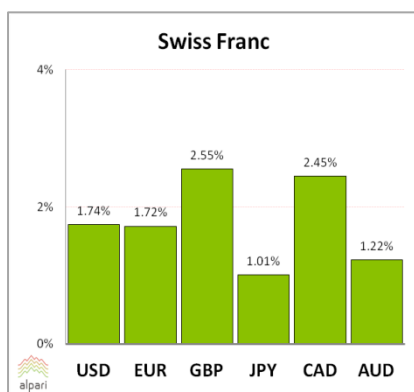
The Yen was extremely volatile throughout the week as multiple factors swung sentiment. The most crucial factor for the Yen was the rating downgrade by S&P to AA-, pushing USD/JPY rapidly higher from around 82.15 up to 83.20 within half an hour.

The US Dollar recovered most of its early losses on Thursday morning as a result of the Japanese debt downgrade. Most investors would probably



accept that a ratings cut for Japan was always on the cards given the extremely high level of Japanese public debt alongside extremely sluggish economic conditions. The Yen is presenting market participants with a puzzling paradox – while most currencies suffer on the back of debt/default concerns, JPY has managed to defy gravity, appreciating its way to being the best FX performer in 2010 and inducing the BoJ into artificial weakening of the Yen in late 2010.

CHF



The Swiss Franc was the strongest currency in the G20 last week as a mixture of geo-political risk and global growth concerns pushed capital flows into the Swissie. Largest gains were against GBP (+2.55%) and CAD (+2.45%) because UK and Canadian macro data was on the softer side thus extending CHF gains.

Others

Yet again Australian CPI has undershot expectations (0.4% vs. 0.7% exp.). Inflationary pressures are abating quickly – maybe too quickly as underlying measures of inflation drop to their lowest levels in 10 years. Although inflationary pressure may be falling quicker than the RBA expected or intended, we don't see a case for the RBA to pause its policy normalisation schedule. Commodity prices are at their highs, geo-political risk in Egypt is adding upward momentum to oil prices and post-flood reconstruction programmes will add to aggregate demand.

Preview: 31st January – 6th February 2011



Looking ahead

- Egyptian unrest had a meaningful impact on FX rates through sharply higher demand for JPY, USD and CHF. Since the emergence of geo-political risk in Egypt, fears of an economic collapse have faded significantly. EUR/USD has opened lower this week but has since traded higher in Asian trading hours
- Political instability in Egypt has heightened the markets' awareness of geo-political risk – a reduction in media attention regarding this issue and/or the succession of the current government would be very positive for risk-FX
- In the wake of recent flood damage, AUD sensitive macro data will be NAB business confidence on Tuesday and building approvals on Thursday
- A further 20% of the S&P500 is scheduled to report including bellwethers like Exxon, Pfizer and Merck
- ECB rate decision is very unlikely to surprise but clarification of Trichet's "ready to respond" quote could come across to market participants as the ECB's attempt to talk the market down from pricing in premature increases in policy rates
- Huge week for the UK as last week's Q4 GDP number continues to cast a shadow over GBP. Construction, Manufacturing and Services PMI's in addition to house prices and lending data could be explosive if they indicate a Q4 GDP revision is not forthcoming. On the flip side, a strong batch of PMI's would attract rapid inflows into Sterling

There are several active themes in the FX space this week.....

The Q4 US earnings season continues with several bellwethers reporting (Exxon, Pfizer and Merck). For the past few weeks, earnings estimates have had a significant impact on USD in particular. As approximately 70% of all earnings estimates have been expectations, equity markets across the globe have risen as strong corporate profitability attracts further investment into US equities in particular.

The European Council (EC) meets this coming Friday but a firm, ratified solution to Europe's 'peripheral problem' will probably not be forthcoming. The EC's summit on March 24th is a more realistic option considering the level of disagreement currently evident amongst EU members on the issue of peripheral sovereign debt. Over the weekend, plans to allow Greece/Ireland/Portugal to borrow at artificially low rates with existing debt duration being extended to 30 years were made public by a Greek newspaper. Also, troubled countries would be allowed to borrow from the ECB in order to purchase its own government debt! Support for such plans is splintered as stronger EU members such as Germany/France resist attempts to dilute the financial responsibilities of smaller nations. Greek Sunday newspaper 'Vima' reported that Bundesbank President Weber could support a maturity extension for Greece; but only alongside the introduction of tough deficit controls. This particular issue could have a severe effect on EUR pairs. Market participants will be keen to see what kind of commentary comes out this week from the ECB considering that there are so many options on the table for EU policymakers. EUR volatility should remain elevated and the currency

pair that best reflects the ongoing changes in sentiment will be EUR/CHF taking into account the Swissie's safe-haven status.

There are two major interest rate decisions this week – ECB and RBA. Both will most likely stay on hold although the RBA does have some upside risk. Although Australia is recovering from severe flood damage which suggests interest rates will be left unchanged, there is an outside chance of a 25bp hike because of the strong increases in most commodity prices – primarily crude oil. The political situation in Egypt has already put a bid into oil prices so further escalation in the stand-off between protesters and the ruling government could quite plausibly lead to much stronger price spikes.

With the ECB, given the relatively short gap between policy meetings (Jan 13th – Feb 3rd) and a key quarterly meeting in March, it's unlikely that a significant change to the ECB's stance would have occurred.

Peripheral supply will be light this week. Belgium will auction €3bn of T-bills on Tuesday, Portugal auctions €1.5bn of T-bills on Wednesday. Spain auctions €2.5bn of 3-year bonds and €1.5bn 5-yr bonds on Thursday. A weak auction in either nation would probably resurrect anxiety and most importantly, put undue pressure on European policymakers to find not only a viable solution to the sovereign debt problem in Europe, but also a speedy one.

FX Sensitive Calendar Events

<p><u>Monday 31st January</u> (EUR) CPI (CAD) GDP (USD) Core PCE Price Index (USD) Personal Spending</p>	<p><u>Tuesday 1st February</u> (CNY) Manufacturing PMI (AUD) Interest Rate Decision + Statement (AUD) Commodity Prices Y/Y (AUD) NAB Business Confidence (GBP) Halifax HPI (GBP) Nationwide HPI (CHF) Retail Sales (CHF) SVME PMI (GBP) Manufacturing PMI (GBP) Net Lending to Individuals (GBP) Final Mortgage Approvals (EUR) Unemployment Rate (USD) ISM Manufacturing</p>
<p><u>Wednesday 2nd February</u> <i>(CNY) Bank Holiday</i> (GBP) Construction PMI (USD) ADP Employment Report (NZD) Unemployment Rate</p>	<p><u>Thursday 3rd February</u> <i>(CNY) Bank Holiday</i> (AUD) Building Approvals (AUD) Trade Balance (CHF) Trade Balance (GBP) Services PMI (EUR) Retail Sales (EUR) Interest Rate Decision + Statement (USD) Unemployment Claims (USD) ISM Non-Manufacturing PMI (USD) Factory Orders</p>
<p><u>Friday 4th February</u> <i>(CNY) Bank Holiday</i> (AUD) RBA Monetary Policy Statement (CAD) Unemployment Rate (USD) Non-Farm Employment Report (USD) Unemployment Rate (CAD) Ivey PMI</p>	

Disclaimer:

We provide an execution-only service. The material contained here does not contain (and should not be construed as containing) investment advice or an investment recommendation, or, an offer of or solicitation for, a transaction in any financial instrument. We accept no responsibility for any use that may be made of these comments and for any consequences that result. This communication must not be reproduced or further distributed. All information in this publication has been compiled from publically available sources that are believed to be reliable, however we cannot guarantee the accuracy of all information. All information and documentation associated with this report has been produced for the purposes of providing the report only.

Trading foreign exchange, commodity futures, options, precious metals and other over-the-counter products carries a high level of risk and may not be suitable for all investors. The high degree of leverage associated with such trading can result in substantial losses, as well as gains. The past performance of any trading strategy or methodology is not indicative of future results, which can vary due to market volatility; it should not be interpreted as a forecast of future performance. You should carefully consider whether such trading is suitable for you in light of your financial condition, level of experience and appetite for risk, and seek advice from an independent financial advisor, if you have any doubts. Alpari (US), LLC is dually registered with the CFTC as a Futures Commission Merchant and Retail Foreign Exchange Dealer and has been a member of the NFA since 2007 - Member ID: 0379678. Alpari (UK) Limited is authorised and regulated by the Financial Services Authority (FSA) Registration Number 448002.