

7th February 2011

FX Weekly

Review: 31st Jan – 6th Feb 2011



Recap

- Inflation is quickly becoming the focus. Both developed and developing nations are facing increasing inflationary pressures but only a few central banks can afford to tighten policy at this stage in the recovery
- US Dollar was lower across the board (except against CHF) as continuing equity market strength, higher commodity prices, declining political risk and risk-tolerant market sentiment weighed on the Greenback
- Above target inflation and resulting speculation for a pre-emptive move by the ECB is talked down by ECB officials
- Sterling benefitted from a swathe of positive macro data. The likelihood for a significant revision to Q4 GDP is very high following last week's PMI figures in particular
- Egyptian political crisis not a significant factor for vast majority of asset classes although sudden and rapid escalation remains plausible

Currency pair	At Open on 31 st Jan.	At Close on 4 th Feb.	% Change	Week High	Week Low	Volatility
EUR/USD	1.3579	1.3580	0.01%	1.3861	1.3543	2.34%
GBP/USD	1.5828	1.6108	1.77%	1.6276	1.5820	2.88%
USD/JPY	82.14	82.16	0.02%	82.46	81.17	1.57%
USD/CHF	0.9416	0.9549	1.41%	0.9592	0.9327	2.81%
EUR/GBP	0.8575	0.8432	-1.67%	0.8618	0.8422	2.29%
EUR/CHF	1.2791	1.2969	1.39%	1.3036	1.2779	2.01%
GBP/CHF	1.4906	1.5383	3.20%	1.5409	1.4894	3.45%
GBP/JPY	130.02	132.37	1.81%	132.92	129.82	2.38%
EUR/JPY	111.56	111.59	0.03%	112.90	110.75	1.93%
CHF/JPY	87.12	86.01	-1.27%	87.44	85.36	2.39%
AUD/USD	0.9889	1.0135	2.49%	1.0199	0.9865	3.38%
NZD/USD	0.7690	0.7696	0.08%	0.7822	0.7663	2.07%
USD/CAD	1.0010	0.9871	-1.39%	1.0056	0.9830	2.26%

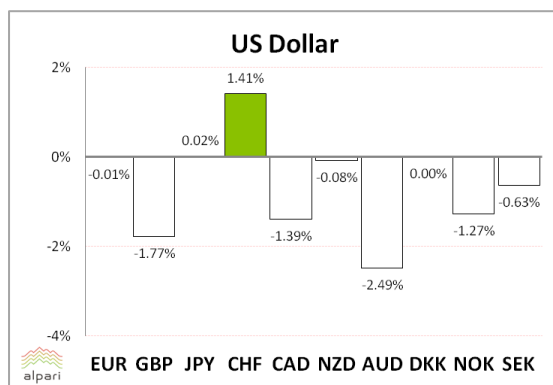
| Source: Alpari (UK)

USD

The US Dollar was lower across the board (except against CHF) as continuing equity market strength, higher commodity prices, declining political risk and risk-tolerant market sentiment weighed on the Greenback. Despite ongoing tension in Egypt, market reaction to the ongoing demonstrations and political unrest is gradually calming down. Economic impacts have been very minimal which explains the gradual descent of oil prices from above \$92 to below \$90 over the course of last week.

Strong ISM manufacturing (60.8 vs. 57.8 exp.), ADP (187,000 vs. 148,000 exp.), ISM Non-Manufacturing (59.4 vs. 57.2 exp.) and an unexpected 0.5% drop in the overall unemployment rate boosted confidence across equity and commodity markets. The benchmark CRB commodities index hit its highest level since September 2008 at 345.19.

The familiar pattern of a falling US dollar alongside strong US data is continuing. The rationale continues to be that low yielding USD investors are putting capital to work around



the World where yields are higher. This is favouring commodity currencies that are traditionally considered as risk-on i.e. AUD, CAD, NZD and Scandies.

The most keenly anticipated economic release was of course the non-farm payrolls employment report. The headline jobs number (36,000 vs. 138,000 exp.) was incredibly pessimistic considering the large

shortfall between actual and expected. Other macro data from the US has been indicating a robust recovery (ISM's, stable inflation, home sales). Market participants were quietly confident of a good jobs number that fits into the strengthening recovery story – but were disappointed by the headline number. However, a surprise drop in overall unemployment (9% vs. 9.5% exp.) was enough to convince market participants that the report was broadly positive for the US.

When looking at the report in greater detail, it's clear that weather-related effects were a large factor as 'persons not at work due to weather' was 700,000 compared to an average of 300,000 during the rest of the year. Employment in construction was down (-32,000) but other sectors added strongly; manufacturing (+49,000), retail (+28,000) and business services (+31,000) were all up.

The slightly unintuitive labour report created a lot of volatility upon its release due to the contradictory elements. Even still, analysts are in disagreement as to why overall unemployment is decreasing yet monthly additions are still meagre and well below the expected 100,000+ tallies needed to move US unemployment significantly lower. The participation rate has also remained stable so unemployment is not falling due to long-term unemployed people not being counted. Below is a brief comment from Barclays on the subject of the unemployment rate/headline number disparity:

'Some of the confusion in this report can be attributed to the inclusion of the annual population control effect as the officially reported statistics are net of this process. The published numbers show that household employment rose 117k. However, stripping away the effects of the population control effect that occurs once a year, household employment grew 589k and there was no change in the participation rate. When viewed in this light, the substantial drop in the unemployment rate appears consistent with the dramatic increase in m/m household employment. We therefore see significant potential strength in this report and will be looking to see whether the drop in the unemployment rate persists. If

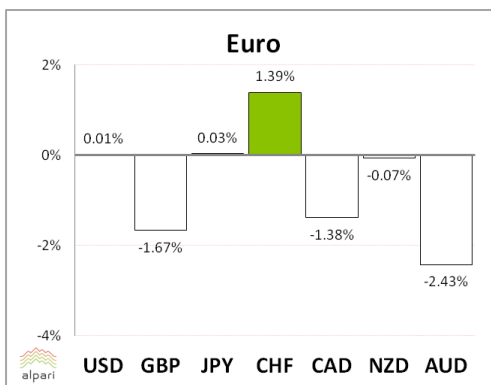
it does, then it will be a further signal that underlying job growth is stronger than reported and conditions in labor markets are better than advertised by the establishment survey'

– Barclays

EUR

An inline CPI estimate (2.4% vs. 2.4% exp.) took the spotlight off inflation in the early part of the week only to return on Thursday as the ECB kept interest rates unchanged. Financial markets had priced in significant rate-hike expectations in the days leading up to the meeting so an unforthcoming actual result led to a sell-off of speculative longs.

ECB members refrained from any hawkish comments last week despite growing market expectations that the ECB would intensify its anti-inflation stance. The ECB reiterated



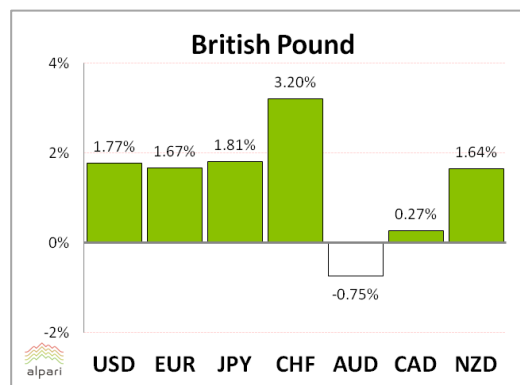
that current policy remains “appropriate” and despite “short-term upward pressure,” inflation risks are balanced. EUR/USD suffered as a result of comments made at the ECB press conference following the decision to leave interest rates unchanged at 1%. The Euro declined by over 100 pips as investors reduced bets on a pre-emptive increase in borrowing costs by the ECB. In a statement on Jan 13th the ECB promised to

raise borrowing costs if needed to contain inflation to maintain inflation at around 2%. The ECB’s attempts to control inflation are beginning to go awry – European inflation is now at its highest level for more than two years. In our view, European growth rates will be revised higher but so too will inflation rates. EUR/USD should benefit from the gradual shift in policy stance because of the rising yield premium between EUR and USD. Also, the ECB is a traditionally very hawkish central bank that is considered much tougher on inflation than the Fed.

GBP

Sterling benefitted from a swathe of positive macro data in the UK – helping Sterling to across the board gains.

The Nationwide HPI (-0.1% vs. -0.3% exp.) showed a smaller than expected decline in month-on-month house prices in the UK. However, the most uplifting factor for Sterling pairs was the immensely strong round of PMI numbers. Construction (53.7 vs. 49.8 exp.), Manufacturing (62.0 vs. 58.0 exp.) and Services (54.5 vs. 51.2 exp.) PMI’s were all very Sterling positive. More so because of what that would mean to the Q4 GDP revision at the end of February. Let’s

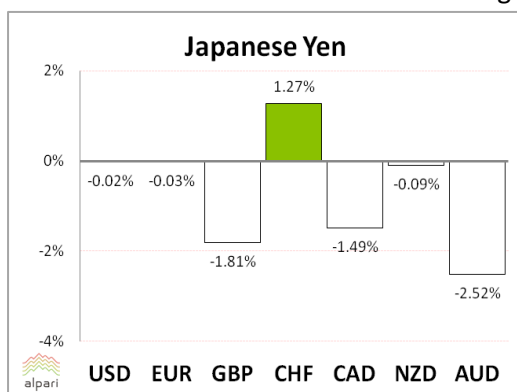


not forget the impact that had on all UK asset classes two weeks ago. Sterling pairs have rallied across the board last week as investors reconsidered the true impact of the Q4 negative GDP figure – strongest apperceptions were against CHF (+3.2%) and JPY (+1.77%) as geo-political concerns in Egypt eased.

UK Q4 growth was estimated to be negative on Jan 25th but macro data made available last week indicates that the UK manufacturing sector grew at its fastest pace since the early 1990's. The abnormally cold weather in December 2010 has had a severe impact on economic activity in the UK but whether that translated into negative growth remains to be seen. Market participants are gradually increasing their bets that the Q4 GDP number will be revised significantly higher at the end of February. In the meantime, any upbeat UK data is being seized upon as good buying opportunities at discounted levels. It's worth remembering that the latest MPC minutes published January 26th, indicated a shift towards a more hawkish stance with Martin Weale changing his prior position and voting for a hike – this was prior to the GDP data being known by the MPC and also prior to the latest round of PMI data. We think the BoE will hike 25bp on March 10th if Q4 GDP is revised above 0% on February 25th.

JPY

A severe lack of macro data ensured the Yen traded in line with broader global themes. Bouts of risk aversion were evident throughout last week as the Egyptian political crisis

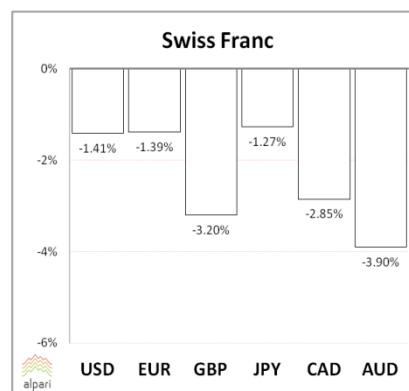


meandered through various stages of confidence as to whether a new political regime would be set up without large-scale damage to the domestic economy. The most important issue for G20 FX and FX investors is whether the hugely important trade route through the Suez canal affected and whether Egyptian instability spreads to neighbouring countries in the region. Either

development would increase risk-averse capital flows into the US dollar, Yen and Swiss Franc

CHF

The Swissie had one of its worst performances in the G20 space for many months. Across the board declines were helped not only by a slow outflow from risk-averse investments due to the diminishing effect of the political protests across Egypt but also because of a shock decline in retail sales (-0.4% vs. 2.6% exp.). The Swissie has experienced strong appreciation against the Euro over the past two years and SNB attempts to intervene in EUR/CHF as and when deflationary pressures begin to surface could give way for more surprise SNB action over next few months.



Others

The RBA kept its key cash rate unchanged at 4.75%. In their commentary, the RBA said keeping policy unchanged was “appropriate” for now and would look past the temporary impact of the floods in Queensland. The bank also said that it expects to meet its inflation target of 2-3% citing the highest terms of trade since the 1950’s and business investment picking up in response to high and still rising commodity prices. In the eyes of the RBA the flood damage suffered in Queensland would only drag on Australian growth for Q1 because of the large rebuilding programmes being initialised. The RBA also cited muted underlying inflation which is providing extra breathing room to leave interest rates unchanged for the time being. We think the RBA will be extremely vigilant going forward so despite policy action not being expected until Q2 or Q3, we think a knee-jerk reaction by the RBA is likely if price pressures continue to show.



Preview: 7th – 13th February 2011

Looking ahead

- BoE interest rate decision is the highlight of the week given the huge event risk associated with the BoE at the current time
- A further 30% of the S&P 500 reports this week. Around 70% of reporting firms have beat earnings estimates. Strong US earnings have been very USD negative up until now. As Q4 earnings season comes to an end stay weary of USD relief rally
- In the US, prime focus will be on US debt auctions and the January budget statement (both due on Thursday). In Europe, the focus is Spanish GDP and Industrial Production estimates from Europe's core
- Chinese NY holiday period comes to an end this week
- Commodity prices and inflation remain the key macro themes. Relative interest rate policy amongst the G20 deserves closer scrutiny as frequency of policy action amongst G20 central banks looks to increase sharply over the next 6 months

This coming week the focus is squarely on the UK once again. The BoE is due to announce its latest policy decision on Thursday and given the fireworks seen in UK macro data over the past few weeks, a surprise hike isn't out of the question. All talk of tighter policy was vanquished after a negative Q4 GDP figure (-0.5% vs. 0.5% exp.) on January 25th. Since then, strong housing data, PMI's set against a backdrop of persistently elevated inflation have resurrected widespread calls for the BoE to act pre-emptively ahead of market expectations. In the recent past, the BoE has often surprised against all expectations which indicates a willingness to act even if that action creates adverse volatility in the financial markets.

In our view, it's a 50/50 call whether the BoE will raise interest rates or keeps them unchanged. According to implied futures prices, the market is pricing in a 20% chance of a rate cut this week and a 100% chance of a hike by the meeting on May 5th.

The ongoing political crisis in Egypt continues to remain in the background as an active theme for G20 FX. At first, when news first broke about large scale instability in Egypt, oil prices felt the most impact followed by safe-haven flows into USD, CHF and JPY. However, despite ongoing tension, violence and media attention, the economic impact of the Egyptian protests remains limited and manageable. Although Egypt as a nation will suffer hugely as result of lost tourism, infrastructure damage, lost foreign investment etc, the broader impact on G20 currencies has been almost non-existent since this issue originated 10 days ago. At most we have seen sporadic rallies/sell-offs, primarily in USD pairs on the back of individual news items such as President Mubarak's statement to the public last Tuesday. It is highly unlikely that severe economic consequences occur unless global trade routes are affected (Suez canal) and/or the wider region suffers similar instability, damage and unrest – even then, this would only be significant if the supply of oil is disrupted either via physical damage to pipelines/shipping routes or via political regime change that causes friction with US authorities. A repeat of the 1970's oil embargo or something of similar nature is essentially the worst case scenario. In our view, Egypt is



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unlikely to destabilize significantly within a short period of time but should still be monitored closely for developments.

FX Sensitive Calendar Events

<u>Monday 7th February</u> (CNY) Bank Holiday (AUD) Retail Sales (EUR) German Factory Orders (JPY) Bank Lending (JPY) Current Account	<u>Tuesday 8th February</u> (CNY) Bank Holiday (CHF) Unemployment Rate (EUR) German Industrial Production (CAD) Housing Starts
<u>Wednesday 9th February</u> (EUR) German Trade Balance (GBP) Trade Balance (USD) Crude Oil Inventories (JPY) Core Machinery Orders	<u>Thursday 10th February</u> (AUD) Unemployment Rate (CNY) Trade Balance (CHF) CPI (GBP) Manufacturing Production (GBP) Industrial Production (GBP) Interest Rate Decision + Statement (USD) Unemployment Claims (USD) Federal Budget Balance (NZD) HPI
<u>Friday 11th February</u> (JPY) Bank Holiday (GBP) PPI (CAD) Trade Balance (USD) Trade Balance (USD) Michigan Consumer Sentiment	<u>Saturday 12th February</u> N/A
<u>Sunday 13th February</u> (NZD) Retail Sales (JPY) GDP	

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