

14<sup>th</sup> February 2011

# FX Weekly

## Review: 4<sup>th</sup> – 11<sup>th</sup> February 2011



### Recap

- Oil prices fell dramatically to close last week at \$85.32 after Egyptian President Hosni Mubarak resigned and handed power to the military, easing concerns over the disruption of crude-oil supplies from the Middle East
- Despite improving macro-data, the Fed re-iterated its ultra-low policy stance. Earliest policy tightening likely to be early 2012
- BoE passed up the chance for an ahead-of-the-curve rate hike as Inflation Report looms this coming week
- Portuguese long-term bond yields reached record highs. The broad issue of EFSF/IMF/EU funding may not wait until March to be resolved if market speculators push Portuguese yields to the brink
- Surprise PBOC policy action (+25bp) taken in their stride by market participants. China remains on a clear and long-term tightening phase

Currency pair	At Open on 31 <sup>st</sup> Jan.	At Close on 4 <sup>th</sup> Feb.	% Change	Week High	Week Low	Volatility
EUR/USD	1.3569	1.3548	-0.15%	1.3744	1.3497	1.82%
GBP/USD	1.6097	1.5998	-0.62%	1.6184	1.5962	1.38%
USD/JPY	82.26	83.38	1.36%	83.66	81.77	2.30%
USD/CHF	0.9560	0.9729	1.77%	0.9774	0.9523	2.63%
EUR/GBP	0.8428	0.8458	0.36%	0.8529	0.8388	1.67%
EUR/CHF	1.2971	1.3180	1.61%	1.3204	1.2930	2.11%
GBP/CHF	1.5387	1.5573	1.21%	1.5620	1.5330	1.88%
GBP/JPY	132.41	133.49	0.82%	134.24	131.57	2.02%
EUR/JPY	111.61	112.99	1.24%	113.43	111.23	1.97%
CHF/JPY	86.02	85.69	-0.38%	86.29	85.22	1.24%
AUD/USD	1.0134	1.0015	-1.17%	1.0188	0.9960	2.25%
NZD/USD	0.7692	0.7600	-1.20%	0.7786	0.7552	3.04%
USD/CAD	0.9873	0.9869	-0.04%	0.9987	0.9857	1.32%

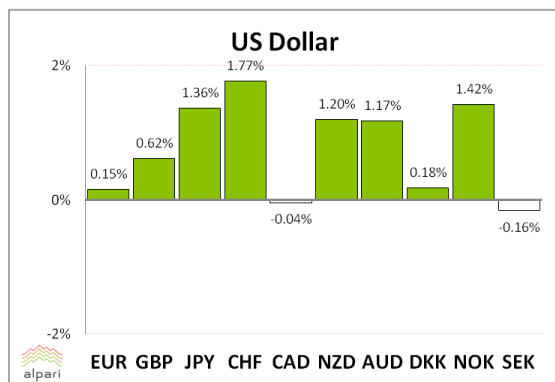
| Source: Alpari (UK)

### USD

The Egyptian political crisis managed to exert some effect on FX rates last week. Mubarak's refusal to stand down as President contrary to popular opinion gave global equity indices a jolt and heightened fears of broader instability in the region. Commodity prices have been sensitive to events ongoing in Egypt (especially oil) since the end of January. Asian stocks fell more than 1% with some indices taking their heaviest losses for nine months; in the US, the S&P 500 managed to hold above 1,300 - falling as low as 1308.47 before recovering to close above 1,327. The strong lift in equities came on the back of a public resignation by Mubarak. The issue has ebbed away somewhat as media attention focused on celebrations and chickens being counted but the realisation over the weekend that Egypt remains in a

transitional state with an evident quasi power-vacuum has led to heightened USD demand in the early part of this week. This nervousness should persist in the short-medium term as 6 nations report CPI figures - India, China, Canada, UK, US and Sweden. Assuming inflation remains a topical issue because of rising commodity prices and stronger than expected recovery rates in the developing world, exposure to currencies where domestic markets are overheating is likely to be most effective.

In the US last week, the lack of significant macro data intensified the focus on Ben Bernanke (Fed Chairman) as he made a crucial speech to the House Budget Committee. Following a puzzling employment report on Jan 4<sup>th</sup> market participants were keen to gauge what flat job growth alongside a falling rate of unemployment actually means for the US economy.



What we were looking for in the speech was how the chairman characterized the sharp drop in the unemployment rate in December and January. He said that the decline in the unemployment rate and "improvement in indicators of job openings and firms' hiring plans" provide "grounds for optimism on the

employment front."

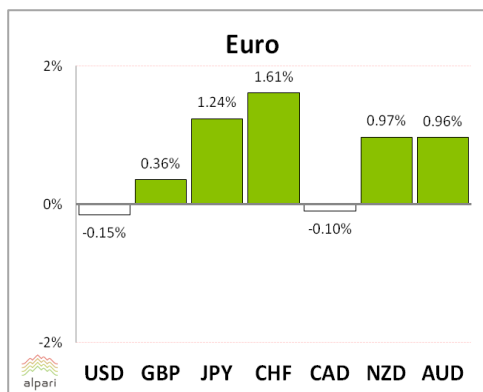
Bernanke also said: the unemployment rate probably will remain elevated for some time" and "inflation is expected to persist below" the levels the Fed sees as consistent with its mandate". In Fed speak this means that it will be several years before the unemployment rate returns to a more normal level and a sustained period of job creation is needed to ensure the durability of the recovery. In short, Bernanke didn't dismiss the decline in unemployment as an anomaly, but by the same token, he remains focused on headline payroll employment.

Despite heightened anticipation of the speech, Bernanke refrained from altering comments he made earlier this month. We were expecting to hear re-affirmation that the Fed remains in ultra-loose mode – and this was the broad tone of the speech. Bernanke reiterated his core view that the Fed should be patient and accommodative despite the better-than-expected macro data observed in recent months.

## EUR

The ECB President, Jean Claude Trichet indicated that the Euro-zone needs stricter rules on budgets and other elements of economic policy and "an appropriate economic union" to function properly.

The Portuguese 10yr bond yield climbed to its highest level since the launch of the Euro last week after the European leaders meeting in Brussels failed to establish concrete plans



for ongoing reform - delaying the final outcome until March 24<sup>th</sup>. Demand for peripheral sovereign debt remains a key price driver for all EUR pairs as investors continue to monitor the persistent debt problems in Europe, in wait for a viable, long-term solution.

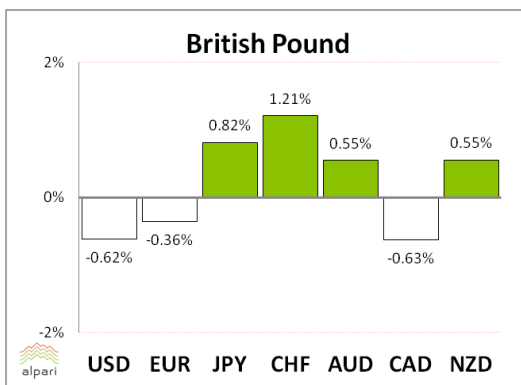
An unexpected fall in German IP (-1.5% vs. 0.2% exp.) capped EUR gains against the US Dollar. Despite the figure and nervousness surrounding peripheral sovereign debt, risk tolerance remained high allowing equities to post fresh multi-year highs.

A factor that came out of nowhere and punished EUR pairs across the board was the shock exclusion of Axel Weber as future ECB President. Currently the head of the Bundesbank, Axel Weber is considered to be a strong hawk on the ECB board and was thus seen as a direct source of confidence for Europe and the Euro. Considering the ongoing crisis in Europe's periphery, Weber was likely to be a steady hand in a rough storm. EUR/USD sold off rapidly on the news. A range of candidates will now vie for the ECB's top spot. Each candidates' preferred core policy stance may influence investor opinion of the Euro and any firm announcement may lead to EUR rallies (if hawkish candidate is selected) or EUR declines (if dovish candidate is selected).

## **GBP**

Inflation concerns were the theme for GBP pairs last week and it remains so this week as the BoE is due to publish its eagerly awaited Inflation Report on Wednesday. Last week, inflation concerns rose as UK PPI (1.7% vs. 1.3% exp.) indicated the fastest pace of UK factory gate inflation for over two years. Britain's 'high inflation without strong growth' problem is being attributed to imported inflation via commodity prices rather than domestic causes. BoE

polymakers will be concerned because the inflation is becoming a problem for business and consumers alike.



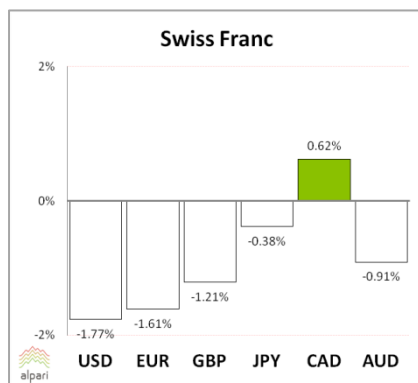
In our view, persistent consumer inflation above the BoE's target rate is slowly beginning to augment future inflation expectations. Also, BoE assurances that inflationary effects would fade after the financial crisis have not rung true. This week's CPI estimate is likely to show further upside pressures on prices – Y/Y inflation is

currently 3.7% but a print above 4% is very likely according to a mean average of analyst expectations.

The BoE left interest rates unchanged last week, the APF was also kept unchanged at £200bn. The BoE is clearly hesitant about taking pro-active steps ahead of the market on interest rates. The thinking seems to be that if rates were raised, the current level of UK GDP growth would be too anaemic to avoid deflationary effects. Market participants have not taken the BoE at face value however and see a 60% chance that the BoE will raise interest rates by 25bp at its next meeting on March 10<sup>th</sup>.

## CHF

With tension in Egypt fading away as an active FX theme, runs into the Dollar, Yen and Swiss Franc are subsiding. The overall impact of political unrest in Egypt has been localised so effects on major currencies have been fairly minimal. The Swissie lost more ground last week against its G20 counterparts. Heaviest losses were against USD (-1.77%) and EUR (-1.61%).



The global risk-profile wasn't helpful for CHF pairs while further downside was induced due to a very unexpected fall in month-on-month inflation (-0.4% vs. -0.1% exp.). For us, the surprise was the fact that commodity price pressures are not being felt as much as in other territories (e.g. UK). The SNB could not justify a hike in Q1 on the back of such a weak headline CPI figure although a negative number was expected. Probably the most important aspect for the SNB will be the lack of feed-through from headline to core

inflation. Core inflation remains subdued and within the SNB's remit because volatile components such as food, energy, fuel as well as other seasonal products are excluded. Intervention in EUR/CHF is a long-shot given the stability in core inflation.

## OTHERS

The PBOC surprised all market participants with a 25bp rate hike, taking the official Chinese rate to 6%. This was the second increase in just over a month and indicates the PBOC doing all it can to cap inflation effects. Despite the shock value of the announcement, market participants were largely expecting further PBOC tightening so the price action wasn't incredibly volatile. Investors were quick to understand that the PBOC hike is actually a positive sign because the Chinese economy is growing strongly thus requiring adjustment – rather than hiking because they have lost control of inflation in a desperate attempt to contain rapid growth. Going forward, further rate hikes are likely as part of a normal tightening phase within the business cycle.

Very interestingly, last week's hike comes at a time when macro data is outperforming across the globe; compared and contrasted to last year when China was being seen as the primary avenue of world economic growth. Consequently, any meaningful Chinese slowdown and/or overly hawkish policy have a good chance of being offset by other nations with strong rates of recovery.

## Preview: 14<sup>th</sup> – 21<sup>st</sup> February 2011

### Looking ahead

- Bond auctions take centre stage – Belgium (Tuesday), Portugal (Wednesday) and Spain (Thursday). Speculative attempts to destabilise Portuguese bonds are possible and likely
- Two key interest rate decisions: Bank of Japan and Riksbank. BoJ will stay on hold while Riksbank should hike 25bp
- UK Inflation report and CPI data will probably show upward revision to inflation and downward revision for GDP growth – GBP pairs likely to see higher volatility
- In the US - CPI, Fed Minutes, IP and Housing data are the key macro data readings
- G20 Meetings in Paris may have an effect on G20 FX if the US/China currency war spat is re-kindled or action is announced to combat rising oil prices. If political uncertainty in Egypt persists, economic uncertainty is almost sure to follow

At the start of this week it was the Euro's turn to take centre stage. EUR/USD has shed 0.5% in the first trading session of the week following the London open on Sunday. Investors are incredibly vigilant given the mass of EUR themes in play. Peripheral bond auctions are anticipated to be crucial for investor confidence and considering that last week we saw quasi-speculative attacks on Portuguese government bonds, it is a possibility that an auction on the weaker side prompts further pressure from speculators. The EFSF/EU/ECB may be called upon if yields rise/prices fall too far, too quickly. Also, rumours of a rescue plan for German bank WestLB have added to existing concerns about European banks.

Event risk is present for SEK traders as we expect the Riksbank to resume with its series of rate increases. We see a 0.25% hike as almost certain. In addition to the announcement, the Riksbank will be publishing an updated Monetary Policy Report on Tuesday. The report is likely to indicate or at least hint that policy expectations have changed (so market participants should expect more hikes over the next 12-18 months).

We see the current interest rate in Sweden rising to 3.0% before the end of 2011 and up to 4.75% in 2012. Sweden has largely avoided the effects of the financial crisis and has even managed to avoid large-scale fiscal adjustment that's been so gravely needed in other nations. A slowdown in economic activity due to weakness in Europe for example poses a risk to this view. Swedish economic data will have added importance in the meantime. Equally, excessive SEK strength could also weigh on economic growth and prosperity leading to questions being raised about the practicality of tightening monetary policy too soon.

In the past month China, Indonesia and India have all raised interest rates as a way of combating inflation and maintain stable inflation expectations. The problem facing the UK for example and other developed economies alike is inflationary effects without the growth to show for it. Current inflation is mostly cost-push driven from the supply side. It is not demand led which means taming inflation when demand is weak would only mean a larger financial burden for consumers, especially mortgage-holders.



### Market Research

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The likely beneficiaries of the seemingly all encompassing inflation outlook that's pervading most G20 economies are the risk-on currencies such as NZD, CAD, AUD, Scandies and potentially the Euro if other factors don't interfere. On the other side of the spectrum are countries that are likely to be languishing in negative real interest rates for some time and thus should take comparatively longer to attract investor capital flows (USD, GBP). The Fed is most likely to tolerate higher inflation over the next year which more or less cements negative real interest rates in the US at least until the start of 2012.

Positive real interest rates, GDP growth, stable but rising inflation and hawkish policy are the prime conditions for currency appreciation – emerging economies are closer to meeting these conditions (or they've already met them) than developed nations are which explains the broad based appreciation of commodity currencies against traditional alternatives such as USD, CHF, JPY, GBP over the course of this recovery since 2009.

The Eurogroup meets on Monday and the broader Ecofin on Tuesday. Setting a firm fiscal framework will be the focus. Some form of agreement will be seen as a strong positive by market participants in the long-term and could even induce a good-will rally in the short-term as investors breathe yet another sign of relief. However, unless we see a direct change to the EFSF's modus operandi, G20 FX is unlikely to be affected significantly. The size (amount) and scope (type of asset class) of EFSF buying is the key. A resolution is most likely in March but an agreement now is possible. If the scheduled European auctions don't proceed smoothly, tension will be high amongst European policymakers to find a quick, firm solution to the European sovereign debt problem. We could see hasty action on behalf of European Finance Ministers and Central Bankers if market rumours and opinion take the same course as they did with Greece and Ireland in 2010.

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**FX Sensitive Calendar Events**


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<u>Monday 14<sup>th</sup> February</u> (AUD) Home Loans (CNY) Trade Balance (CNY) New Loans (EUR) Industrial Production (USD) Mortgage Delinquencies	<u>Tuesday 15<sup>th</sup> February</u> <i>ECOFIN Meetings</i> (AUD) RBA Monetary Policy Meeting Minutes (CNY) CPI (CNY) PPI (CNY) FDI (JPY) BoJ Interest Rate Decision + Statement (EUR) French / German GDP (GBP) CPI (GBP) RPI (EUR) German ZEW Econ. Sentiment (EUR) GDP (EUR) European ZEW (USD) Retail Sales (USD) TIC Long-Term Purchases
<u>Wednesday 16<sup>th</sup> February</u> (GBP) Nationwide Consumer Confidence (GBP) Claimants Count Change (GBP) BoE Inflation Report (USD) Building Permits (USD) PPI (USD) Fed Meeting Minutes	<u>Thursday 17<sup>th</sup> February</u> (EUR) Current Account (USD) CPI (USD) Unemployment Claims (USD) CPI (EUR) Consumer Confidence (USD) Philly Fed Manufacturing Index (JPY) BoJ Monetary Policy Minutes
<u>Friday 18<sup>th</sup> February</u> <i>G20 Meetings</i> (GBP) Retail Sales (CAD) CPI	<u>Saturday 19<sup>th</sup> February</u> <i>G20 Meetings</i>

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