

21st Febraury 2011

FX Weekly

Review: 14th – 20th February 2011



Recap

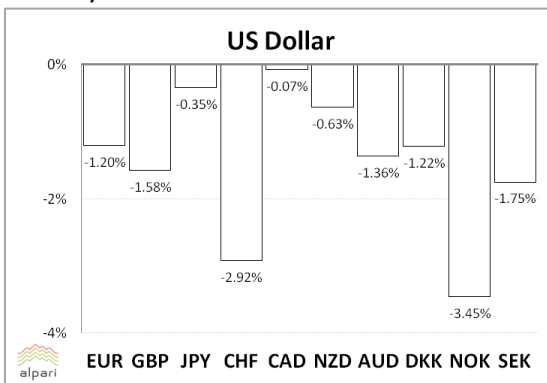
- The G20 meetings failed to produce anything concrete and deferred any market-moving developments until April
- In Germany, the CDU party's heavy defeat in Hamburg over the weekend has provoked a gentle fall back in risk-tolerance
- Three major themes are in play – Emerging Market inflation, Middle-Eastern politics and lingering peripheral stress in Europe
- Market pressure on BoE to act in the name of reputation was resisted although three rate hikes are still priced in

Currency pair	At Open on 14 th Feb.	At Close on 18 th Feb.	% Change	Week High	Week Low	Volatility
EUR/USD	1.3528	1.3691	1.20%	1.3714	1.3428	2.11%
GBP/USD	1.5998	1.6250	1.58%	1.6262	1.5981	1.76%
USD/JPY	83.46	83.17	-0.35%	83.97	83.02	1.14%
USD/CHF	0.9728	0.9444	-2.92%	0.9744	0.9435	3.18%
EUR/GBP	0.8455	0.8424	-0.37%	0.8455	0.8355	1.18%
EUR/CHF	1.3161	1.2932	-1.74%	1.3202	1.2894	2.34%
GBP/CHF	1.5562	1.5349	-1.37%	1.5691	1.5321	2.38%
GBP/JPY	133.53	135.15	1.21%	135.51	133.17	1.75%
EUR/JPY	112.90	113.88	0.87%	113.92	112.08	1.63%
CHF/JPY	85.77	88.01	2.61%	88.05	85.36	3.14%
AUD/USD	1.0008	1.0144	1.36%	1.0157	0.9943	2.14%
NZD/USD	0.7566	0.7614	0.63%	0.7655	0.7505	1.98%
USD/CAD	0.9873	0.9866	-0.07%	0.9902	0.9775	1.29%

| Source: Alpari (UK)

USD

A fairly turbulent week with few trends holding up in G20 FX crosses. News flow and



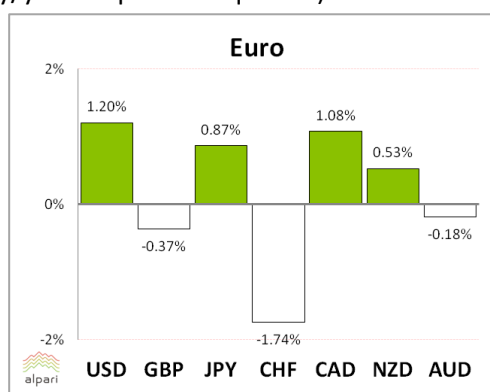
sentiment has been very mixed across the developed world whereas macro-data from EM countries has tended to outperform expectations. Last week, several key data releases swayed market opinion. Retail sales figures (0.3% vs. 0.6% exp.) were disappointing whereas CPI beat expectations (0.4% vs. 0.3% exp.) which set the mood for mixed and choppy USD trade.

Fed minutes from their late January meeting were made available although nothing new was mentioned in the official text. An issue which may come back as an active theme was the news of fresh stress tests planned to be imposed on US banks prior to additional liquidity measures being withdrawn. The Fed is seemingly attempting to test whether US banks can take the strain as capital is returned to investors thus putting untimely pressure on bank balance sheets given the ongoing recovery.

EUR

The sovereign debt crisis lingers on with a concrete solution still only on the horizon. European policy makers expect to present a firm plan by the end of March 2011. In the meantime, indicators that shed light on Europe's ability to stabilize its periphery are getting a lot of attention.

Greek GDP figures (-6.6% y/y, from -5.7% y/y in the previous quarter) indicated to market participants that the austerity measures imposed in Greece (and elsewhere) have drastically affected economic prosperity. This is compared to a 4.52% decline in 2010. On a quarterly basis, Greece shrank 1.4% in Q4 2010. For the Euro, the 'Greek effect' is minimal because Greece makes up only about 3% of total European GDP whereas the 'contagion effect' has been very actively weighing on EUR pairs.



Spain approved a law on bank capital requirements. The law gives savings banks (Cajas) until September to clarify any plans regarding additional capital and sets a minimum core capital requirement of 8% for listed banks and 10% for savings banks. Regardless of what decisions are made, weaker banks will continue to struggle and could potentially require further assistance. Debt is simple to acquire but very difficult to eradicate once there is too much of it. The probability of a Spanish institution requiring central bank intervention at some stage in the next year is high which is likely to act as a weight for the Euro.

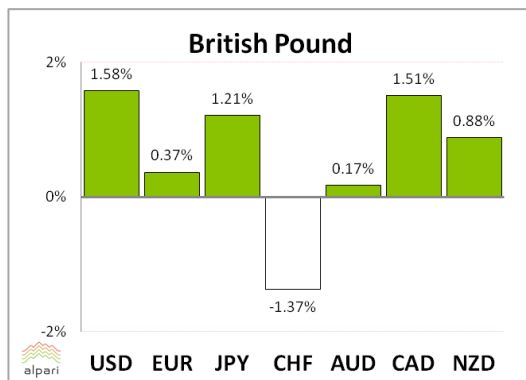
By the end of the week the Euro was broadly higher in most pairs – the largest gain was against USD (+1.20%) while the largest loss was against CHF (-1.74%). The EUR/CHF pair was particularly volatile last week as the SNB stepped in to artificially intervene in the value of the Swissie. The primary reason was most probably excessive CHF strength.

GBP

UK CPI figures were in line with expectations and prevented additional speculation about an imminent interest rate rise. The headline rate rose from 3.7% to 4.0%, but wasn't higher than consensus. The fact that CPIY (CPI excluding tax effects) has now risen above the BoE's 2% target is probably providing BoE members with a juicy topic of conversation. Once food and energy effects are excluded, inflation is much lower

but crucial assumptions such as a strengthening GBP and an abatement of commodity price increases seem quite hopeful.

Despite inflation being on the offensive and potentially rising further in the UK, it should nevertheless slow to some degree before the end of the year because of



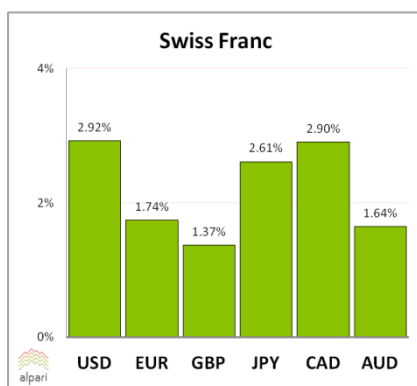
medium-term factors like wage growth, money growth and spare capacity all having more than enough slack to absorb the inflationary effects thus capping any potential rise in inflation.

UK growth was revised lower and inflation was revised higher in the Quarterly Inflation Report. This was a toxic combination for GBP pairs although

Sterling finished the week broadly higher across the board in G20 FX – largest gains were against USD (+1.58%) and the largest loss was against CHF (-1.37%).

Also, retail sales data (1.9% vs. 0.6% exp.) was stronger than expected despite the downward revision to December's figures. Trying to discern underlying trends from retail sales data at this time of year is incredibly difficult given the large amount of seasonal effects in play.

CHF



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Others

The Riksbank raised interest rates in line with expectations (+25bp) as expected last week. The fifth increase in a row ensures inflation stays within target as economic growth remains robust. The Riksbank also raised its forecasts for future rates, saying "the repo rate would need to be raised somewhat faster in the coming period" to contain inflation.

A key point for us is that the Riksbank is sticking to its earlier assessments and its estimates are not far off the mark in terms of accuracy. This adds to central bank credibility. Forecasts for 2012 and 2013 in terms of both policy rates and GDP performance have been raised. The central bank said it expected inflationary pressures to rise as wages increased at a faster rate and spare capacity in the economy declined.

Preview: 21st – 27th February 2011



Looking ahead

- Three major themes are in play – Emerging Market inflation, Middle-Eastern politics and lingering peripheral stress in Europe Middle East tensions escalated over the weekend with fresh political unrest growing
- As earnings season winds down (80% of the S&P has reported), markets focus on a heavy data calendar and policy events in Europe
- Highest risk of adverse price moves and elevated volatility is with the commodity currencies - CAD, AUD, NZD, ZAR, RUB, BRL in USD and JPY pairs
- Next Wednesday's BoE minutes fully in focus for the voting split which the street will closely analyse. Revision to shocking Q4 2010 GDP figure is expected.
- In the US, focus is on the housing sector as new and pending home sales figures are due
- German six states CPI on Friday will also be key ahead of Euro area flash CPI on March 1 and the next ECB meeting on March 3
- There are no significant Chinese data due during the week, but Singapore and Malaysian CPI on Wednesday will shape the broader Asian inflation outlook

Bank of England publishes minutes from its February 10 meeting. The December 2010 vote was 1-7-1 (Posen, Sentence dissent), and the January 2011 count 1-6-2 (Posen, Sentence and Weale dissent). This week's inflation report left any outcome possible for the MPC, and only the minutes can inform whether additional members have shifted in favour of hikes.

Middle East tensions escalated over the weekend with fresh political unrest growing - following on from Egypt, Libya, Bahrain, Yemen and Iran are now firmly in the media spotlight as protests push for political change in the region. Economic effects have been limited to fearful risk-off plays for now without any severe price shocks. The important element is crude oil supplies which may be restricted given the scale of the political unrest as well as the fact that oil is usually used as a bargaining chip for most matters in the region.

On several occasions over the past few months EM inflation and capital controls have threatened major currencies through two channels: risk of a global slowdown due to higher interest rates, which in turn could force an unwind of dollar-funded carry trades; and slower capital inflows or even capital outflows from emerging markets which could reduce reserve accumulation and recycling into non-dollar currencies, particularly the euro.

But they do underline the difference in view between the Fed and ECB about how to treat commod price inflation. The ECB is just a lot more hawkish. It takes years of inflation above 3% for the BoE to show signs of worry, a couple of months above 2% and the ECB lays down the law. This is likely to matter increasingly going forward and illustrates one of the cornerstones of our positive EUR/USD view: Fed policy will remain loose, the Europeans in general are much more likely to act. It's not going to kick in immediately but this will be a key theme for FX in 2011.

Foreign official purchases of US assets have fallen dramatically since QE was launched, to net sales of \$9bn per month on the TIC data and to purchases of only \$13bn per month on the modified Fed custody data.

FX Sensitive Calendar Events

Monday 21 st February (USD) Bank Holiday (GBP) Rightmove HPI (EUR) French & German Manufacturing PMI (EUR) French & German Services PMI (EUR) German IFO (EUR) EU Manufacturing PMI (EUR) EU Services PMI	Tuesday 22 nd February (NZD) Inflation Expectations (CHF) Trade Balance (GBP) Public Sector Net Borrowing (CAD) Retail Sales (USD) CB Consumer Confidence (JPY) Trade Balance
Wednesday 23 rd February (AUD) Construction Work Done (CHF) PPI (GBP) BoE Monetary Policy Minutes (GBP) BBA Mortgage Approvals (EUR) Industrial Orders (USD) Existing Home Sales	Thursday 24 th February (AUD) Private Capital Expenditure (GBP) Nationwide HPI (CHF) Employment Level (USD) Durable Goods Orders (USD) Unemployment Claims (USD) New Home Sales (USD) Crude Oil Inventories (JPY) Tokyo CPI
Friday 25 th February (EUR) German CPI (GBP) Revised GDP (CHF) KOF Economic Barometer (USD) GDP	

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