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Fundamental | FX

7th March 2011

FX Weekly

Review: 28th February – 6th March 2011

Recap

- Expected yield differentials between Europe and other nations overpowered the ongoing geo-political theme that's supporting USD, CHF, Oil and Gold
- RBA kept rates on hold as expected, with AUD broadly weaker across the G20
- Strong set of US employment reports (ADP & non-farm payrolls) helped the USD; EUR/USD remains in buy-dips mode as key 1.40 level is tested in early Monday morning trade
- ECB maintains its 1% benchmark rate but outlook for future policy changed drastically as ECB press-conference blew the doors open to rate hikes on April 7th and/or May 5th

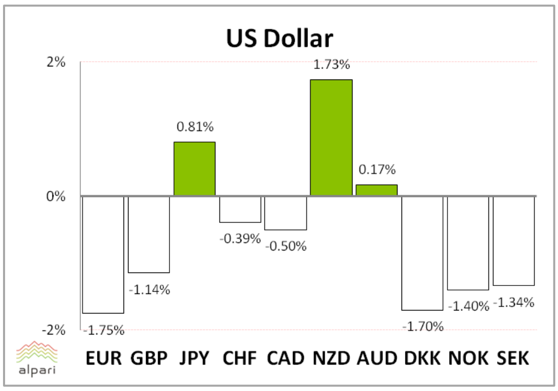
Currency pair	At Open on 28th Feb.	At Close on 6th Mar.	% Change	Week High	Week Low	Volatility
EUR/USD	1.3746	1.3986	1.75%	1.4006	1.371	2.15%
GBP/USD	1.6082	1.6266	1.14%	1.6343	1.6070	1.70%
USD/JPY	81.65	82.31	0.81%	83.05	81.56	1.82%
USD/CHF	0.9280	0.9244	-0.39%	0.9328	0.9200	1.38%
EUR/GBP	0.8546	0.8596	0.59%	0.8606	0.8459	1.72%
EUR/CHF	1.2759	1.2932	1.36%	1.3025	1.2725	2.35%
GBP/CHF	1.4924	1.5037	0.76%	1.5199	1.4904	1.98%
GBP/JPY	131.34	133.89	1.94%	135.17	131.25	2.98%
EUR/JPY	112.27	115.12	2.54%	115.96	111.95	3.57%
CHF/JPY	87.99	88.99	1.14%	89.26	87.87	1.58%
AUD/USD	1.0153	1.0136	-0.17%	1.0201	1.0074	1.25%
NZD/USD	0.7509	0.7379	-1.73%	0.7551	0.7336	2.86%
USD/CAD	0.9781	0.9732	-0.50%	0.9787	0.9682	1.07%

| Source: Alpari (UK)

USD

The US dollar was on the back foot last week, only managing gains against an earthquake hit NZD and structurally weak JPY. Macro data was very mixed as housing data highlighted a very dislocated recovery. Pending sales of previously owned U.S. homes fell faster than expected in January to the slowest pace in three months (-2.8% vs. -2.2% exp.). The continuing slack in the US housing sector is by some measures hampering the transition from weak growth into a stronger recovery backed by higher interest rates – inflation is also very subdued which makes US monetary policy a very mixed bag. Although sentiment, confidence and future expectations are broadly positive and improving, actual macro-data isn't supporting that confidence. Affordability has come down and interest rates but a lack of sufficient bullishness in the labour sector is pulling back on spending/investment decisions.

Two PMI surveys released last week were both upbeat. Manufacturing PMI (61.4 vs. 60.9 exp.) and non-manufacturing PMI (59.7 vs. 59.6 exp.). Offering no hint that he was considering cutting short the Fed's $600bn stimulus, Ben Bernanke told the Senate Banking Committee he saw increasing evidence that the US economic recovery was becoming self-supporting. At the same time, he warned job growth remains far too anemic. The manufacturing sector grew at its fastest pace since 2004 but significant challenges remain. Manufacturing is only a small portion of the U.S. economy which makes its economic impact more significant in terms of sentiment rather than actual price action within a trading environment.



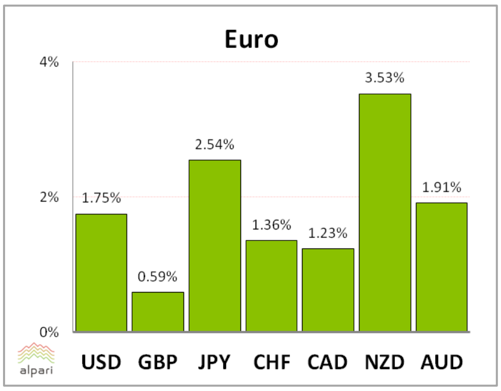
In our view, the lack of a consistent upward trend in US macro-data simply reflects the unstable path of recovery we've been seeing for the past 18 months. Recovery is ongoing as evidenced by equity market prices, gradual increases in employment and fairly strong consumer demand. In our view, we are starting to see the services sector catch up to the manufacturing sector in terms of growth, output and jobs created. Interest rates and their expectations have not been yet been affected but stock market prices have. Over the next 3-6 months, we expect US data to continue firming and in turn should induce higher rate expectations – if this scenario unfolds, we could see a strong inflow back into USD in search of higher yields on USD. The USD/JPY rate should see a natural retracement from its historic lows in this scenario.

The most significant bit of macro news from the US was the announcement of US non-farm payrolls data (192,000 vs. 190,000 exp.) in addition and contrasted with ADP data earlier in the week (217,000 vs. 178,000 exp.). US businesses hired the most workers in one month since May 2010, with the unemployment rate falling to a two year low of 8.9% - a hugely important psychological factor for the US economy. The net addition to the private sector was 222,000, higher than expected and confirmed a strengthening recovery in the private sector. February's bounce in employment after payrolls were depressed by extreme weather in January failed to sway the Fed from its currently loose policy path. Market participants are aware that the US recovery is burgeoning but the support for the US dollar has been lacking due to a broader slowdown in the demand for US assets. It is likely that a high proportion of investors are biding their time, preferring to wait out uncertain market conditions (fresh announcement on European bailout in March, Middle-East unrest, sky rocketing commodity prices and potentially the biggest unknown, the rate and method of Fed policy normalization).

EUR

The Euro was the strongest performer in the G20, gaining most against NZD (+3.53%) and JPY (+2.54%) and closing the week stronger in all pairs. The prime reason for such strong EUR price action despite a fairly strong risk-off outlook by market participants was the unexpectedly hawkish position of the ECB. A rate hike is now a real possibility in April and/or May of this year.

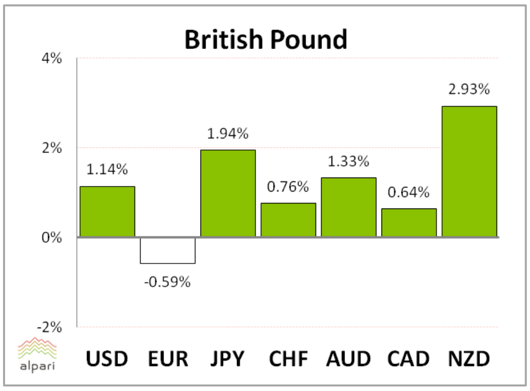
Oil prices are continuing to climb and tension in Libya as well as other Arab states has not necessarily abated despite the lack of severe fighting/infrastructural damage – in such an environment we would usually expect to see a risk-off market mood that pushes cyclical currencies lower in favour of traditional safe-havens. In this instance however, the risk-off market sentiment has been very muted by historical standards because investors are anticipating a short-medium term impact of ongoing political protests in the Middle-East. Oil prices are also reflecting such expectations as longer dated futures contracts (>12months) are attracting less buying interest compared to shorter term contracts (<6 months).



The dynamics in EUR pairs has changed significantly last week – a change we feel will support EUR against USD, GBP, JPY because of widening yield differentials. The clear risk is the US gaining momentum and bringing forward their rate hike expectations. Interestingly, at last week's ECB press conference the phrases "very accommodative" and "strong vigilance" were the exact same words Trichet used before the previous tightening cycle in December 2005.

In our view, a tightening cycle at this juncture in Europe's precarious fiscal situation is quite a risk. The European periphery is likely to stay under market stress for some time to come due to ongoing warnings from credit rating agencies, default risk and escalation risk (Portugal being followed by Spain and then by Italy in requiring an ECB/IMF sponsored bailout). In this context, we find it unlikely for the ECB to justify a series of hikes at this point given the negative consequences that may be result. Additionally, a higher Euro weighs on export volumes – probably the most important economic factor in deciding the fate of aggregate demand in the European periphery.

GBP

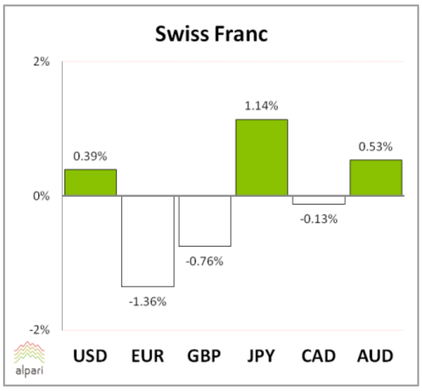


Sterling was higher against all other G20 currencies except the Euro as higher interest rate expectations lifted GBP pairs. Robust house price data that indicated vigour in the UK housing market (Nationwide HPI, Halifax HPI) was further supported by strong PMI data in the manufacturing (61.5 vs. 61.5 exp.) and construction sectors (56.0 vs. 53.0 exp.) –

readings above 50 indicate expansion, below 50 indicates contraction.

CHF

The Swissie was very mixed in its price action last week. A very strong upside GDP surprise (0.9% vs. 0.5% exp.) was aided by a strong PMI reading (63.5 vs. 60.8 exp.) which helped CHF pairs to find strong support. Weak retail sales on the other hand (-2.6% vs. 1.7% exp.) raised the issue of deflation and in turn CHF intervention. Retail sales data is very seasonal, volatile and needs a continued set of readings for a pattern to be identified.



The SNB's next quarterly meeting on March 17 is the critical date for a shift in language, where the bank could signal vigilance around asset prices and credit growth, if not the ECB-style focus on inflation.

Others

Brazil's Central Bank (CBB) raised its benchmark interest rate last week from 11.25% to 11.75% - the second rate hike in three months as the CBB tries to suppress consumer prices. The bank's monetary policy committee (Copom) voted unanimously for the 50bp rate rise. The large increase was in line with expectations surveyed prior to the announcement.

Australia's central bank (RBA) kept interest rates unchanged at 4.75% last week saying "inflation has moderated significantly" and was likely to remain within its target band for the coming year. In the accompanying statement, the RBA repeated that rates were appropriate given the economic outlook. Markets had seen no chance of a hike at this meeting and are not priced for a move until Q3/Q4. The RBA has been the most aggressively hawkish central bank in the G20 since late 2009 with 175bp of policy tightening already completed.

Overall, the RBA's stance and statement in March closely resembles its stance from January. The outlook remains finely balanced; very interestingly, the historical low in Australian unemployment is 5%. At this level, inflationary pressures have surfaced in the past and considering the broader inflationary phenomenon ongoing across the globe (especially in the EMEA region), we could see the RBA take a very precautionary stance and raise rates preemptively to head off inflation effects.

The BoC kept interest rates unchanged at 1%, adding that underlying inflationary pressures remain subdued. The BoC made clear that their previous assessment still stands as growth proceeds in line with expectations. The statement had an additional provision for geo-political risk (referring to the small but plausible chance of oil prices remaining permanently high as a result of unrest in the ME region) and underlines the fact that although higher oil prices would be beneficial for the commodities/oil sensitive CAD, it would also be detrimental to the Canadian economy due to the significantly negative effect on Canada's prime export market – the U.S.

Preview: 7th – 12th March 2011

Market Research

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Looking ahead

- European equity indices are lower at the start of this week after a triple-step downgrade of Greece's credit rating by Moody's – the sovereign issue remains an active theme. Furthermore, increasing geo-political risk and higher oil prices within a broader escalation of global inflation would only be detrimental to the peripheral European economy
- Peripheral debt auctions are small and thus subdued this week – risk of failed/poorly subscribed auction remains with the psychological impact not being mitigated by the auction size
- Only two major interest rate meetings this week: BoE and RBNZ. RBNZ could surprise considering the economic impact of the recent earthquake. BoE will probably stay on hold given weak Q4 GDP and repeated comments from BoE that UK inflation effects are transitory given their origination (commodities/non-core)
- Mass of Chinese macro-data is likely to buffet G20 FX and world equity markets this coming week – further signs of inflationary pressures is likely to escalate policy tightening expectations and hurt the 'global growth' story. Bouts of intra-day risk aversion over the past 6 months have been used to get in at better levels as up-trends in commodities, equities and risk-FX are still ongoing

March could be an explosive month for all asset classes including FX. In Europe, officials are preparing to announce a reportedely comprehensive solution to the 'peripheral problem' in Europe. The European Council (EC) is expected to deliver additional measures to the already existing EFSF facility announced last year:

- An increasee in the EFSF's lending capacity (current expectations are for a €400bn-€500bn increase to the fund as a maximum. If this arbitrary limit is exceeded, this may well be seen as a sign of weakness added to a lack of transparency – speculative EUR weakness is the likely outcome. For European equities, the higher the size of the fund, the better.
- A lower lending rate
- Longer repayment schedule

Other measures could also be included but are more unlikely given German unease i.e. bond buybacks using the EFSF facility. Bond resetructuring has been vehemently denied as a viable option although it remains a very plausible (and in the long-term very likely) scenario. However, despite all the event risk surrounding the Euro, the shambolic state of the US fiscal situation may discount a lot of the uncertainty in Europe, at least as shown in the EUR/USD rate. The US Fiscal deficit is approximately $1.5Trn and yet US authorities continue to "debate" the various conotations surrounding only $60bn of budget cuts (4% of overall total).

Given the large market focus on the issue it is likely that a large proportion of market participoants are speculatively short the Euro as a hedge against default risk becoming market news. The comprehensive set of measures set to be nnounced on March 25th have a decent chance of inducing additional EUR buying as the European outlook becomes a little clearer and more certain.

EU leaders hold an extraordinary summit on March 11 ahead of the Euro-group sessions over the following two weeks (March 14/15 and March 21) and the final European Council summit on March 24/25. This coming Friday's session is unlikely to deliver anything concrete but commentary is likely to indicate the rate of progress, scope for new measures and if there are any rifts amongst European leaders.

In the UK, it is fairly quiet on the macro data front aside from the eagerly awaited interest rate decision on Thursday. QE is likely to stay unchanged at £200bn and the probability of a pre-emptive rate hike is very unlikely. We see April 7th (if macro-data adds support) or May 5th as the most likely windows for a move. The minutes from the previous meeting showed another MPC member shifting over into the hawk's camp (6-3 in favour of unchanged). The key development from the meeting is whether Deputy Governor Bean joins the hawks (Sentance, Weale, Dale) in voting for a rate increase. The UK GDP estimate from the NIESR for February (-0.1% in January) could have an indirect impact on the vote as BoE members are very likely to have been made aware of it prior to release.

Although there are only two major central banks meeting this coming week (BoE, RBNZ) in addition to several from the EMEA region (Thailand, South Korea, Malaysia), the RBNZ meeting will attract most trader attention.The futures market are now pricing in a 50% chance of a 50bp rate cut to lift sentiment following last month's earthquake. A 25bp cut could thus very plausibly be considered as a hike leading to NZD strength! Event risk is extremely high for the NBNZ decision and extreme caution is warranted. A rate cut following a localised natural disaster would be an odd policy choice as monetary policy is usually used to balance broader risks/distortions. Using monetary policy to essentially solve a funding issue is the same as cutting off your arm when you want to lose weight – you get excellent results immediately but the long-term consequences can be disastrous.

FX Sensitive Calendar Events

Monday 7th March (CAD) Building Permits (JPY) Bank Lending	*Tuesday 8th March* (GBP) BRC Retail Sales Monitor (CHF) Unemployment Rate (CAD) Housing Starts (JPY) Core Machinery Orders
Wednesday 9th March (AUD) Home Loans (CHF) CPI (GBP) Trade Balance (NZD) Interest Rate Decision + Statement (USD) Crude Oil Inventories (JPY) GDP	*Thursday 10th March* (AUD) Employment Change (CNY) Trade Balance (CNY) FDI (EUR) ECB Monthly bulletin (GBP) Manufacturing Production (GBP) Industrial Production (GBP) Interest Rate Decision + Statement (CAD) Trade Balance (USD) Trade Balance (GBP) NIESR GDP Estimate (USD) Natural Gas Storage (USD) Federal Budget Balance
Friday 11th March (CNY) CPI	*Saturday 12th March* N/A

(CNY) Fixed Asset Investment (CNY) Industrial Production (CNY) PPI (CNY) Retail Sales (CNY) New Loans (GBP) PPI (CAD) Unemployment Rate (USD) Retail Sales (USD) University of Michigan Consumer Sentiment	
Sunday 13th March *Daylights Savings Time Adjustment in US & Canada (+1 hour)* (NZD) Retail Sales	