Fundamental | FX

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FX Weekly

Review: 8th December – 15th December 2008

Market Research

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Market Focus

- Sentiment plays a leading role once again as $15bn bailout confusion plays havoc with FX market direction
- USD makes a broad retreat as bad news begins to take its toll on the US dollar
- Commodity currencies stronger as risk aversion subsides at the expense of the USD and JPY
- Interest rate reductions continue with more expected
- GBP hits multi-year lows against the G10 currencies as parity with the EUR draws closer

Currency pair	Previous Week Open	Current Rate	Nominal Change	% Change
EUR/USD	1.2722	1.3457	0.0735	**5.78%**
GBP/USD	1.4699	1.5025	0.0326	**2.22%**
USD/JPY	92.72	90.59	-2.13	**-2.30%**
USD/CHF	1.2204	1.172	-0.0484	**-3.97%**
EUR/GBP	0.864	0.8955	0.0315	**3.65%**
GBP/JPY	136.47	136.09	-0.38	**-0.28%**
EUR/JPY	117.94	121.91	3.97	**3.37%**
AUD/USD	0.6469	0.6662	0.0193	**2.98%**
NZD/USD	0.5357	0.5493	0.0136	**2.54%**
USD/CAD	1.2739	1.2385	-0.0354	**-2.78%**
EUR/CHF	1.5525	1.5774	0.0249	**1.60%**

Correct at 08:42 GMT on 15th December 2008 | Source: Alpari (UK)

Last week began on a positive note which turned sour very quickly as investors discounted the US stimulus package as being inadequate and insufficient. The $15 billion plan designed to rescue the US automobile industry as a whole but more specifically automakers Chrysler and GM did boost confidence for a brief period in early Monday trading but the package was unable to sustain confidence over the course of the week. Initially, risk aversion fell sharply leading to a surge in equities and periphery currencies such as the AUD, CAD and NZD. However, the gloom that has dominated market sentiment in recent weeks returned to diminish any gains made. Over the course of the week the USD suffered most, giving up 5.8% against EUR, 2.1% against GBP, 2.3% against JPY and almost 4% against CHF. Broad USD weakness was the story of the week as sombre US economic news was priced into the price of the US dollar which helped many currencies claw back some of the vast losses made against the USD in recent months. The US trade balance was announced to be almost $3.4bn

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worse than expected combined with elevated unemployment claims which rose significantly last month. The deteriorating trade balance highlighted weaker demand for US goods and dashed hopes of an export led recovery in the US. The USD fell rapidly after the announcement of the figure on Thu and consolidated its losses earlier in the week.

Some market commentators are seeing last week's USD weakness as a sign of risk appetite making a comeback around the globe while others are seeing the weakness as an inevitable consequence of the problems that have occurred in the US over the past year. Another theory is that the USD has been strengthening since July because many market participants needed to repay Dollar based loans within a short period of time as a result of large asset price falls leading to creditors reigning in their loans. However, as investors unwind their USD based positions in response to the financial crisis, a return to traditional valuations of currencies is likely to occur. The events of last week may be an indicator that broad US weakness will continue as demand switches from the USD into currencies with better trade balances, fiscal policies and higher yield.

The bailout of the US automotive industry is expected to be finalised this week but on Friday the bailout plan failed to pass a vote in the Senate which frightened market participants and sent the USD sharply lower to the benefit of the JPY as it harboured risk-averse capital flows. The $15bn rescue is fast becoming a political tug-of-war so regardless of the rescue plan being beneficial or not, the pressure is on politicians to push the package through in order to save thousands of jobs. The $15bn number is also a symbol of how sentiment is fast becoming the dominant factor in currency markets under the current financial crisis. Fifteen billion dollars is a very small number when compared to the overall exposure of a country or even some multinationals and yet the rescue package helps to cause significant currency moves that dwarf this number. This is typical sign of fearful and panicked investors making knee-jerk reactions on the back of the assumption that 1 case sets a precedent for the rest of the economy.

Last week saw the unexpected interest rate cut of 0.75% against an expected cut of 0.5% by the Canadian central bank. Although the reduction was more aggressive than expected, the CAD managed to post gains against the JPY and USD over the week.

Headlines in all major financial publications mentioned the worrying weakness of Sterling. Sterling fell to a 6 year low against the USD two weeks ago and fell to an all time low against a trade weighted basket of currencies last week after more negative data and economic news in the UK. UK PPI figures showed a 3.3% fall in producer prices which heightened expectations that the Bank of England will reduce interest rates further in 2009. EUR/GBP made a fresh high every day last week as the currency pair posted 5 consecutive days of gains. Sterling has suffered immensely in recent months as lower interest rate expectations, contracting interest rate differentials, higher current account deficits, higher fiscal expenditure and several high profile banking failures have all weighed on the UK currency.

The CHF came under some pressure last week after the SNB reduced interest rates down to 0.5%. Although this reduction was expected it still creates a scenario of almost zero interest rates in Switzerland. We have yet to see the full impact of how an environment of such loose monetary policy around the world will actually affect FX markets in the longer term. Interest rate increases look a very distant prospect at the moment so we are likely to be in an environment of low rates for some time. It begs the question of what factors will influence currency movements in the absence of interest rates? These are likely to be economic fundamentals such as GDP, current account surpluses/deficits, fiscal policy, inflation and other fundamental factors that act as indicators of economic health and investor sentiment for that currency. Many other currencies face the realistic prospect of zero rates so the Swiss Franc is in a better position than most because of its traditional status as safe-haven currency in addition to having very strong economic fundamentals and tight government expenditure.

Preview: 16th December – 23rd December 2008

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Looking ahead

- Very busy economic calendar could mean significant volatility and intra-day price swings
- US and Japanese interest rate decisions due this week
- CPI numbers for the UK, US and Canada also being anticipated
- The US automobile industry rescue to be finalised this week after last week's uncertainty and confusion
- Relative sentiment likely to be the dominant factor in deciding direction of currencies

This coming week should be very significant in helping investors gauge the future direction of events in the currency markets. This week sees TIC Long-term data being released on Monday which will show how foreign demand for US securities compares with US demand for foreign securities. The next day we will see US CPI data which could be a key factor for market participants because current levels of inflation are well above official interest rates. Part of the reason why banks have been unwilling to lend to consumers and thus hamper economic activity is because lending capital for rates lower than inflation is counter –productive. Lower levels of inflation would help creditors feel more secure about the real value of their savings as well as encourage real interest rates to fall and become affordable for consumers. Later in the day we will see the final FOMC interest rate decision for 2008. Market expectations are for a 0.5% reduction from 1% to 0.5%. This would mean the lowest US interest rates for over 50 years and could put severe pressure on the USD. The USD has had strong support from foreign purchases of US Treasuries; despite the US being the source of the housing and credit market problems being seen around the world today, the demand for US debt has increased significantly throughout 2008. Yields on US government debt are close to record lows with some maturities yielding zero return yet demand continues to rise because investors are panicked and distressed at the potential risk of taking significant losses on their assets. Simply maintaining the value of your principal is taking precedence over yield in current market conditions, it seems.

The UK will also see major economic news this week that is likely to dominate the headlines. UK CPI figures will be revealed on Tuesday along with the Bank of England minutes which will show how committed and dovish the MPC actually are with regards to monetary policy. There are lingering worries in the markets that the BoE will follow the Fed in cutting rates very aggressively almost down to zero whilst trying to stimulate the UK economy. If the minutes show such willingness to slash interest rates, the GBP may fall dramatically because investors are already struggling to find reasons for holding GBP. Economic fundamentals are relatively weak compared with currencies such as the EUR, JPY, CHF and even the USD so by taking away strong yields via dovish monetary policy, we could see the GBP go into freefall.

Other important events this week will be the Bank of Japan press conference that follows their interest rate decision. All market commentators and analysts expect the interest rate to be left unchanged at 0.3% (the lowest of all G10 currencies) as any increase would be unthinkable. Investors will be keen to gauge the future direction of monetary policy in Japan considering that the BoJ has no room for manoeuvre with interest rates. Focus will probably turn what policy Japan is likely to take regarding the artificial weakening of the Yen in order to support Japanese exports. The Tankan survey (released yesterday) showed confidence in Japan to be at 30 year lows so export demand could be a key factor for Japanese growth prospects in the months to come. Historically, Japan has purposefully weakened its currency at times when the Yen has been overbought and Japanese export business has begun to suffer. Intentional weakening of the Yen could occur if the Japanese government deems Yen strength to be hampering export sales.

Coming into the Christmas holiday period volumes may be lower than expected although volatility may well be higher as investors remain nervy and fearful of fresh bad news. The busy economic calendar combined with several scheduled central bank speakers due to make comments (Trichet and Hildebrand on Monday, FOMC on Tue, Carney on Wed, Fisher on Thu and BoJ on Friday) may result in a whippy week for currencies.