Fundamental | FX

23rd December 2008

FX Weekly

Review: 15th December – 23rd December 2008

alpari

Market Research

George Tchetvertakov
Head of Market Research
gtchetvertakov@alpari.co.uk

Market Focus

- Broad USD weakness as safe-haven perception of the currency weakens
- Huge volatility seen in the markets. USD was at one stage 10% weaker against the EUR, before recovering to finish the week on a strong note and only 4% down
- EUR performs well against all currencies as hawkish ECB stance and better relative performance against GBP, USD, JPY helped to lift the Euro to record highs
- CHF was the star performer of the week as it gained against all other currencies on the back of a flight to safety and a potential change of sentiment that could see the CHF emerge as the safety haven of choice
- JPY had a mixed performance as it gained against the USD and GBP but weakened against the EUR and CHF as Bank of Japan reduces base rate to 0.1%

Currency pair	Previous Week Open	Current Rate	Nominal Change	% Change
EUR/USD	1.3393	1.3975	0.0582	**4.35%**
GBP/USD	1.4966	1.4843	-0.0123	**-0.82%**
USD/JPY	90.97	90.09	-0.88	**-0.97%**
USD/CHF	1.1737	1.0917	-0.082	**-6.99%**
EUR/GBP	0.8949	0.9413	0.0464	**5.18%**
GBP/JPY	136.16	133.68	-2.48	**-1.82%**
EUR/JPY	121.83	125.89	4.06	**3.33%**
AUD/USD	0.6624	0.6827	0.0203	**3.06%**
NZD/USD	0.5445	0.5725	0.028	**5.14%**
USD/CAD	1.2456	1.2242	-0.0214	**-1.72%**
EUR/CHF	1.5722	1.5259	-0.0463	**-2.94%**

Correct at 09:17 GMT on 23rd December 2008 | Source: Alpari (UK)

USD

Last week could prove to be a very important sea change in the future trends of some currencies. The USD was weaker against all G10 currencies with the exception of GBP as investors reacted to more disturbing economic news in the US; TIC Long-term purchases data that measures foreign interest in long-term US assets was very weak at $1.5bn against an expected $40bn. The aforementioned TIC data came out on Monday and set the tone for negative sentiment to prevail over the week as market participants began to contemplate the possibility that recent USD strength that has been attributed to Dollar repatriation and safe-haven interest is finally coming to an

alpari.research

end as the incessant negative sentiment weighs on the currency. Last week saw the automaker rescue, the TARP plan, a record budget deficit and a Fed admission that it may buy long-term Treasury securities all make the headlines once again which raised questions about how valuable the USD will be in the long term.

A catalyst for USD weakness was a larger than expected interest rate cut on Tuesday which took the Fed interest rate to “a range between 0% and 0.25%”. This unprecedented move means that America has the lowest interest rate since 1954 and is now lower than the Japanese official rate, which hasn’t happened for decades. In addition, some short dated bond yields actually fell below zero which means that investors are willing to invest funds at a small loss because they are worried about losing more if they keep their wealth in other asset classes.

The phrase “quantitative easing” was making headlines last week because interest rates around the world are quickly approaching zero. Japanese rates are almost there and so is the US. Many market participants are worried that after monetary easing has been exhausted, the only option left would be to expand the money supply which would be inflationary and damaging to the USD. The EUR/USD pair saw its largest weekly appreciation ever as the knee-jerk reaction on Wednesday was to sell the USD in favour of CHF, EUR and JPY.

Losses made throughout the week were re-traced to some degree on Thursday and Friday as fresh confidence over the automaker rescue and profit taking stimulated demand for the USD going into the Christmas holidays.

GBP

Sterling had a nightmare week as one shock after another sent Sterling lower against all G10 currencies. You know that things could hardly be worse when better than expected inflation figures actually weigh on your currency. This scenario happened last week as good UK inflation numbers spurred traders to sell GBP on the back of heightening expectations that the BoE will reduce interest rates close to zero because inflation is becoming less of an obstacle. Sterling fell further when BoE minutes (released from their meeting in early December) showed that the MPC were considering a deeper interest rate cut than the one they actually gave. Unemployment figures out on Wednesday confirmed the largest monthly increase in unemployment since 1991. Furthermore, an announced increase in the UK budget deficit and comments from MPC member Charles Bean on Thursday suggested that the BoE will eventually establish a zero base rate ensured further negative sentiment for GBP. Despite all the GBP negative news and comments, the currency made a comeback in the last 2 days of the week as profit taking and worse news elsewhere helped Sterling to recover steep losses made in the early part of the week.

EUR

The Euro had a strong week as healthy demand and hawkish comments from several top ECB officials helped to keep the currency supported in light of very sanguine economic statistics. The EUR may have benefited the same way the USD has in recent months as investors read between the lines and buy currencies for their security in the long term. On Thursday we saw the worst IFO figures since 1991 as economic sentiment amongst German business fell for the 6th month running. Despite the gloomy economic climate, a better than expected trade balance (-1.3bn vs. -5.2bn expected) pushed the Euro higher finishing the week up against all G10 currencies with the exception of the CHF. Another key factor in Euro’s performance was the consistently hard line stance on monetary policy by several ECB members; it has been made clear that official EUR rates may fall gradually or not at all rather than in huge steps down to zero. In a time where every central bank is easing, comments that suggest a central bank will reduce rates but *at a slower rate* gives investors confidence about the value of a currency and the potential to reap an increasingly higher reward over time.

CHF

The star performer of the week was CHF which appreciated against all G10 currencies, rising by almost 7% against the USD, 3% against the EUR and 6% against JPY. Last week saw a weakening of the recently strong currencies i.e. USD and JPY despite risk aversion still being elevated because market participants were sheepish about buying JPY and USD due to an unfavourable interest rate outlook in both nations. In addition, both had interest rate decisions due which prevented significant buying. The CHF on the other hand bucked sombre expectations and posted better than expected trade balance and retail sales figures which gave weight to the theory that some nations may actually be insulated from the worst effects of the financial crisis.

Whether last week's price action is a sign of things to come or whether USD strength returns, the CHF seems to be in a good position amongst other currencies. Switzerland has a moderately expansive policy stance, very strong fiscal balances and maybe most important of all, it is considered as a currency that investors rush to in times of adversity. As the global financial crisis plays out over the coming months, CHF may be pushed higher because investors are looking for currencies that will hold value over time which is more likely to occur if a currency has a strong fiscal position.

JPY

The Yen suffered on the back of expectations that the Bank of Japan will reduce rates from 0.3% down to effectively zero. The interest rate decision was due on the 19th December but expectations were being priced throughout the week. Japan did cut interest rates to 0.1% which weighed on JPY after an initially positive reception. The big story from last week was the official comments made by Shoichi Nakagawa that suggested forthcoming intervention in the Yen by the central bank. The Yen has been appreciating steadily for months as risk-averse demand has been strong considering the deteriorating economic conditions worldwide.

Preview: 23rd December – 30th December 2008

Looking ahead

- A shorter than usual week due to the Christmas holiday period may lead to elevated volatility amongst lower volumes
- Traders are expected to focus on US housing market figures due on Tuesday as a barometer for how the US economy is progressing
- All eyes are likely to be on how the USD responds to last week

This week is likely to be very subdued as very few economic releases are due. In addition, markets will be closed in many regions on Thursday and Friday due to the Christmas holidays so expect lower volumes and as a consequence, there may be more volatility.

From the economic calendar, the focus will probably be UK current account figure on Tuesday followed by US housing sales figures, both are expected to deteriorate since last month. Canadian GDP figures released on Wednesday alongside US unemployment claims could prove volatile for the USD/CAD pair judging by previous US employment sector figures which have tended to disappoint on the downside.

Aside from the economic calendar, many market participants will be looking forward to seeing the price action this week after the unusual events of last week. The USD was over 10% down against the Euro before recovering; many market participants are trying to understand whether the recent USD weakness is a sign of more to come in 2009 as the USD begins to lose its tenacity or whether its just a temporary correction without anything actually changing which would mean renewed USD strength next year.

The USD shortage between August 08 and November 08 was most probably due to firms trying to de-leverage simultaneously, repatriation of US dollars back to the US and investors buying USD as a secure store of value. These catalysts may become less pronounced as time goes on because there is only so de-leveraging and repatriating that one can do. The Dollar's status of safe-haven currency may not be enough to attract foreign capital because of the many other problems facing the US. A worrying sign for the Dollar has been the possible change of policy by the Fed. As a last resort, the Fed may decide to buy long term Treasuries directly from the US Treasury which is considered highly inflationary.

Now that the de-leveraging rate has slowed and repatriation is falling market participants will likely focus on US fundamentals such as budget, debt, fiscal policy and geopolitical factors for USD direction in the future. If sentiment for the USD were to be decided solely on economic fundamentals, the outlook would be bleak compared to other currencies.

It's not all bad news because other nations such as UK, EU may follow the US lead; reduce rates to almost zero and use fiscal policy to resurrect struggling economic activity. This would support the USD or in other words, the USD wouldn't fall as quickly as it would otherwise.

Disclaimer: