23rd February 2009

FX Weekly

Review: 16th – 22nd February 2009

Market Research

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

Market Focus

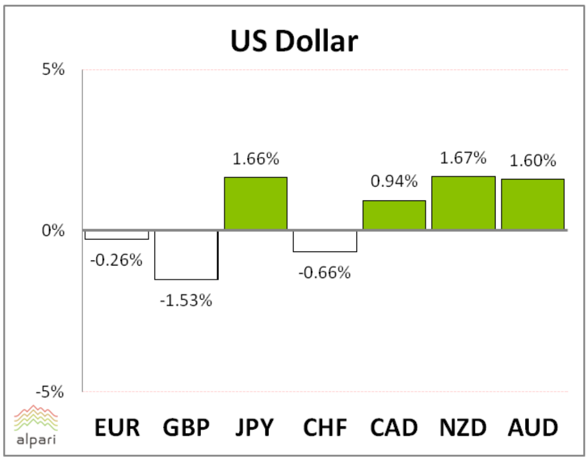
- Yen's status of risk-haven currency of choice put into question
- Sterling defies its critics by strengthening across the board
- Amid elevated volatility the USD remained largely unchanged against other majors and strengthened against the Commodity currencies
- Anxiety and fear still remain and constantly overshadow market events despite a rise in risk tolerance

Currency pair	At Open on 16th Feb	At Close on 20th Feb	Nominal Change	% Change
EUR/USD	1.2792	1.2825	0.0033	**0.26%**
GBP/USD	1.4213	1.4430	0.0217	**1.53%**
USD/JPY	91.81	93.33	1.52	**1.66%**
USD/CHF	1.1636	1.1559	-0.0077	**-0.66%**
EUR/GBP	0.8997	0.8884	-0.0113	**-1.26%**
EUR/CHF	1.4885	1.4829	-0.0056	**-0.38%**
GBP/CHF	1.6536	1.6683	0.0147	**0.89%**
GBP/JPY	130.46	134.67	4.21	**3.23%**
EUR/JPY	117.43	119.70	2.27	**1.93%**
CHF/JPY	78.21	80.68	2.47	**3.16%**
AUD/USD	0.6555	0.6450	-0.0105	**-1.60%**
NZD/USD	0.5200	0.5113	-0.0087	**-1.67%**
USD/CAD	1.2401	1.2518	0.0117	**0.94%**

| Source: Alpari (UK)

USD

It was a very difficult week for market participants as several fundamental factors played a part in influencing the direction of currency prices. US Dollar trading was boosted by negative sentiment towards the Yen as fears over the long-term health of the Japanese currency became apparent. Last Sunday we saw the shocking GDP figure of -3.3% in Q4 2008 (13% annualised) in Japan which overshadowed the mood in financial markets for the rest of the week and capped risk appetite. Many investors have deployed their capital in Japan as a way to store value amidst uncertainty created by the financial crisis sweeping the globe. Asian markets and Japan in particular have gained a reputation of not being excessively exposed to US sub-prime mortgages or any other toxic liabilities, on the contrary, Japan is seen as a savings orientated country that has done well to avoid banking difficulties that have plagued the US,UK and the EU. This has helped the Yen become a risk-haven which has been more attractive than the USD, EUR or CHF. This status was put into question last week because market participants reassessed Japan's exposure to the current financial problems. Although Japan has not been directly exposed to the financial products that caused the current crisis, investors are starting to worry that Japan's export focused economy may suffer to the same extent as other more exposed countries have, due to a sudden heavy fall in global demand.



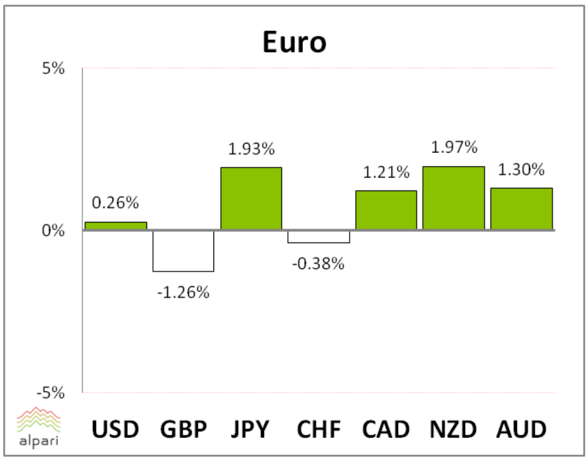
The economic calendar was eventful as market participants awaited key European data on Tuesday and key US data on Wednesday. Overall, the majority of economic releases were better than expected but despite the positive economic calendar risk-aversion remained in the market allowing the USD and CHF to edge higher. USD was the largest benefactor of Tuesday's economic releases. Also on Tuesday, Obama announced that the $787bn stimulus plan would be coming into action within a month. The speech was taken as positive by some market participants because funds would actually become available and would support key areas of the US economy but others were disappointed, criticizing the time scale of the plan. USD was broadly stronger but fell against the Yen.

On Wednesday, USD reached a 6 week high vs. JPY partly due to Obama's announcement of a stimulus plan being enacted. The plan grabbed headlines on Tuesday and its anticipation continued to captivate investor attention. The other key factor that took priority amongst traders was the rapidly deteriorating economic picture in Japan. This has not yet translated into JPY weakness against other currencies but it has altered investor perceptions of how safe the Yen is in relation to the US Dollar and Swiss Franc. It is a possibility that the Yen's position as being the safety haven of choice is affected thus inducing flows into USD initially and against other currencies such as the CHF and EUR going forward if Japan's economic profile deteriorates further.

A late USD sell-off on Friday reigned in the good mood created earlier in the week as strong fears of government takeovers of Bank of America and Citigroup in particular (other institutions also mentioned) weighed on investor minds. Over the course of the week, currencies were willing to price in risk appetite but equities remained weak, maintaining their weekly pattern. Equities performed poorly as sentiment towards the health of the US economy remained fragile. Shareholders of major US banks are worried that nationalization will reduce the value of their holdings inducing many to sell their stakes.

EUR

The Euro performed well last week as improving economic sentiment and trade balance figures reinvigorated the Single Currency. Pessimistic data elsewhere such as the Services and Manufacturing PMI's on Friday failed to dampen interest in the Euro as it gained against every currency apart from GBP (-1.26%) and CHF (-0.38%). Support for the Euro also came from German authorities who confirmed that they would support any EU country that encounters fiscal difficulties. This signal of solidarity concerned some traders because the subject of EU nations being unable to meet their obligations has been raised numerous times in recent weeks so a statement from authorities instilled some paranoia in the minds of some. The positive view prevailed however as investors were unwilling to look past long-awaited positive sentiment.

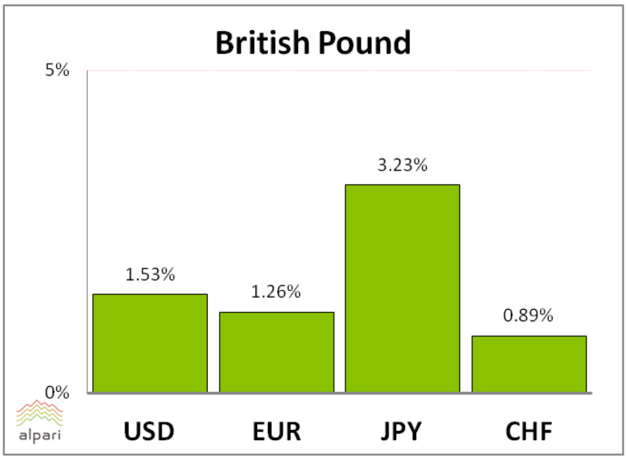


Looking over the week economic sentiment in Germany was much better than analyst expectations on the back of confidence related to the €50bn stimulus package provided by the German government. The stimulus package has been largely well received up to now although this could change once actual implementation of the funds has commenced. The European trade balance was much better than expected but as was the case in the UK last week, the majority of the improvement came from lower imports (- 4-6%) rather than higher exports (-1%).

In the latter part of the week the Euro fell sharply against the USD as concerns over Eastern European/Russian defaults on EUR based loans resurfaced. As was mentioned in our FX Weekly report last week, this theme is currently active and continues to weigh on EUR sentiment.

GBP

Sterling was the best performing currency last week although there were several occasions when GBP was trading on weekly lows against USD and EUR and was looking like it could end the week lower against the major currencies. Strangely enough, Sterling's best performance was against JPY as Japanese factors made the Yen less valuable in proportion to GBP.



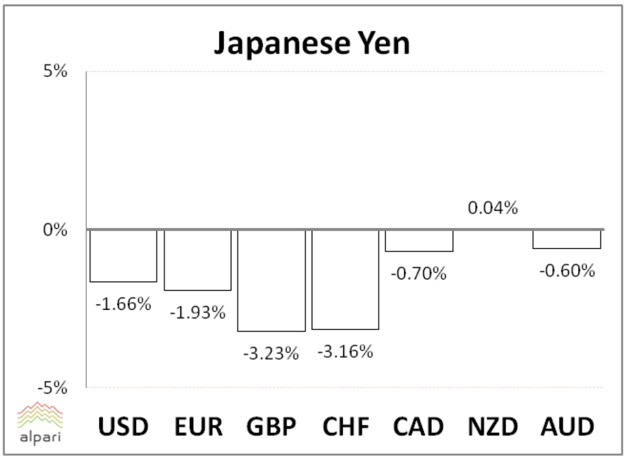
Amidst a limited UK economic calendar GBP gained ground on the back of stronger than expected inflation figures released on Tuesday. The RPI index remained positive against most expectations and postponed the likely dip into negative prices. The RPI index is an important indicator for the UK economy because it is used in salary negotiations and includes household spending so persistently weak RPI figures would cap wage increases and reduce economic growth. The CPI measure remained at 3% as upward price pressures remained within the government's preferred inflation measure.

Trading in GBP was overshadowed by events in equity markets. As early as Monday Lloyds Banking Group fell by as much as 20% at one stage before recovering and closing approximately 9% down; worries over bank solvency still persist in the UK as rumours of new financial sector regulation, bank nationalisations and fresh capital injections circulate amongst market participants.

On Tuesday, Sterling weakened after BoE minutes revealed that 1 member wanted a full 1% cut rather than the 0.5% done on 4th Feb. The speed with which rates have fallen in the UK has shocked many investors and explains the rapid decline of Sterling in 2008 and beginning of 2009. This development was followed up on Wednesday by news of Mervyn King asking for authorisation from Alistair Darling to commence quantitative easing which involves the BoE buying Gilts and corporate debt, thereby transferring public funds into the private sector in the hope that those funds will be utilised by the institutions receiving the capital and generating economic activity.

JPY

Risk tolerance fluctuated wildly during the week. The Yen began the week very strongly as investors continued to unwind carry trades and buying of the Yen due to poor Japanese GDP figures. However, by Wednesday and Thursday the mood in currency markets began to shift as market participants began to see value in riskier investments accompanied by a feeling of overbuying the Yen for risk-aversion purposes. Good economic numbers in several regions helped to lift the collective gloom while worries over the JPY intensified as Japan's finance minister resigned on Tuesday sparking fears that Japanese authorities were failing to handle the pressure of an accelerating economic downturn. As the Yen was already seeing lower demand due to lower risk aversion, it was pushed even lower via concerns over its fundamental outlook.



It was revealed that Japan plans to buy 3,000bn Yen ($31.7bn) in commercial paper before 31st March as well as increasing purchases of government bonds. Both measures are aimed at stabilizing funding problems in Japan's economy which has been deteriorating rapidly in recent months. As the Japanese economy suffers from lower confidence, increases in quantitative easing and the resignation of their Finance minister (who was accused of being drunk during a press conference, then resigning the next day) questions are beginning to be asked as to what steps Japanese authorities will take in the near-medium term as they attempt to stem the recent flow of sombre economic news.

CHF

Swiss retail sales were much stronger than expected in similar fashion to US retail sales last week. How much actual significance the figure has is not clear because reaction in the price of the Swiss Franc was muted. The lack of reaction could be attributed to the seasonality of the number i.e. retail sales may have been stronger in January because of holiday period discounting for example, which would explain why market participants largely ignored the figure. There were however more dominant themes affecting the Swiss Franc last week that took attention away from the minimal economic calendar available.

Potentially damaging news for the CHF came via Swiss bank secrecy laws, famous for their stringency and a large contributor to CHF demand. It was becoming clear secrecy was close to being relaxed due to pressure from US authorities. UBS, the Swiss investment bank is being forced to provide private client details to US prosecutors as they form a case against tax evaders. This news has not affected capital flows so far but this could change quite quickly if large US investors get nervous holding Swiss denominated investments. Market participants are monitoring this theme and awaiting developments.

CHF strengthened by approximately 3.45% in the space of a few hours late in the London session last Friday which came as a massive surprise to many investors. Swiss bank secrecy law relaxation was, and is likely to remain; a recurring theme in the currency markets but last Friday's aggressive move suggested that it may not be as significant as first thought. The Swiss Franc managed to recover losses made during the week and finished the week stronger against USD, JPY, EUR and CAD despite a flat week up until then as the Franc trended down on the back of falling risk aversion.

Others

Norwegian Kroner did very well as Norway posted 1.3% GDP growth in Q4 2008. This surprised many investors and helped to highlight Norway as an exception to the European rule which helped the currency strengthen against the USD over the week despite a slow start. Risk appetite entered the market gradually last week as confidence was slow to rebound.

Canadian banks were praised for their prudent, traditionalist methods of banking which has helped them to weather the economic problems very well. Canadian banks are moving up the world rankings in terms of size because of large falls in the values of their US, UK and European counterparts. It is quite possible that Canada is revealed to be much less affected by the current economic problems and so goes into the economic recovery before everyone else. If this is indeed the case, the Canadian Dollar is likely to rise in proportion to other currencies alongside Canadian equity markets which are likely to benefit from increased foreign capital flows.

It is worth noting that Gold rose strongly last week (almost touching 1,000 USD per troy ounce), it is now 14% higher since the start of 2009. Investors are worried over higher inflation in several countries as substantial increases in the money supplies of some G7 economies draw closer.

Preview: 23rd February – 1st March 2009

Looking ahead

- Another volatile week expected as a hefty economic calendar is scheduled for all major currencies
- Several key themes likely to be in-play as rumours and speculation of future developments remain
- Quantity, type and timing of central bank intervention in several G7 countries could be mentioned as a multitude of central bank speakers are expected to make comments on policy

Themes

This coming week market participants are likely to be assessing whether the Yen weakness seen last week was a case of increasing risk tolerance amidst improving economic indicators worldwide or whether it was because the Japanese economy posted such a sombre performance in Q4 2008 and probably Q1 2009 that the currency cannot possibly remain strong and must therefore fall as Japan borrows more to support the economy, conducts quantitative easing to provide liquidity and possibly intervenes in JPY pairs in an attempt to make their Japanese exporters more competitive. If the latter is truer then we can expect to see significant JPY weakness in favour of the USD, CHF and EUR going forward. The other scenario is that the Yen is simply pricing in lacklustre economic data but will remain well supported via carry trade unwinding, safe-haven support and fundamental strength in view of Japan's strong fiscal balance.

Also under assessment will be the level of exposure by European banks to Central and Eastern Europe. The possibility that Central and Eastern European firms default on over €200bn of loans has been a recurring topic amongst market participants (refer to previous issues of FX Weekly for more detail). So far no pronounced effect has been noticed upon the Euro but this may change very quickly if a large default is announced. European authorities have been vaguely suggesting that their sovereign members and institutions will be protected and supported in case of difficulties; this support has been mostly welcomed and considered as EUR supportive.

Over the weekend, reports from the US were suggesting that Citibank and Bank of America may be in negotiations with US authorities to receive more state aid. At the time of writing, speculation that some US banks would be effectively nationalized were beginning to circulate. This development is in advance of 'stress-tests' upon US banks that are due to begin on February 25th as laid out in Geithner's stimulus plan announced 2 weeks ago. The development of this theme is likely to play a key part in the future development of the US Dollar because the future of the US financial system is at a cross-road. The level of public sector involvement in a traditionally private sector such as banking could ultimately save the sector from the financial crisis but simultaneously drive away private investment in fear of inefficiencies and lower profitability.

Economic data

In terms of economic data, we have a very busy week ahead. In Europe, we are expecting the German IFO business climate index and EU current account figures (Tue). The IFO index is usually a good barometer of business sentiment in Europe and seeing as the index is expected to remain unchanged from January's number, we could see high volatility in EUR pairs if the survey shows a significant decline. Traders are eager to see whether the recent stabilization of EU macroeconomic data is actually a ray of light for the future or just abnormal readings that have not actually reversed the downward trend.

On Wednesday, final GDP figures for Germany alongside UK GDP will be of most interest to investors. In the US, existing home sales are expected to continue their decline as the US housing market remains fragile and oversupplied. This figure will be followed by New Home sales the next day. On Thursday and Friday we are expecting to see inflation estimates for Europe (Fri) as a whole as well as regional CPI estimates for Germany (Thu). These could be very important as they are a good barometer of inflation in the whole of the EU; any significant surprises in Thursday's readings would augment expectations for Friday's data. On Friday, apart from the EU inflation estimate (as mentioned above) all attention will be squarely on preliminary US GDP Q/Q. On average analysts expect the US to have contracted 5.4% in Q4 of 2008 but surprises are likely, possibly to the upside.

Speakers

The key highlight of the week as far as the US Dollar is concerned could be testimony from Fed Chairman Bernanke. A pessimistic tone on the US economy is most likely which is what markets expect but the focus will be on Fed quantitative easing plans. How much Treasury buying will be done, what other assets the Fed plans to buy and when all of this buying takes place are all criteria that market participants will be focusing on.

Elsewhere we are expecting the following commentary that is likely to influence market direction:

Monday – Trichet (ECB), Jenkins (BoC), Lockhart (Fed), BoJ minutes
Tuesday – Sentance (BoE), Bernanke (Fed), Duke (Fed)
Wednesday – Bernanke (Fed), Blanchflower (BoE)
Thursday – King (BoE), Trichet (ECB), Obama (US President)
Friday – Yellen (Fed)

Central bank commentary is becoming increasingly important because central bank and political action has become the dominant factor in financial markets. Support for whole industries, capital injections into specific firms, currency intervention and overwhelming stimulus packages have become the norm to a large extent. In effect, the most influential market participant in the last year or so has been sovereign government.

Our view is that traders should be watching government statements and actions with extra care as further difficulties in the private sectors of any G7 economy could induce talk of government intervention and aid. Partly because of the recent rise in government influence we believe that currencies with the most effective fundamental policies (firm fiscal policy that preserves the value of the currency and doesn't overburden the country with debt and appropriate monetary policy that tackles the problem of capital availability rather than simply the cost of capital) will be the ones to come out of the economic crisis in best shape and with most value. So far the two central banks that have abstained from private asset purchases (or 'quantitative easing') have been the ECB and the Norwegian central bank (Norges Bank). However, constantly resurfacing concerns about European banking exposure to central Europe and the potential negative fiscal implications

Fundamental | FX

of further bank bailouts may cause NOK and EUR to be put under pressure via foreign counterparty risk rather than domestic factors such as an expanding money supply.