

FX Weekly

Review 19-26 January 2009



Market Focus

- The major theme of last week was the severe weakness in Sterling as the financial sector took centre stage.
- Several British banks announced severe liquidity problems which induced a 2nd government sponsored bailout of the sector.
- Sombre results from several UK banks maintained risk-averse sentiment in currency markets as the USD and JPY maintained their strong upward trends. Bank of Japan left rates unchanged.
- Very volatile price action throughout the week, especially in GBP pairs as investors rushed for the exit on Sterling positions.

Market Research

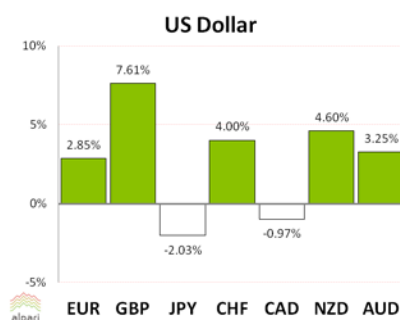
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Currency Pair	Previous Week Open	Current Rate	Change	% Change
EUR/USD	1.3352	1.2972	-0.0380	-2.85%
GBP/USD	1.4872	1.3740	-0.1133	-7.61%
USD/JPY	90.99	89.15	-1.84	-2.03%
USD/CHF	1.1135	1.1581	0.0446	4.00%
EUR/GBP	0.8973	0.9438	0.0465	5.18%
EUR/CHF	1.4870	1.5023	0.0153	1.03%
GBP/CHF	1.6562	1.5913	-0.0649	-3.92%
GBP/JPY	135.29	122.48	-12.81	-9.47%
EUR/JPY	121.50	115.63	-5.87	-4.83%
CHF/JPY	81.66	76.95	-4.71	-5.77%
AUD/USD	0.6779	0.6559	-0.0220	-3.25%
NZD/USD	0.5510	0.5257	-0.0254	-4.60%
USD/CAD	1.2384	1.2264	-0.0120	-0.97%

Correct at 08:50 GMT on 26th January 2009 | Source: Alpari (UK)

USD

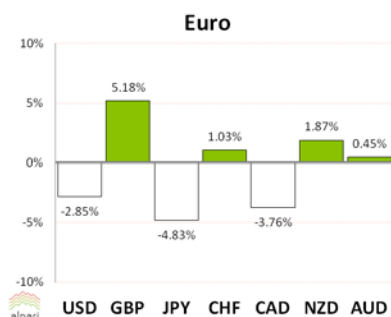
The USD made strong gains last week against all G10 currencies with the exception of the Yen and the Canadian dollar. Most attention in currencies was focused on Sterling although the problems facing the US were also at the front of traders' minds. The US has its fair share of problems stemming from the credit crisis but those problems were not focused on last week because the US calendar was relatively empty. In addition, the feel good factor of the Presidential inauguration helped investors take on a brighter outlook over the US economy with the long term prospect that US public sector spending is likely to fall under Barack Obama's presidency.



The US dollar benefited mostly from risk anxious investors looking for the best compromise between liquidity and security. Despite pessimistic tones coming out from global equity markets and prospects for protracted recessions in several G10 economies, the US dollar held its ground impressively in similar fashion to its performance in mid-2008. The greenback rose over 7% vs. Sterling and 4% vs. CHF. The strong gains against the Swiss Franc in the past month have been very encouraging for US dollar bulls because they underline the current preference for risk-averse investors as being US dollars rather than Swiss Francs. CHF has traditionally been a reserve currency that has seen most demand in times of anxiety and fear. Today's market climate is such an example and yet the US dollar is in higher demand compared to Francs.

EUR

The euro began the week trading off British Sterling in the absence of Euro specific news and flat comments from ECB members. Negative news, sentiment and data all focused on the UK had a knock on effect on the Euro as market participants assessed the likelihood of British problems having an impact on the EU and vice versa. The result was a very mixed picture for the Euro as it ended the week higher against GBP, CHF and NZD but lower against USD, JPY and CAD.

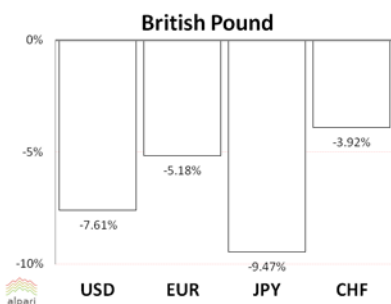


Probably the most important news to come out of last week in relation to the Euro was the news that Spain's AAA rating on its long-term sovereign debt had been downgraded because of Spain's deteriorating public finances. The Euro fell heavily on the news because Spain is the first AAA nation that has seen a rating downgrade since the beginning of the credit crisis. Market participants are focusing their attentions on other European countries such as Ireland, Portugal and Italy as the potentially new candidates to be downgraded because of their poor fiscal balances. The reason rating agency opinions are important is because many investors, firms and governments around the world must hold top-tier rated assets as part of their portfolio in order to satisfy regulatory and/or strategic requirements. If more EU countries are downgraded demand for European assets would fall leading to lower demand for Euros.

Market participants are also worried that the Euro may have long-term structural problems because theoretically there must be a strong performing country in the EU to counter-balance the poorly performing ones; so far almost every country in the EU has suffered from the same ills which makes a quick economic recovery look less likely.

GBP

The UK banking sector problems surfaced with a vengeance as RBS, Barclays, Lloyds and even HSBC (which had so far avoided most of the sub-prime problems) announced further losses and difficulties in providing sufficient funding to continue operations. The news was expected to affect financial markets very negatively when they opened last Monday. The UK government attempted to take the initiative and put forward plans for a huge injection of public funds into banks to alleviate their funding constraints but this failed to re-assure investors over the health of the UK banking sector and the UK economy in general. Sterling followed all major stocks indices, bonds and commodities lower as a result. GBP was 7% lower against the USD, 5% lower against the EUR, 9% lower against JPY and 4% lower against CHF. Fixed income was lower on fears that UK government debt may not sustain its AAA rating; this added pressure on Sterling because investors became anxious at the possibility of a domino effect whereby firms holding AAA UK assets would begin to sell those assets because of their lower stature leading to further downgrades.



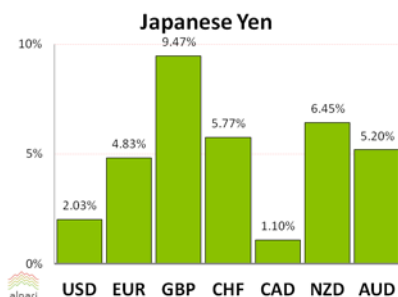
The events of last week precipitated fears that a policy of monetary expansion would ensue in the UK because the funding commitments made by UK authorities have been very large in proportion to its GDP and more importantly, in proportion to other nations. Public sector borrowing was reportedly higher in December, official figures showed on Wednesday. Market participants are expecting the continued rescue of top banks but whether continued support for failing banks leads to a crisis of investor confidence in the UK has yet to be decided. In the meantime, risk-averse investors have chosen to reconcile the facts of today with their fears for tomorrow by hedging their positions through other currencies.

Two bits of good news for GBP last week was the news of lower inflation figures which has alleviated fears of 'stagflation' occurring in the UK. Stagflation is the simultaneous increase of inflation alongside falling GDP growth. The news has also justified the Bank of England's decision to cut interest rates so aggressively in 2008 because inflation has been the main obstacle for the BoE when discussing rate cuts. The other good news was the unexpectedly strong retail sales figures for Dec 08. Although retail spending in December is the month most difficult to analyse because of the seasonal impact on the figures, the higher number did provide a boost to confidence and helped Sterling hold onto some ground despite official figures released on the same day showing that UK GDP growth had now become GDP contraction (-1.5% Q/Q). The UK is now in its worst recession since 1980.

JPY

The Japanese Yen ended the week stronger against every currency bar none. Its strongest performance came against Sterling (+9.47%) and CHF (+5.77%) as a week of pessimistic economic headlines helped traditional risk-havens like the Yen gain ground once again. The recurring pattern of safe-haven currencies doing well amidst dismal economic news across almost every sector continued last week as both the USD and JPY emerged broadly stronger.

Yen appreciation versus the USD was strongest on Wednesday of last week but this was tempered quite suddenly as a Bank of Japan official made comments relating to currency markets. This gave rise to the possibility of government intervention following JPY strength. Volatility soared very quickly and ensured the Yen gave back most of Wednesday's gains by the end of the evening trading session. Considering the prevailing market climate, many market participants are seeing government intervention as the only downside catalyst for the Yen. Although Japan hasn't avoided the financial crisis completely, it has avoided the crisis more so than other nations thus allowing its currency to be desired for its security potential. Although the Yen is experiencing strong gains largely as a result of risk-aversion, the risks for a reversal are clearly there in the form of falling sentiment and demand if the economic climate begins to improve and risk bias takes on a more balanced state.



CHF

Swiss Franc events were relatively subdued compared to other currencies although there were some important comments made by Swiss National Bank (SNB) members that anchored any gains that may have been expected considering the strong pessimistic tone set for the week by news emerging from the UK and US. SNB member Hildebrand acknowledged that the Swiss authorities are "willing to sell unlimited amounts of the Swiss Franc" to temper its appreciation amongst G10 currencies. This type of strong wording had a bearish effect on CHF as it struggled to gain ground over the course of the week.

Looking Ahead

- Average economic data calendar scheduled for this week overall as the US rate decision (with comments) on Thursday is expected to take centre stage.
- New Zealand expected to reduce rates by 1% although the range of expectations available suggests nothing is certain. Volatility is expected.
- First estimate of USD GDP figures for 2008 is likely to grab the headlines with an eye watering figure of -5.4% being expected by a survey of analysts.
- Germany scheduled to announce preliminary inflation figures which often act as a barometer for the rest of the EU.

This coming week is likely to be eventful and full of surprises purely because every week since the start of the year has managed to surprise market participants in one way or another. Despite a relatively subdued economic calendar and an absence of central bank speakers we are expecting to see an interest rate decision in the US and New Zealand. The Fed is likely to keep rates at their current level of pretty much zero so there is unlikely to be a market moving surprise there. What will be more important is the statement made by the Fed following the decision. A statement which makes quantitative easing more likely, more severe or more wide ranging than first thought may induce severe doubts over the value of the USD in the medium-long term despite its stellar performance in the short term.

A clear split in direction with regards to economic policy is occurring between the US/UK and Europe. The US/UK approach is to create liquidity by any means necessary including the expansion of the money supply whereas the European approach has been to let events take their course and only react when necessary, leaving plenty of room for action if required. This fundamentally different approach is likely to decide the EUR/USD and EUR/GBP outlooks in the medium-long term depending on the duration of the financial crisis in its present form. Comments made by ECB's Mersch late last week underline this division. Mersch suggested that the EU would have severe difficulties in following the policy examples set by the Fed and BoE primarily because the fiscal framework in Europe is very fragmented between the greatly different member nations. A move to force quantitative easing could force some EU members to leave the single currency if inflation and fiscal balances are not kept in check.

Last week's brutal assault on Sterling was restrained by speculation that the Bank of England would intervene in the FX market in an attempt to stem the tide against GBP. This speculation may become more widespread this week or could even become reality if the slide in GBP pairs continues at last week's rate. Currency devaluation is considered to be positive because it can stimulate export led growth via cheaper exports. This scenario has failed to materialise so far because foreign demand has not increased by the same rate at which GBP has fallen.

Comments made yesterday from the incumbent US Treasury Secretary – Tim Geithner suggested that then new US administration is keen to follow a strong dollar policy. This comment is quite often reported by the financial media and would usually have no significance because previous US politicians have claimed to have the same aim whilst conducting policy actions that are contrary to a strong dollar. The difference this time is that the US is in the middle of an unprecedented economic downturn that could rival the Great Depression of the 1930's. The future direction of the US Dollar is to a large degree likely to be influenced by political decisions because the government has openly been trying to prop up struggling industries and firms. In addition, it is highly likely that parts of the US economy will be placed under state control by the time the US economy begins to post positive growth figures; so as a result of the actions taken to deal with the current financial crisis, government intervention and influence will now become more common and accepted within financial markets.

In terms of other economic data, we are scheduled to see US existing home sales figures on Monday. These figures alongside new home sales on Thursday will give an indication as to how well the US housing sector is fairing in current conditions. Expectations suggest that both indicators will show sharp falls. Nationwide house price data from the UK (a very well respected estimate of UK house prices) due for release on Thursday is keenly anticipated because house prices are often associated with the performance of the macro economy overall. Also out this coming week are US durable goods orders data (Thu) and Canadian GDP figures (Fri); both could have a significant effect on USD and CAD pairs. As a side note, the USD/CAD pair could experience very wide daily ranges this week to reflect significant price swings because both economies have significant data out this week.

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