

# FX Weekly

## Review: 2<sup>nd</sup> February – 9<sup>th</sup> February 2009

### Market Focus

- A broad shift away from risk-averse, anxiety driven sentiment helps Commodity and Scandinavian currencies recover recent losses. Unexpected increase in Canadian unemployment capped any CAD gains
- British Pound takes the headlines again after unexpectedly gaining against all major currencies
- Japanese Yen falters significantly but maintains bullish sentiment amidst fears of falling risk tolerance in advance of major economic announcements this week
- Two very different interest rate decisions by the ECB and BoE sparked widespread criticism



### Market Research

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Currency pair	Previous Week Open	Current Rate	Nominal Change	% Change
EUR/USD	1.2751	1.2898	0.0147	1.15%
GBP/USD	1.4435	1.4789	0.0354	2.45%
USD/JPY	89.66	91.28	1.62	1.81%
USD/CHF	1.1635	1.1660	0.0025	0.22%
EUR/GBP	0.8832	0.8721	-0.0111	-1.26%
EUR/CHF	1.4839	1.5043	0.0204	1.37%
GBP/CHF	1.6793	1.7246	0.0453	2.70%
GBP/JPY	129.40	135.00	5.60	4.32%
EUR/JPY	114.32	117.74	3.42	2.99%
CHF/JPY	76.99	78.24	1.25	1.62%
AUD/USD	0.6357	0.6696	0.0338	5.32%
NZD/USD	0.5075	0.5297	0.0222	4.37%
USD/CAD	1.2270	1.2293	0.0023	0.19%

Correct at 09:08 GMT on 9<sup>th</sup> February 2009 | Source: Alpari (UK)

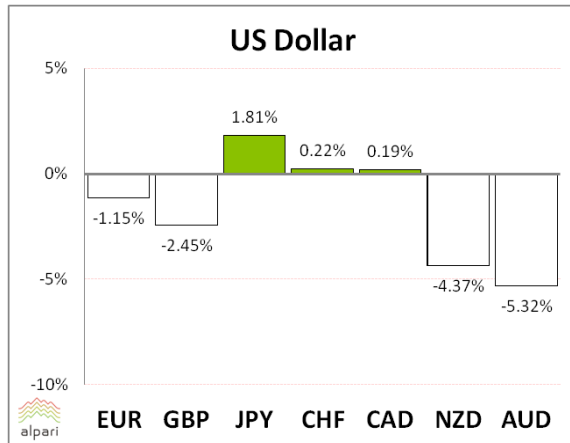
### USD

A Jekyll and Hyde week for most currencies began with heightened risk aversion in the currency markets following delays in the implementation of the fiscal stimulus plan. Republican opposition to some of its contents placed doubt in many people's minds as to how effective it will actually be, if it is ever implemented. Risk tolerance reached a low on Wednesday as Russian government debt was downgraded by Fitch, the rating agency, sparking fears of a repeat of the 1998 financial crisis in Russia that led to many Western firms suffering large losses. A flight to the USD and the JPY ensued but couldn't be sustained until the end of the week.

The US Dollar traded on the back of very subtle logic at the end of last week. Despite a huge increase in unemployment US stocks rose as investors turned their attention to the fiscal rescue package being lined up for the following week. Risk aversion subsided

markedly helping several currencies to gain against traditional risk havens of USD and JPY.

The major USD news from last week was the woeful employment report (598,000 jobs lost in January and 7.6% unemployment) failing to dent positive USD sentiment. Expectations of improving economic conditions in view of the imminent fiscal rescue package setup by the newly formed US government and the US Treasury helped to generate risk tolerance thus helping AUD, NZD, CAD, EUR and GBP to gain against the US dollar.



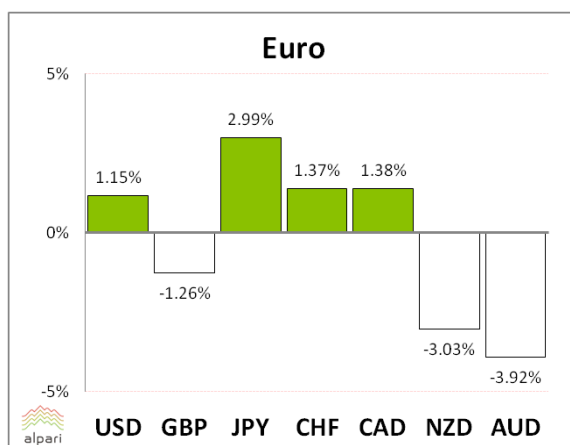
The US employment report has become increasingly difficult to trade in recent months because the wide range of expectations available makes it very difficult to predict the actual, 'true' expectation that will be focused on by market participants. The average of all analyst estimates suggested a figure of -530,000 but in reality a figure close to -675,000 was being expected as a result of disappointing economic data elsewhere and the simple fact that US data has been much worse than

expected over the course of the economic crisis.

Unfounded speculation and rumours helped USD denominated assets higher; first the rumour that the US Treasury was willing to guarantee inter-bank lending was followed by speculation that some US banks may be nationalised as a last resort, which is contrary to statements made by US officials. US equities tracked higher, ending the week in strong fashion in preparation for Geithner's and Obama's statements expected on Tuesday of this week.

## EUR

The Euro had a decent week against the major currencies, holding its ground well despite rumours of more EU members having their government debt downgraded and very pessimistic retail sales, factory orders and industrial production figures from Germany, Europe's largest economy. The Euro suffered a sharp sell-off on Wednesday as a Russian government debt downgrade led many investors to sell EUR in favour of USD. Despite the setback, the single currency recovered well.



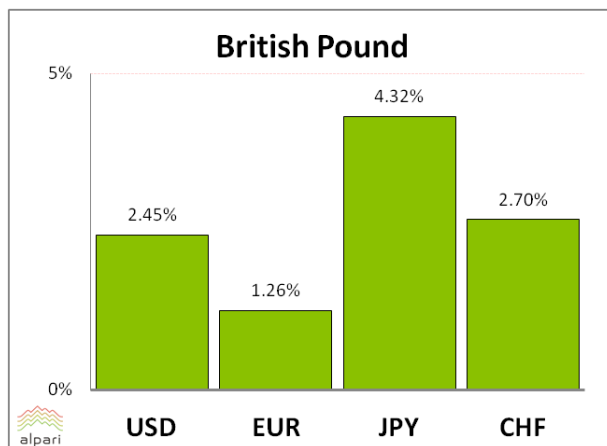
The ECB maintained its 2% interest rate and left room for a cut in March. Markets now expect a 0.5% reduction in March although this expectation may change repeatedly in the next month or so. The European approach to monetary policy has been different to that of the UK, US as well as other G10 nations because of differing attitudes and effects of interest rates in each region. The ECB's decision was met with criticism from some quarters suggesting that policy was 'behind the curve' as rate cuts were too small and would come too

late to save businesses. However, some market participants met the rate decision with applause

as the Anglo-Saxon model to policy was rejected because of its potentially inflationary consequences. Many investors praised the ECB because they were seen to be safeguarding savers and not just trying to prop up the economy with more borrowing via lower interest rates. The effect on the currency was mixed as the two opposing views were priced into the EUR market. The Euro fell immediately after the decision but ended the week higher against the USD, CHF, JPY and CAD.

## GBP

Sterling rallied strongly despite a 0.5% rate cut on Thursday. Market participants assumed that the BoE would be unlikely to cut rates any further and considering the likelihood that most other nations would cut rates down to approximately 1% in the coming months, the UK was actually ahead of the rest in stimulating its economy and would therefore be in a better position to gain the benefits of an economic recovery before other nations such as the EU countries. GBP strengthened against the Euro accordingly although most of its gains came against the JPY (+4.3%), CHF (+2.7%) and USD (+2.4%).



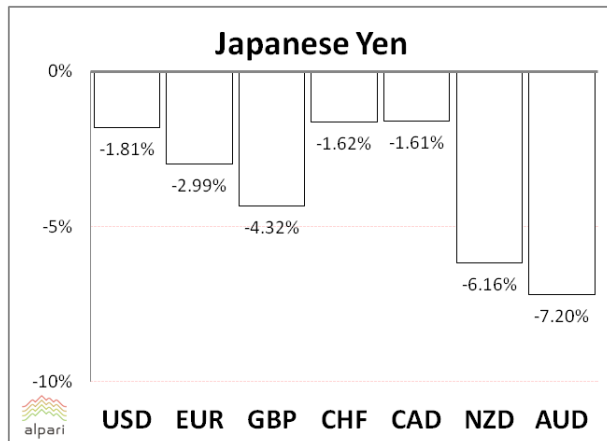
Sentiment was also helped by improved economic data that defied expectations to the upside for once. Manufacturing, construction and services PMI's were all higher which reassured many investors over the stability of the UK and its currency. The past few weeks have seen many comments related to the UK suggesting that its ability to weather the economic crisis has been weakened by a rapidly deteriorating retail sector, an anaemic banking sector, ballooning government expenditures and

plummeting house prices which were all helping to cause a widespread panic and a potential failure of UK authorities to maintain their top-tier rating on government debt. These concerns were subdued by positive economic figures; one of which was the Nationwide house price index that registered a 1.9% increase in house prices (Jan) versus an expected reading of -1.7%. This came as a surprise considering the downbeat sentiment surrounding the UK economy.

Looking at the charts for the past week it is striking how Sterling managed to trend so smoothly against other major currencies. Helped by risk appetite returning to the markets, Sterling was clearly in favour with investors throughout the week as speculation that the BoE would ensue on a policy of "unconventional unconventional measures" (a comment from Mervyn King, the governor of the BoE which some investors assumed to mean the literal printing of money) was quelled. Such fears helped to precipitate Sterling's decline so far this year as fears of future hyperinflation began to circulate.

## JPY

The Japanese Yen had a horrific week as it weakened against every currency. The largest losses came against AUD (7.2%) and NZD (6.16%) which are former carry trade currencies that were very



popular not so long ago because of the yield differential they offered. The Yen has been the risk mitigation currency of choice over the past 12 months so any good news related to the improvement of economic conditions has meant a sell-off in the Yen. This is exactly what happened last week as an imminent fiscal stimulation package from the US was very close to being ratified. Although some opposition to the plan still existed, expectations were strong that all

loose ends would be tied before the February 9<sup>th</sup>. At the time of writing an announcement of the stimulus package had been delayed until February 10<sup>th</sup> although this had not affected market expectations and had not shifted investor preference back towards risk-averse currencies.

## CHF

The Swiss franc suffered from deteriorating economic conditions as several economic indicators undermined Switzerland's good fundamental outlook so far. The trade balance was much worse than expected at 222million CHF compared to 1.74bn CHF expected. The trade balance fell from 2.25bn CHF in December. Much of the Swiss Franc's strength and its international reputation for being a risk-haven are derived from its comparative fundamental advantage over other currencies via a better fiscal balance, better government expenditure policies and its well renowned political status which often attracts foreign capital flows. All of these factors contribute to supporting the Swiss Franc.

In addition to a worsening trade balance, market participants were surprised to see rising unemployment as it edged up to 2.9%. Unemployment rates in Switzerland are one of the lowest in the world so the long-term impact of last week's economic data is unlikely to be significant.

Swiss National Bank's (SNB) Phillip Hildebrand made comments for the third week in a row that hinted at artificial currency devaluation by Swiss authorities. His comments have been taken seriously by market participants in recent weeks which have weighed on the Swiss Franc. The comments made by Hildebrand aim to improve the trade balance i.e. increase Swiss exports at the expense of Swiss imports through a weaker currency so last week's trade balance probably disappointed not only Swiss authorities but also speculators. It is conceivable that the SNB will prefer the Swiss Franc to weaken much further in light of last week's trade balance figures.

# Preview: 9<sup>th</sup> February – 16<sup>th</sup> February 2009



## Looking ahead

- Very informative and volatile week expected as numerous market moving events are scheduled. Timing of any trading decisions will be key as speculative trade is likely to occur well in advance of important data announcements
- US fiscal stimulus package worth up to \$900bn is likely to take centre stage
- UK quarterly inflation report will be a key focus as future interest rate and alternative monetary policy motives could be revealed

The US Dollar has shown glimpses of trading according to levels of risk in the market rather than US centred economic data. We have seen times when very poor US data has led to USD strength because of heightened risk aversion and anxiety inducing liquidation of equity positions in favour of more secure assets as well as more secure currencies such as USD and JPY. This coming week will see formal announcements by Geithner and Obama talking about the latest fiscal stimulus package and 'bad bank' details. Some reports suggest that the 'bad bank' route will not be taken, instead a more gradual injection of capital into banks as and when it is needed may be preferred.

We expect an announcement on Tuesday although we may well have surprise comments/announcement on Monday if details are already ratified. The delay of the US comprehensive plan to deal with toxic debt, ailing banks and the financial crisis overall from 9<sup>th</sup> Feb to 10<sup>th</sup> Feb has not affected market sentiment. However, the actual contents of the plan are far from certain and could still disappoint market participants if some parts of the plan are/are not included. Volatility surrounding the announcement on Tuesday and Timothy Geithner's subsequent speech is likely to be high. In addition, how the package is digested is likely to dictate the long-term direction of the US dollar.

The other major key aspect to this week will be the BoE quarterly inflation report that could either signal further dovish monetary policy if the inflation outlook continues to weaken. On the other hand, we could see a definite pause to monetary policy easing if inflation and inflation expectations remain high. Other UK centred data is also likely to impact GBP sentiment this week including Trade Balance figures (Tue) that will provide an indication as to how the recent GBP weakening is affecting actual trade figures. Several BoE members have noted short-term Sterling weakness as a path to long-term Sterling strength via higher exports creating a UK export led recovery. Tuesday's figure could reinforce such a view or completely vanquish its relevance if the UK economy is seen to be exporting less despite its weaker currency. International trade figures are notoriously difficult to gauge because there are so many factors at work. The key theme here is whether the significantly lower GBP has enabled UK exporters to export more. Under normal circumstances we would assume that exports should increase but under current economic conditions with plummeting demand in several sectors simultaneously we could see that global demand for UK goods is falling faster than Sterling thus nullifying Sterling's fall over the past 6 months. In real terms, Mervyn King is expected to deliver a very pessimistic assessment of future UK growth which could send the currency lower erasing gains made in the past 2 weeks. It is worth noting that on the same day, UK jobless claims and the UK unemployment rate will be announced.

A key theme related to the UK is the current and expected future level of interest rates in the UK. Interest rate cuts in the UK could be a good option for the UK if you take the traditional view that

lower rates make it more likely for borrowing/spending to take place as well as making it easier for the UK economy to come out of the economic recession. The other view which could potentially force Sterling lower is that lower interest rates will actually hurt both lenders and savers thus reducing economic activity, exacerbating the current recession and reducing the value of the Pound as investors switch capital away from the UK. The rationale behind this view is that lower interest rates are not actually being passed onto parties that need capital because banks are reluctantly keeping onto capital to reinforce their own balance sheets and also because the interest rates being offered by banks are very high in real terms as a result of immensely tight margins hurting bank profitability. The other side of the equation; savers (who are estimated to outnumber borrowers 5-1 by some estimates), are being squeezed because their capital is earning less interest with each interest rate cut. The result is that savers end up with lower disposable incomes and borrowers cannot borrow at low enough rates, if at all. This dual effect hurts banks even more because savers withdrawing their funds in search of better yields mean that banks have less capital which is the problem that helped cause the financial crisis in the first place. It is becoming quite apparent that the problem in the UK economy is not the price of money but its availability.

Other notable data expected this week are US Trade balance (Wed), US retail sales (Thu) and US jobless claims (Thu) numbers. These figures could throw a spanner in the works of any upbeat sentiment that is generated by the stimulus package announced days earlier. Market participants have already priced in a significant fall in US growth so the current recession may be further along the curve than the EU's or UK's or any other nation for that matter which may give the US Dollar support despite weak readings. Trade surrounding US figures is likely to be difficult this week as a multitude of views and interpretations are likely to make USD direction choppy and unpredictable.

German current account data could be important if significantly outside of analyst expectations because many investors are specifically looking at core fundamentals of currencies to differentiate between them considering that interest rate differentials are equalising rapidly. A larger than expected negative balance may spook market participants into selling EUR in favour of currencies with better current account statuses such as JPY, CHF and NOK. Also from Europe, EU GDP estimates (Fri) could make an impact on the Euro considering the recent focus on European interest rates.

Also due out this week is the Swiss CPI reading for January (Tue) which is expected to show a deflationary fall of 0.5% for the month. Deflation stokes fear and anxiety amongst investors because deflation hurts savers as well as borrowers simultaneously, eroding the buying power of everyone. A worse than expected could push the Swiss Franc significantly lower while a stronger number is likely to provide support under the shadow of the SNB who are ready to intervene if the CHF appreciates significantly. What exact level that is will only be known to the Swiss authorities and is likely to be a range which could change subject to economic data due for release this week.

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