

Market Insight

A wide selection of themes continue to drive currencies

Over the past 3-6 months several themes have gained prominence for being drivers of sentiment and price action. The most dominant and market moving have changed rank several times leaving many traders lost in the mire as they struggle to keep up with the pace of the FX market. This article aims to outline some of the major themes and talking points that are currently dominating.

- The UK financial sector is pivotal to the level of UK growth so its performance can be closely linked to the overall performance of the UK economy. Over-exuberant risk taking over the past 5 years has led to an economic downturn exacerbated by bad debt and excessive leveraging.
- Protectionism may begin to occur because all governments are under pressure from their citizens to protect jobs, businesses and even whole sectors. The concept of “de-globalisation” has been coined as trade volumes decrease which could lead to the breakup of the European Union, at least in its monetary form because all member states may not be able to agree to a co-ordinated course of action to deal with credit/financial/housing sector problems. Euro weakness could be long term and severe even if one member state left the union because speculation would remain that another would leave. German banks have cut lending to other European banks, preferring to concentrate on credit markets in the domestic economy. This shows that protectionism could be a reality.
- The problems in credit/financial/housing sectors have acted as catalysts for each other and ensured that momentum of economic declines in the US, UK, EU is sustained and even increased as a domino effect occurs. Sub-prime exposure has led to dystrophy amongst lenders so even profitable businesses are having trouble to continue day-to-day operations which require short-term lending.
- The bailouts that have been announced around the world have been planned mainly for domestic markets so large countries have an advantage. US, UK, Germany and Japan have all announced large-scale support for domestic business whereas many other countries are not and will not be able to do so. This trend could either add strength to a particular currency because the domestic economy could grow and economic activity increases. On the other hand, if a nation’s bailout fails to work and simply creates inflation (via an expanded money supply) or an unbalanced fiscal profile (due to excessive government spending) that particular currency could suffer.



Market Research

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- Yield considered less important compared to capital preservation in times of anxiety or panic. The current economic environment has been surprising speculators with its twists and turns for several months now. Standard logic that usually applies to currency markets has changed significantly so the accepted reaction to a particular event must be re-evaluated because of the nature of today's currency markets.
- Current problems in the financial markets are encouraging savings rates to rise; at exactly the time that interest rates are falling along with demand. Individual priorities are focused on saving and securing personal circumstances whereas UK authorities are attempting to make people spend and take on debt via cheap borrowing. Lending at low interest rates helped to create the current economic environment so most people feel inclined to reduce spending as a reaction to the financial crisis. Saving in times of trouble is considered prudent for each particular person saving but it is deflationary for the rest of the economy as spending falls along with aggregate demand.
- Davos meeting raised the issue of Yuan undervaluation. Geithner called on Chinese authorities to help the Yuan appreciate and accused Chinese authorities of artificially weakening the currency. He was immediately criticised because lifting a currency at a time of recession is very damaging to exports and growth. The Yuan issue could spill over into a protectionist stand-off between the US and China. This could be dangerous for both nations because China is one of the largest investors in US Treasuries thus allowing the US to borrow money and keep its economy functioning; a protectionist exchange could further weaken already declining flows into the US from China leading to a weakening US dollar and difficulties for the US to borrow funds needed to sustain a large (yet slowly declining) budget deficit.
- Exposure to emerging markets is a relatively new focus for traders as only recently did the level of exposure and its likelihood began to be estimated. European banks are estimated to be owed €300bn from Central and Eastern European countries. The magnitude of the effect upon the Euro is likely to be dependent on how much of that exposure is written off and not repaid.
- The status of the Yen as the world's premier safe-haven currency has come under scrutiny as investors question Japan's immunity to the current economic malaise. Although all countries have been affected Japan has stood out as the country which could weather the storm best due to its strong fiscal position, savings ratio and lack of exposure to questionable assets such as sub-prime debt, CDO's, mortgage backed securities etc.

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