Fundamental | FX

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Market Insight

Confidence at a premium

Confidence in a recovery in the developed world as well as the broader global economy has waned in the second quarter with volatility rising spectacularly in May. Financial markets are at their mid-way point for 2010, yet most asset classes are severely underperforming consensus estimates made at the beginning of the year. Over the course of May LIBOR rates have spiked higher, equities have weakened across the World in both developed and emerging markets and US Treasuries have seen strong safe-haven demand – taking yields sharply lower below 2009 lows on the 2yr note.
Fixed income markets have on the whole outperformed equities over the first 6 months and commodities have broadly weakened. The standout performer so far this year has been Gold – reaching a lifetime high of $1,265 per troy ounce in mid-June, indicating a strong element of risk- aversion still present in today's 'post-crisis' marketplace.

By far the most dominant theme in global financial markets over the past 3-6 months has been the European sovereign debt crisis. A crucial side-effect of European over indebtedness has been to push the normally conservative ECB into embarking on a path of Anglo-Saxon market resuscitation – huge injections of capital to support hugely underfunded banks and governments. Peripheral European countries such as Portugal, Greece, Ireland and Spain have been able to find adequate funding since the emergence of sovereign debt issues but at the cost of being increasingly reliant on the ECB for capital. This is hurting investor confidence about the viability of non-core Euro members, skewing investment decisions and preventing a broad recovery in the European Union.

One of the major themes over the next 2-3 months will be European funding for sovereigns and financial institutions. The funding obstacle this July is extensive despite the recent €750bn stabilisation fund, extensions in ECB lending facilities and full-blown quantitative easing (QE) – a policy tool that by their own admission gave ECB members nightmares when the US and UK trail-blazed similar policy responses in 2009. The funding requirement for European sovereigns and financials is heavier in June and July than in any other two month period over the next two years. This leaves the door open for distressed auctions, funding problems, deleveraging, duration mismatch and bouts of quasi-panic leading to Dollar, Yen and Swissie strength.

Euro bears are adamant that a funding crisis is ongoing in the Euro-zone and that the debt burden faced by many European countries is far too large even for desperate budget cuts to alleviate. This may have an element of truth over the mid-long term if proposed fiscal austerity measures are not implemented efficiently but in the short-

alpari

Market Research

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

alpari.research

term, if there was a true funding crisis we would have seen European banks bid aggressively for US Dollar funding in the US given the Dollar's relative cheapness. Also, we should have seen a strong rise in the repatriation of existing Dollar denominated assets and capital – neither of these effects have occurred so far, unlike during the financial crisis in 2008.

The huge liquidity and government support measures put in place by most G20 countries over the past 12 months has helped to raise confidence, business activity and trade but the core reality is that as the near-term outlook becomes clearer via government and central bank support, the long-term becomes more blurry because of the inevitable problems that will arise when central bankers decide to unwind their immense liquidity provisions and governments cut into inflated budget deficits. We are already seeing a raft of fiscal adjustment in the US, UK and mainland Europe – other territories are certain to follow if only to hide away from speculators looking for the next weak spot.

In the currency space over the next 6 months, we expect weakness in commodity-linked currencies to abate. CHF, JPY and GBP have been the top performers against the majors over the second quarter and the Euro is posting gains against AUD and CAD – moves away from cyclical currencies such as AUD, CAD and NZD into USD, JPY and CHF should diminish if fiscal austerity is implemented rather than just announced and if the Yuan is allowed to appreciate against the Dollar by the PBOC. Emerging market currencies such as BRL and INR are in a good position to benefit from foreign capital flows over the next 12 months because of increasing worries about inflation and excessive growth. Monetary policy in the emerging markets is more concerned about inflation rather than fiscal imbalance or funding problems at domestic banks which suggests a widening yield differential between rapidly expanding countries in Asia and the developed world.