CitiFX® Strategy – EURUSD

Why we believe it is different to 2005 and why we think a move towards 1.43-1.45 by year- end is likely

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As EURUSD stands just below the major high posted in December 2004 at 1.3670 (traded marginally above this time at 1.3683 on 27th April 2007) the big question is how big is this level?

While understandably everybody is focused on this level (being the prior high since the inception of the EURO) our belief is that the dynamic **could hardly be more different from late 2004.**

In our view (as detailed below) the only thing similar to 2004 is the level of EURUSD. After that, from a big picture perspective, we believe the importance of that level is being way overstated.

Fundamental drivers:

- Economic picture is softer in U.S. and firmer in Europe
- ECB is tightening with Fed on pause (Reverse of 2005)
- Interest rate spreads are dramatically narrower than seen in 2004-2005
- The U.S. yield curve moved to inversion in 2006 (for only the 3rd time in the last 20 years) compared to the positive slope in 2005

Flow drivers:

- Picture today is not the same as 2004.
- **No position restraint to re-building of EURUSD longs**
  - In the leveraged sector where the 'agnostic longs' have translated into short-term tactical positions. There is no positioning constraint to a resumption of the buying interest.
  - Amongst real money investors EUR/USD buying that began last year may still be at a early stage
  - Since the beginning of this year that EUR/USD selling (driven primarily by Opportunistic US exporters and European importers) has finally begun to subside

Technical drivers:

- Technical picture remains remarkably like 1989-1991
- Interest rate spreads still look likely to continue to narrow against the USD
- Inverted yield curve has been a strong dynamic in the past.
- Market psychology and positioning seems different to early 2005

Overview:

We believe that this picture creates a strong and compelling argument for a period of medium term EUR strength and USD weakness

However, in the short-term, the fundamental, technical, flow and triple moving average model all suggest the danger of a short-term corrective move lower (Possibly below 1.3400)

On that basis we are not at this point going to put on a long EURUSD trade but rather be patient in the days ahead to see whether this better entry level can be seen.

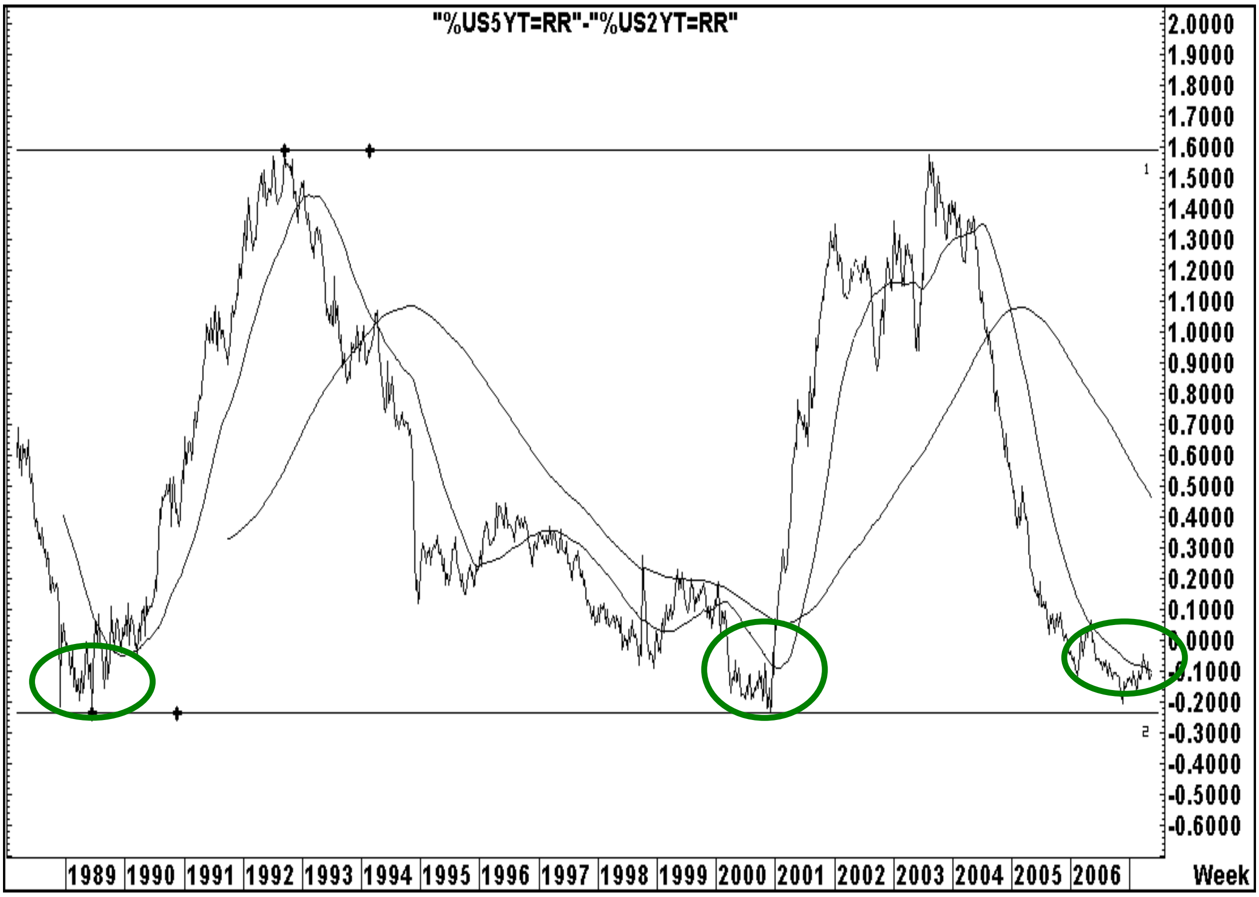
Bottom line we think this whole picture paints a compellingly negative USD story that will continue to see EURUSD move higher with an expectation of close to 1.45 by year-end.

Medium term Fundamental drivers: positive EURUSD

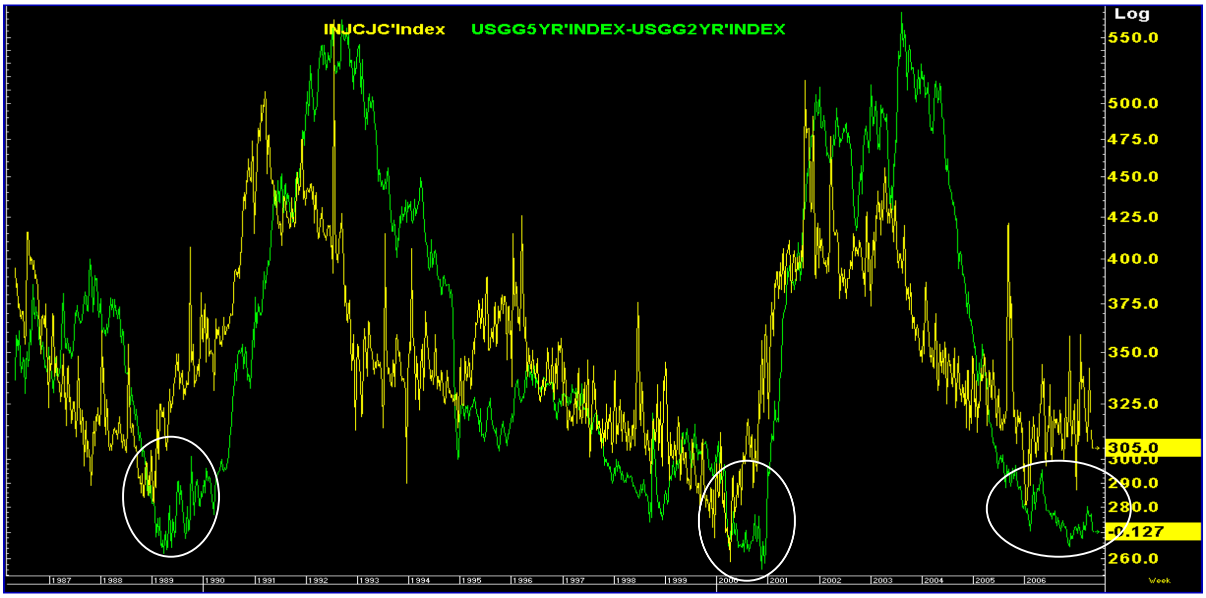
Comparing EURUSD in late 2004 with today

Fundamental picture

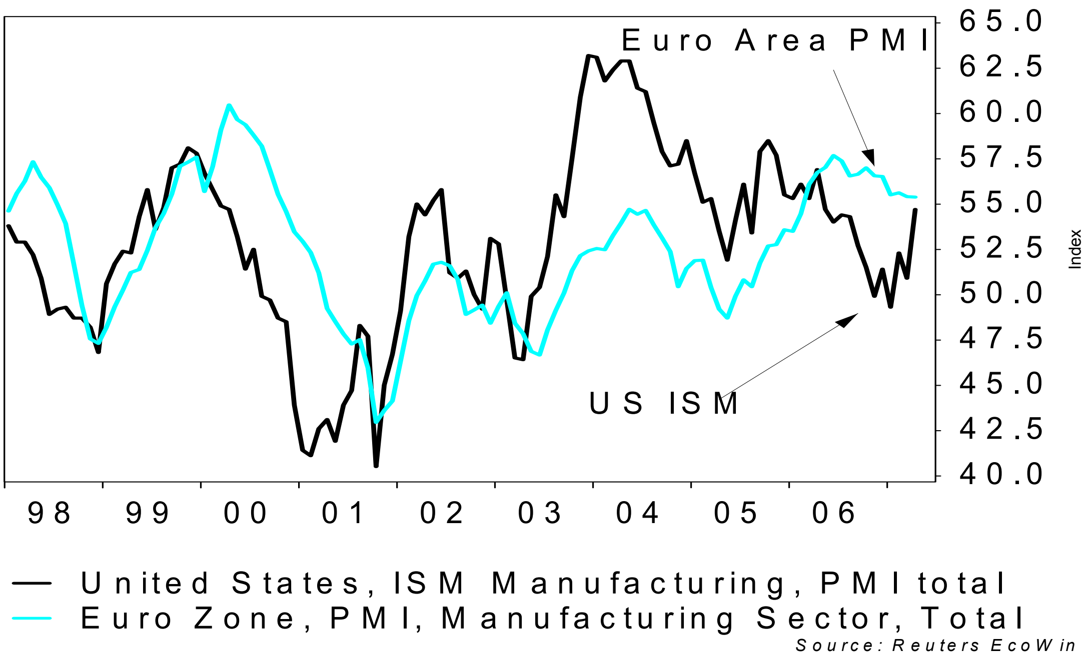
- As we headed into the 4th quarter 2004 Economic growth was at 3.1% compared to the 1.3% just posted for Q1 2007(The lowest since March 2003 and likely to be revised lower).The housing market remained strong, ISM manufacturing was closer to 60 than 50, NFP had just hit the peak of the uptrend at 350k in Oct'04' etc. etc.
- Interest rate spreads have been narrowing dramatically against the USD compared to widening strongly in favour of the Dollar into 2005. The Fed has been on pause for the last 10 months instead of tightening (while the ECB has been tightening instead of pausing)
- In late 2004 the yield curve (5 year minus 2 year) was at +60 b.p.'s and flattened as the Fed tightened more aggressively than expected in 2005. Now the yield curve has inverted to a low of minus 20 basis points. This is only the 3rd inversion in the last 20 years. The other 2 times were in 1989 and 2000 when it inverted –23 b.p.'s in both instances, correctly signalling the only 2 recessions in the U.S. in the last 20 years. This time could reflect increased mobility in international savings and renewed strong credibility on monetary policy,but it at least also suggests a level of concern about future economic conditions.
- In 2005 we also had the homeland investment act which provided a one-off window of significant USD demand. By definition that does not exist this time.
- Today central banks around the world are accumulating more and more USD reserves at a time when they are receiving little premium (interest rate spread) compared to 2005.
- The Fed was in a tightening phase that accelerated in 2005 resulting in a sharp move in interest differentials in favour of the USD. By end December 2004 U.S. 2 year yields had moved to 75 b.p.'s over Europe (From 143 b.p.'s under in August 2002) eventually peaking at 188 b.p.'s over in October 2005.This spread is now back to only 49 b.p.'s in favour of the U.S. and looks set to narrow further in the months ahead. As recently as June 2006 this spread was still as high as 179 b.p.'s in favour of the U.S.



- **The 1989 yield curve inversion is particularly interesting as it came just ahead of the 2nd move lower in the bear market in U.S. housing that fed through to the underlying economy, employment etc.**

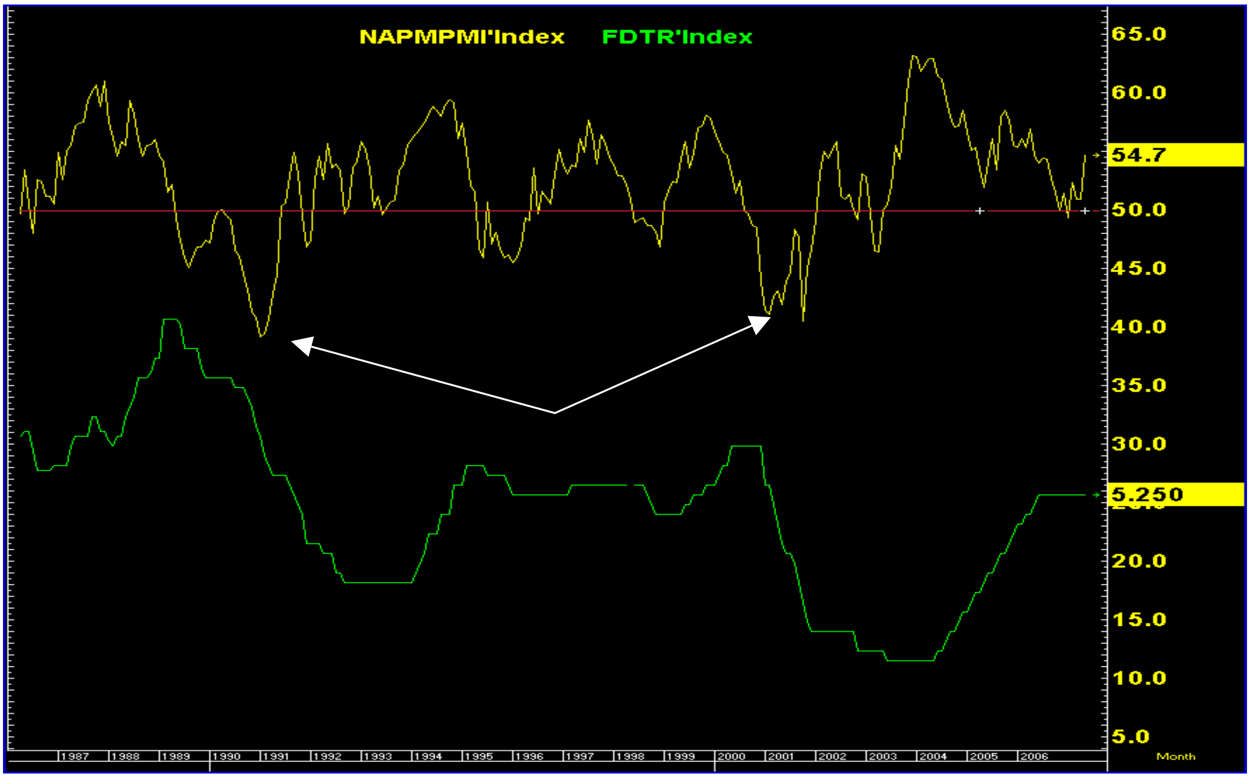


The chart above shows the overlay on the yield curve and initial claims. As can be seen above they are closely correlated. In both the 1989-1991 period (Housing market downturn) and the 2000-2001 period (Stock market downturn) the curve eventually started steepening again as these issues fed into the underlying economy, resulting in a deterioration in the employment picture and leading to the Fed easing substantially.



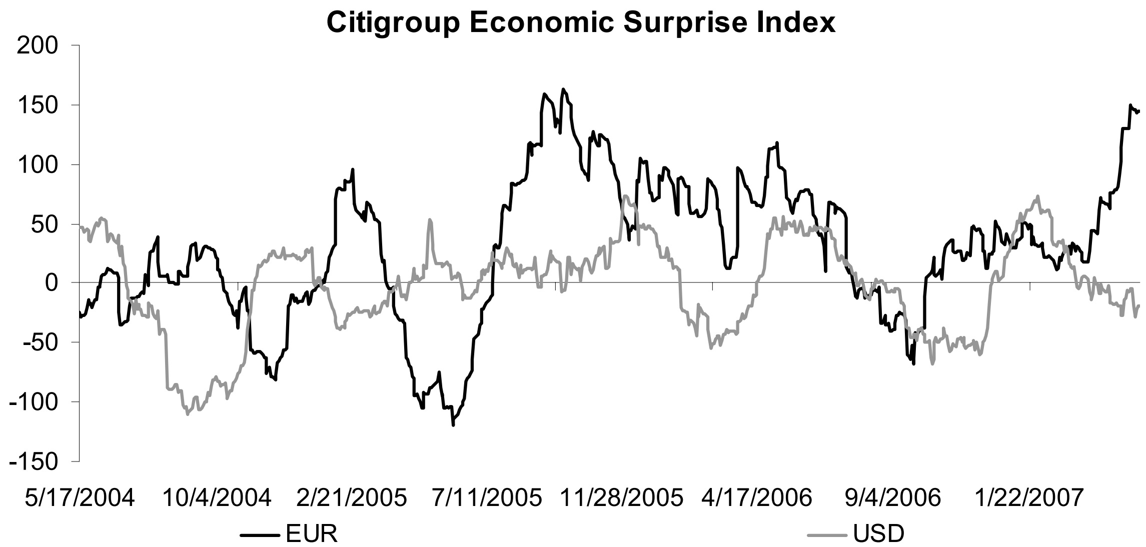
Euro area PMI has crossed above that of the U.S. While the U.S. has had a near term rebound from 49 to 54 it also bounced from 45 to 50 in 1989-90 before falling again to 39 in May 1991. This is one of only 2 times in the last 20 years that it moved towards 40. The other occasion was the 40.5 low in Oct 2001.

Given the chart below. Whether this continues to recover or falters could be a very important factor in how this picture plays out.



This chart shows ISM and the Fed funds rate. **Every time ISM has moved significantly below 50 in the last 20 years (Without exception) the Fed has cut rates)**

The only 2 moves to 40 occurred in 1991 and 2001. This followed the only 2 occasions of yield curve inversion in the last 20 years and was accompanied by the only 2 U.S. recessions in the last 20 years and ultimately the 2 largest easing cycles in the past 20 years.



We have seen a sharp widening in the gap between Citi's Euro area and US economic surprise indices Strong growth in emerging markets has helped to support surprising strength in euro area activity while at the same time the housing market correction has constrained activity in the US.

With relative cyclical trends a key determinant of EUR/USD direction, the USD could be vulnerable to increased evidence of spillover from the housing sector if it took place. Softening in consumption or deterioration in

business conditions could drive significant further USD weakness. As surging euro area activity is driving ECB tightening, the danger is that if this continues it would likely be EURUSD supportive.

Medium term Flow drivers: Positive EURUSD

Rotation, Rotation, Rotation

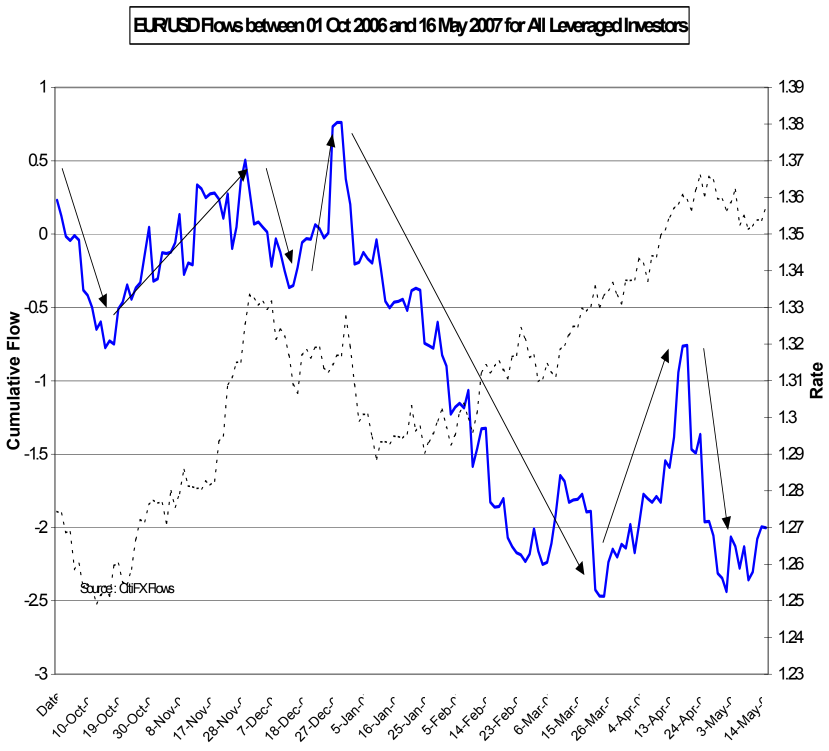
Here we take a step back from both very short-term spot movements and our very latest flows to draw out medium term themes in EUR/USD. These themes emerge by looking at the multi-year flows that provide clear evidence of a series of flow cycles.

From as early as 2002 the real money and more latterly the leveraged sector, drove a cycle of EUR/USD buying that culminated with two legacies by the end of December 2004: a new all-time high for the Euro and extreme positioning. From a flow perspective this legacy was a very important backdrop to EUR/USD's underperformance in 2005.

In 2005, the cycle was for heavy selling of the currency pair as real money and leveraged investors unwound the longs that had built up in tandem with spot's ascent. **In 2007, given that spot is once again hovering at similar levels we want to re-iterate the key view from CitiFX Flows: this is not a déjà vu, the structure of positioning is very different now.** There has been a reluctance to build extreme positioning, preferring regular rotation. This has been particularly prominent **in the leveraged sector where the 'agnostic longs' have translated into short-term tactical positions. There is no positioning constraint to a resumption of the buying interest.**

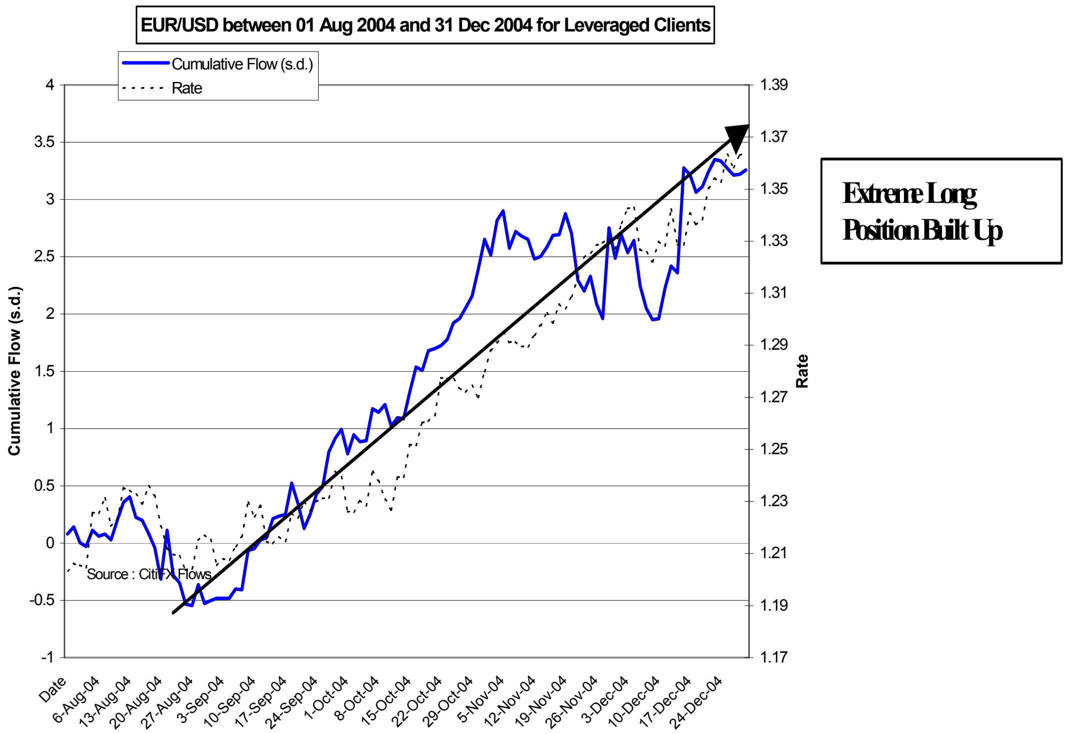
We can divide this question into three primary sectors of our client base: leveraged, real money and corporates. The rotating nature of the leveraged flow is very clearly shown below and is an important element in our view that **there is plenty of fire power should they decide that we can decisively break into a higher range.**

Chart 1. EUR/USD Leveraged Flows Since October of Last Year – 'Agnostic Longs'



Arrows indicate constant accumulation of longs followed by profit-taking on each spot rally

Chart 2. EUR/USD Leveraged Flows In the Run-Up to the 2004 EUR/USD Spot Highs



It must be acknowledged that the **real money sector** has been accumulating long EUR/USD positions since the beginning of 2006 (mostly from US funds). Indeed this has been a primary factor in our strategic EUR/USD positive over that period. However this should be seen in the context of a clear asset preference shift at both a retail and institutional level away from US assets towards European assets, as concerns have grown over the relative performance of the US. Furthermore, in looking back at previous flow cycles we can see that the EUR/USD buying by real money in the previous cycle (the beginning of 2002 until the end of 2004) lasted three years. In this context the **EUR/USD buying that began last year may still be at an early stage particular if the logic behind that asset preference shift remains in place.**

Finally we can look at the **corporate sector.** This group has been a heavily accelerated seller of EUR/USD over the past few years. For the natural corporate EUR/USD sellers, the combined impact of the Homeland Investment Act, elevated commodity prices, attractive spot levels and beneficial forward points has meant that the incentive for accelerated exposure management has been skewed to the EUR/USD sellers. However **since the beginning of this year that EUR/USD selling (driven primarily by Opportunistic US exporters and European importers) has finally begun to subside.** This has ‘taken the brake’ off the spot market, as they no log cap each higher spot level. Without their supply, the risks of not only a spot rally, but also a dysfunctional move higher increases.

In conclusion we would argue that the comparison with the EUR/USD rally in 2004 should not be over-emphasised. Despite the spot rate being close to where the market failed last time, the flow backdrop could not be more different and then the EUR/USD buying cycle may have significant further to run. This is not a time to expect spot exhaustion. This is not a crowded trade.

Medium-term Technical drivers: Positive EURUSD

Comparing EURUSD in late 2004 with today

Price action

In the last 4 months of 2004 EURUSD powered up nearly 17 big figures into year end (14 ½ of those big figures in the last 11 weeks of the year.). The rally in this last 4 months has been less than half of that at just over 8 big figures. In addition EURUSD has rallied 20 big figures low to high in the last 18 months compared to 30 big figures in the 16 months into Dec 2004.The conclusion being that this move is not nearly as stretched as it was then.

Interest rates

The Fed was in a tightening phase that accelerated in 2005 resulting in a sharp move in interest differentials in favour of the USD. By end December 2004 U.S. 2 year yields had moved to 75 b.p.'s over Europe (From 143 b.p.'s under in August 2002) eventually peaking at 188 b.p.'s over in October 2005.

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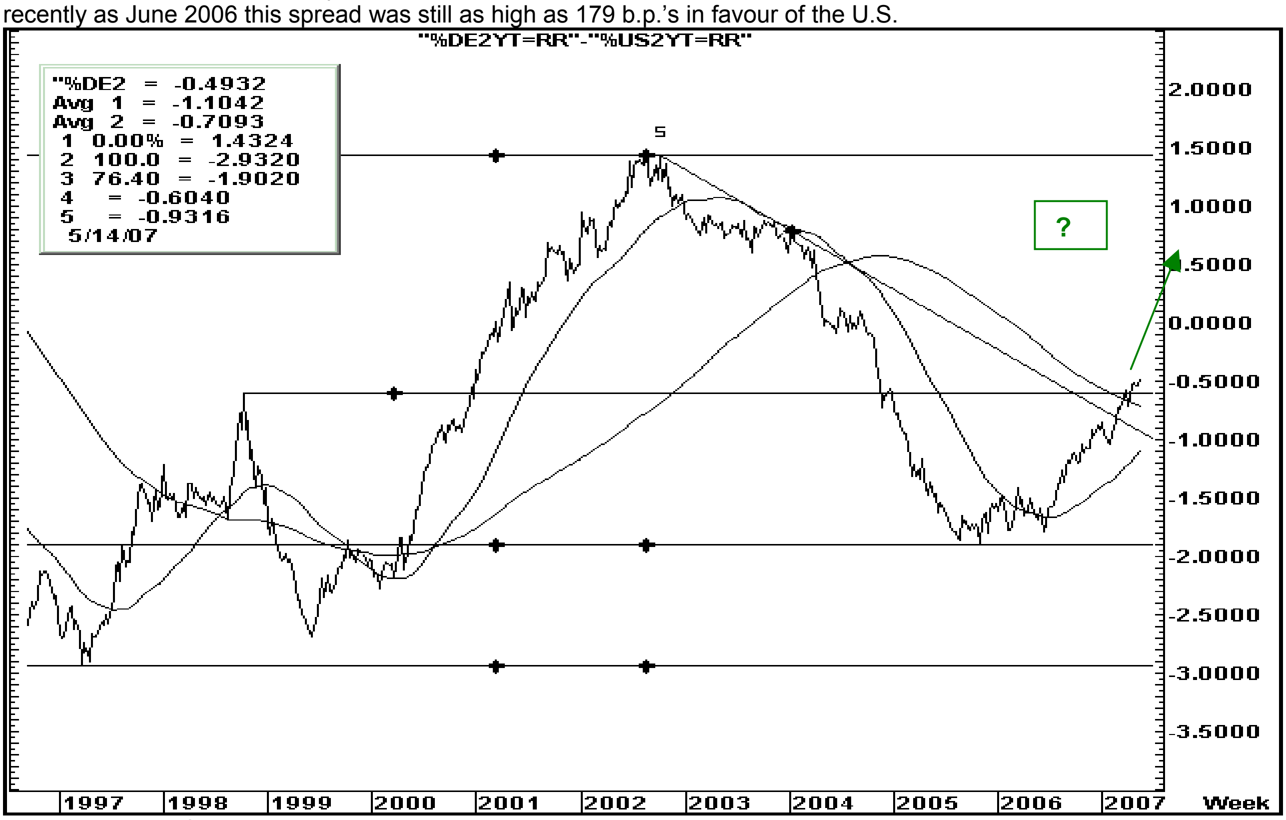


All major levels of resistance (including the 200 week moving average have now been broken here suggesting the danger that this could head all the way back to ZERO in the months ahead.

Market sentiment and positioning

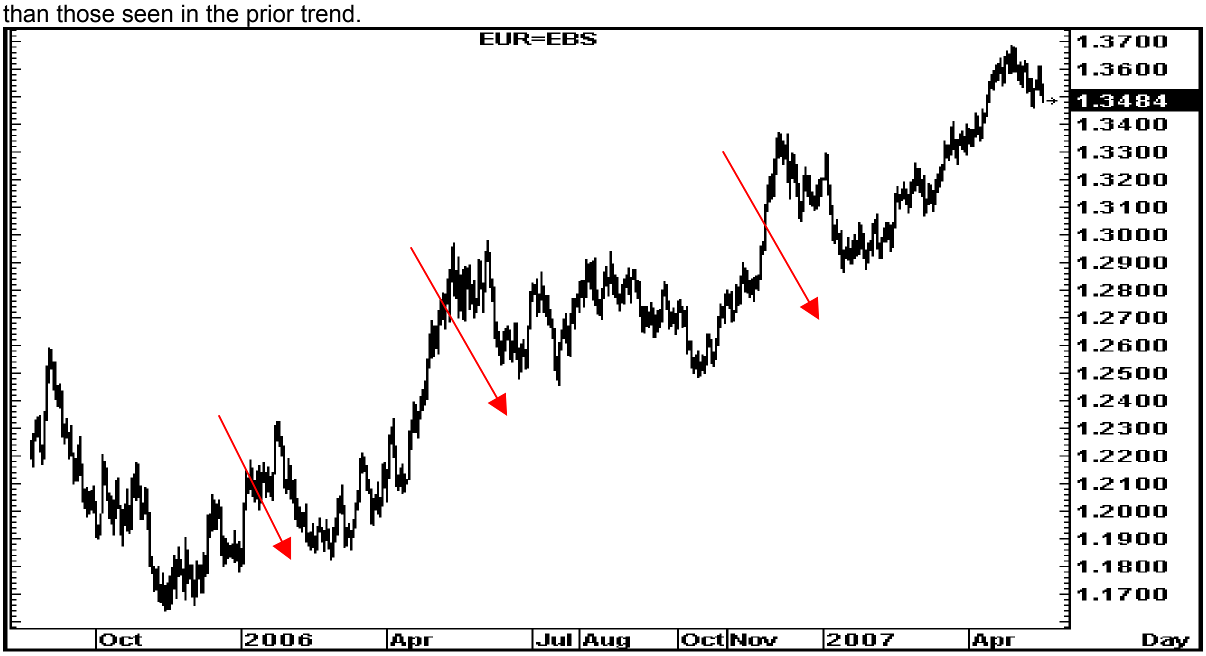
As we headed towards the end of 2004 everybody in the World seemed to be bearish for the USD despite the fact that there appeared to be a number of more positive dynamics developing (Technically as well as fundamentally). Not only was the view very bearish but also "everybody in the World" seemed to be short USD using all the "old arguments" that took it to 1.3670 in the first place. Newspaper and magazine articles proclaimed the end of the Dollar etc.

Then even as we entered 2005 and the fundamental picture was improving, interest spreads were rising in favour of the USD as people remained in denial. The considered view was even if EURUSD headed lower it would not break 1.25-1.27 because of "demand from reserve diversification".

And of course we should not forget the Homeland investment act, which encouraged U.S. corporations to repatriate profits due to a one-off favourable tax treatment in 2005

Given this broad based favourable picture it cannot be that surprising that the "reserve diversification demand" that was expected to save "USD shorts" did not materilaise as expected at the 1.25-1.27 level. Down went EURUSD from 1.3670 to 1.1670 in a "perfect storm" of positive developments for the USD. This was the biggest single correction in favour of the USD since EURUSD turned in late 2000. This followed corrections of 11.70 big figures in mid 2003 and gain in early 2004.

So let us fast-forward to this move and compare:
Since EURUSD turned up from 1.1640 in November 2005 it has not been able to sustain corrections of more than about 5 big figures as we have headed all the way back to the trend high at 1.3670. These corrections have been much shallower than those seen in the prior trend.



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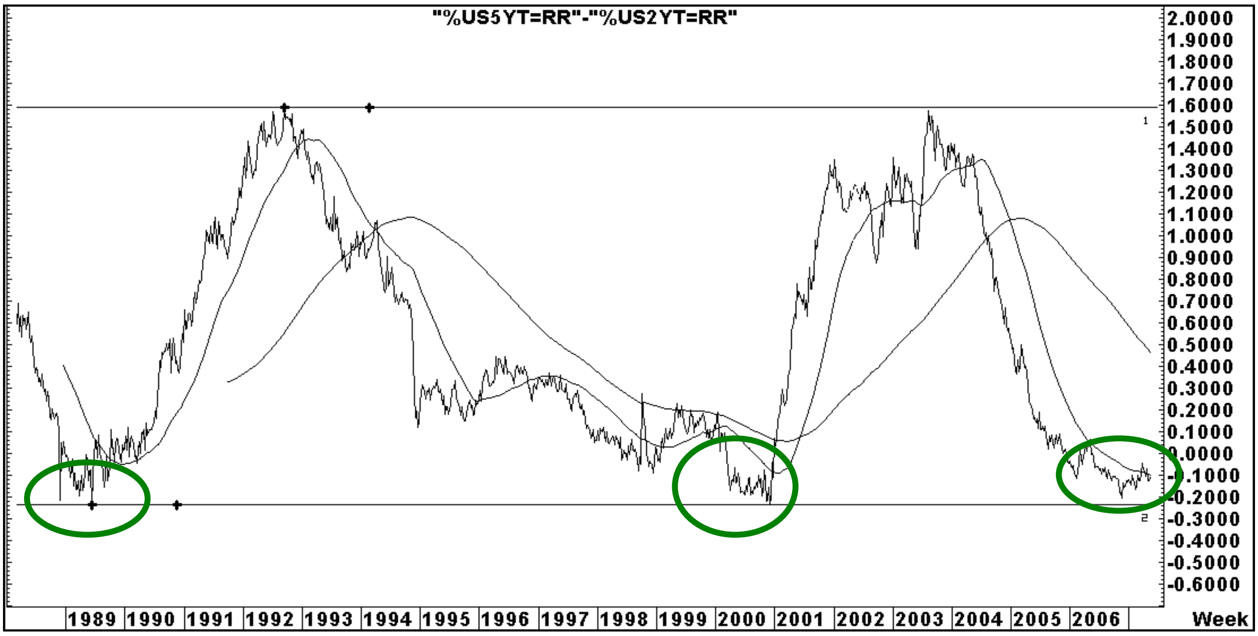
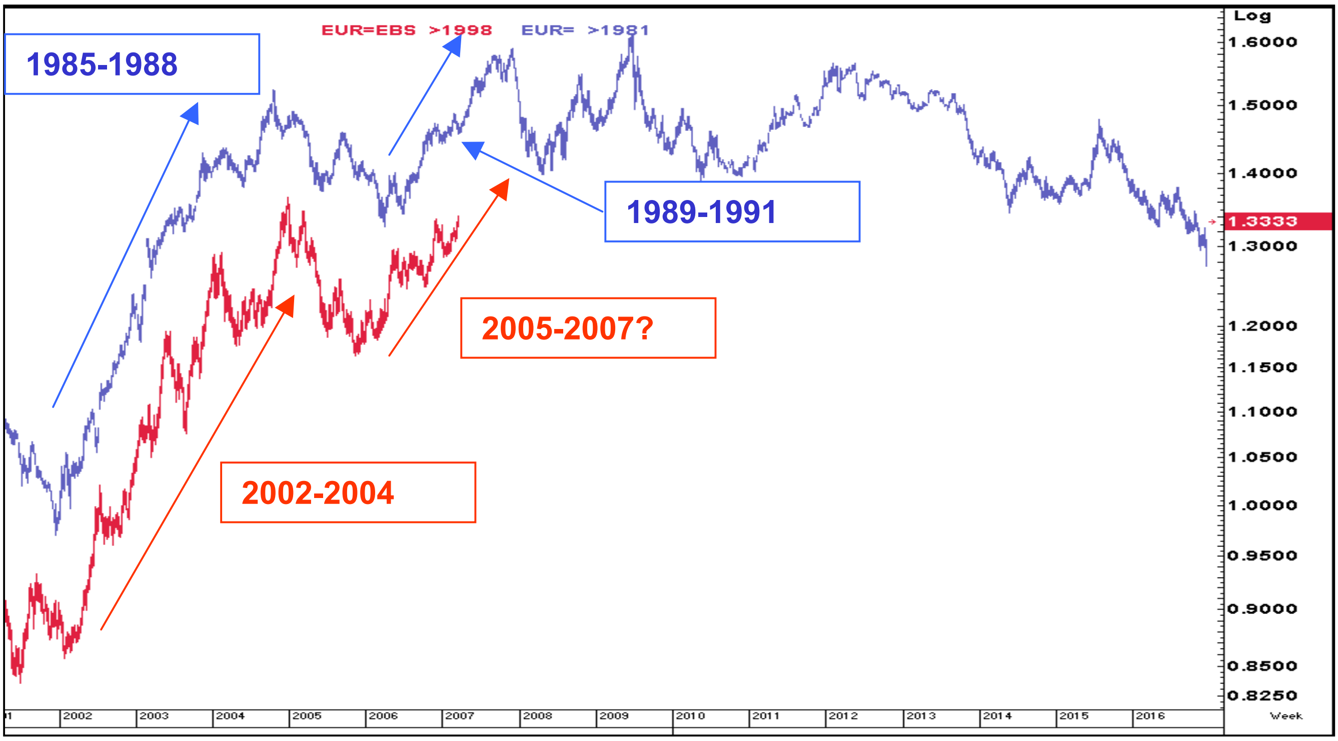
This is only the 3rd inversion in the last 20 years in the U.S. 5 year minus 2-year curve. The other 2 times were in 1989 and 2000 when it inverted –23 b.p.'s in both instances correctly signaling the only 2 recessions in the U.S. in the last 20 years. These 2 periods were also followed by Fed-easing cycles .



Positioning:
The market (in our view) seems to have been so focused on the high yield/ low yield scenario that this USD weakness seems to have crept up on a lot a people without associated positioning taking place.(As Citiflows confirms)
Unlike early 2005 where there were a host of technical, fundamental and interest rate developments building a "perfect storm" in favour of the USD (thereby encouraging reserve diversifiers to step away) we would argue that we are looking at a potential set of "perfect storm" developments on totally the other side of the equation i.e. USD negative. If so with an ever increasing amount of authorities building an ever increasing amount of USD reserves (and getting paid increasingly less premium to take that risk) we think not only would they not be inclined to step away as in 2005 but are in fact likely to get increasingly concerned about this dynamic and continue to adjust their holdings.

Looking at our favourite overlay below we get the icing on the cake:



This has been our favourite FX overlay for some time

- It is a comparison of the present bear market for the USD against the EUR and that seen in the last USD bear market that began in 1985 (EUR as its components against the USD)
- We have been watching this for 3 years or so…Initially this was just as a simple overlay of 1 bear market to another without any real big picture building blocks behind it. **Now if anything the chart is even more compelling. Why?**
- When we were looking at this 3 years ago
    - The economic picture was improving, not looking soft
    - The housing market was booming along
    - The yield curve was not inverted.

Now we have a softer economic environment, weaker housing and an inverted curve…, which is exactly what, happened in 1989-1991 when the next leg lower in the USD that took EUR (As its components) to new highs against the USD. Déjà vu? We think so

Bottom line we think this whole picture paints a compellingly negative USD story that will continue to see EURUSD move higher with an expectation of close to 1.45 by year-end.

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