

Daily Market Strategy

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Market Strategy

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- VIX, CDS spreads up as equities drift, gold at 3-month high
- UK services PMI, ECB ahead

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/\$: 1.6313, €/\$: 1.4282, \$/Y: 92.41

UK 5y sw: 3.33%, US 5y sw: 2.67%, EU 5y sw: 2.73%

Overnight

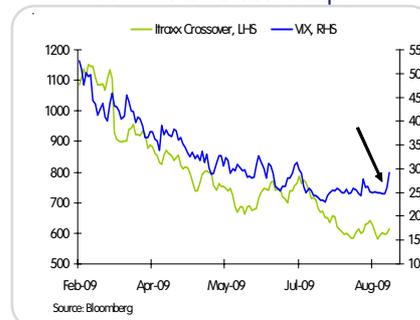
- Shanghai composite rebounds 4.5%
- Fed minutes show FOMC discussed trimming MBS and agency purchases

A 4.5% rebound in Chinese stocks helped risk aversion to stabilise overnight, but with gold finding a bid at \$978 and the VIX flirting with 30.0, the sense of unease about the next move in global equities and credit has not disappeared. A disappointing UK services PMI this morning on the heels of a sub-50 manufacturing PMI and shrinking consumer credit - our economist team forecast a drop to 52.7 - would underline the fragile backdrop for the economy and challenge optimism for a bounce in GDP beyond Q3. With the ECB ready to revise up its outlook for 2010 GDP, albeit from a very low -0.3% mid-point in June, it comes as no surprise to hear that G20 finance ministers of the UK (and US) disagree with German/French proposals to start considering exit strategies. With Germany and France leading other G7 members with a return to positive GDP growth in Q2, we should also hear what the ECB makes today of imposing a possible penalty above the refi rate. The next LTRO takes place at the end of the month and some council members may be warming towards the idea of charging a premium to stimulate bank lending.

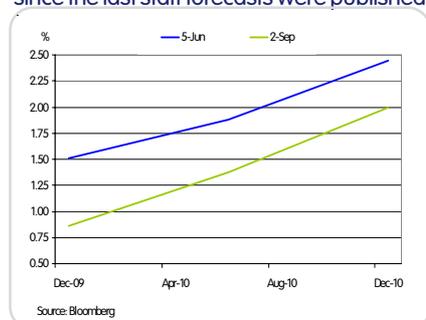
FX: EUR/GBP flirts with the 10-day MA around 0.8760 (GBP/EUR 1.1416) ahead of the UK PMI release and the ECB press conference. A narrowing in the EU/UK 2y yield spread below 30bp (support at 22bp) and ECB president Trichet's tone are likely to dictate the next move. USD/JPY traded below 92.50 for most of the session in Asia, keeping the JPY top of the G10 table this week. A pullback towards 92.0 is still on the cards on risk aversion (gold at a 3-month high) and positioning for a disappointing US NFP number tomorrow. Elsewhere, the NOK managed to claw back some losses overnight, with USD/NOK slipping back below 6.08 as crude stabilises at \$68.50.

Rates: UK 5y swaps are stagnating around 3.33% pivot but that could be about to change as we digest the UK services PMI and US NFP, and corporates take advantage of the 50bp decline in rates since June (Nationwide issued yesterday). In the euro zone, the breakout in 2y yields below 1.20% could be halted by the ECB as the Bank looks to upgrade its GDP outlook for 2010. A break in EU 2y swaps below 1.70% could force a pullback towards the July low of 1.62%. The Greek/German 10y spread climbed above 105bps on the snap election decision.

Risk aversion and VIX have edged up from the lows. Just a blip?



ECB rate hike expectations have dropped since the last staff forecasts were published



	Close	Daily Change %
FX		
EUR/GBP	0.8763	-0.45%
GBP/USD	1.6273	0.70%
EUR/USD	1.4264	0.28%
USD/JPY	92.216	-0.76%
AUD/USD	0.8337	0.93%
Bonds %		
US 10Yr	3.306	-5.7
EUR 10Yr	3.231	-0.4
UK10 Yr	3.560	0.5
UK 5yr Swap	3.332	-0.1
Equities		
S&P500	994.75	-0.33%
FTSE100	4817.55	-0.04%
Eurostoxx50	2703.76	-0.44%
Shanghai Composite	2714.97	5.04%
Commodities		
Crude Oil \$/bl	68.05	0.00%
Gold \$/oz	978.5	2.32%
Copper	282.6	0.27%
Baltic Dry	2413	-0.41%
Other		
VIX	28.90	-0.86%
iTraxx XOVER	621.12	5.1

Today's Events

Event	Time	Consensus	Previous
UK Services PMI, Aug	09:30	54.0	53.2
EU-16 Services PMI, Aug	09:00	49.5	45.7
EU-16 Retail Sales, Jul	10:00	0.1%	-0.2%
ECB Rate Decision	12:45	1.0%	1.0%
US Initial Claims, 29-Aug	13:30	565K	570K
US ISM Non-Manufacturing Index, Aug	15:00	48.0	46.4
UK DMO auctions £2.25bn, 4.25%, 2039 conventional gilts			
ECB member Stark speaks in Frankfurt (15:00)			

Quantitative Market Analysis

Naeem Wahid, Quantitative Strategist

• Correlation with FX falls as USD DXY index becomes range-bound

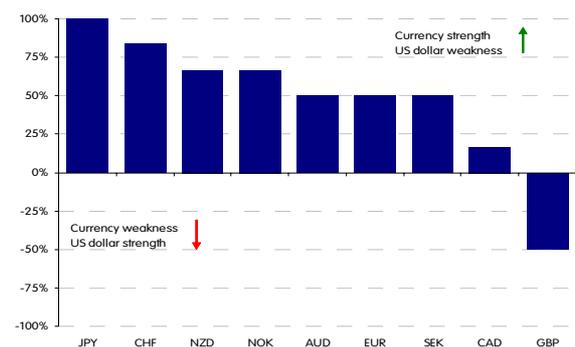
The latest Japanese portfolio data, for week ending 28th August, was released by the Ministry of Finance overnight – the data are shown in the charts on page 4. In equities, Japanese investors have bought ¥55.8bn of foreign stocks whilst foreigners bought ¥86.7bn of Japanese stocks, resulting in a small net inflow of ¥30.9bn. This reverses the past week’s outflows, returning to the recent trend of net equity related inflows into Japan. In bonds, Japanese investors sold ¥78.1bn of foreign bonds whilst foreigners bought ¥8.2bn of Japanese bonds. This results in a further net inflow of ¥86.3bn into Japan, supporting the yen. Of interest this week has been the sharp net outflow in money markets, which was larger than the inflows of equities and bonds combined. We watch this cautiously - if this persists in the coming weeks then the risk of a reversal in the recent yen strength will build.

The trend following model has left its positions unchanged this morning. In emerging market currencies the model is holding a 20% net short USD portfolio. Across G-10 currencies, the model’s position is larger at 60% net short USD. The USD DXY index is little changed over the past month holding the 77.43 – 79.66 range. This band is relatively small, at 2.9%, and whilst it holds (which may not be too long now given the USD DXY index has entered a triangular formation), implied volatility levels should continue to drift lower in G-10 FX. The recent range-bound nature of developed market currencies is resulting in correlations with equities/commodities/interest rate spreads falling - see table 1.

Table 1: 1-month correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY
2 YR SPD	-0.03	-0.30	-0.50	0.55	0.90
10 YR SPD	-0.10	-0.46	-0.10	-0.54	0.89
S&P500	0.48	-0.36	0.44	-0.24	-0.07
Gold	0.47	-0.15	0.52	0.19	-0.30
Oil	0.47	-0.72	0.55	0.26	0.16
CRB	0.50	-0.78	0.29	0.82	0.80
Relative Yield Curve	0.06	0.48	-0.08	0.71	-0.13

Chart 2: Trend Strength

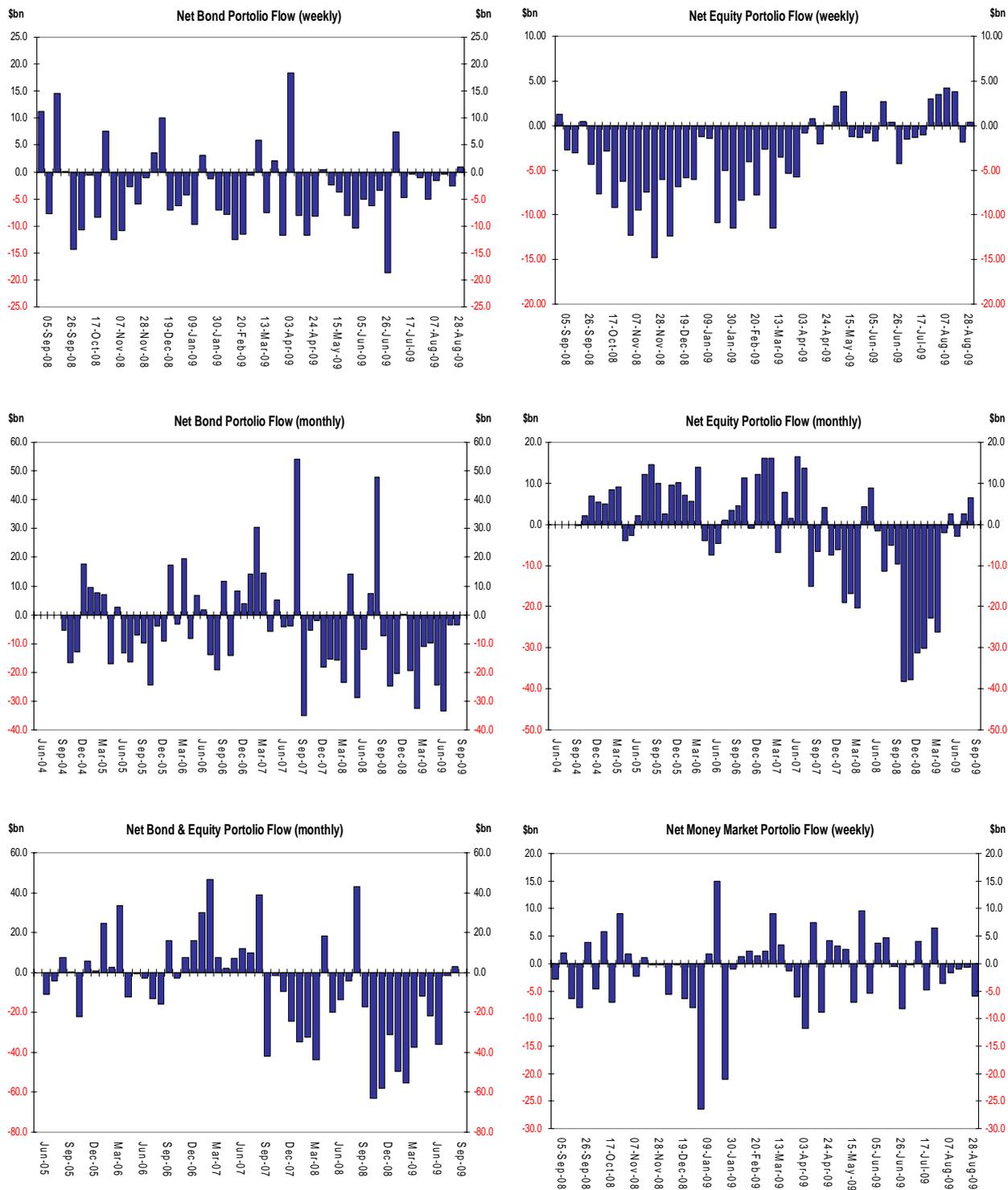


Trend following model signals

Trend Following Model Positions			
	Signal	Date	Entry Level
AUDUSD	short	17-Aug-09	0.8327
NZDUSD	long	10-Jul-09	0.6298
EURUSD	long	17-Jul-09	1.4146
GBPUSD	short	10-Aug-09	1.6684
USDCHF	short	17-Jul-09	1.0730
USDCAD	long	26-Aug-09	1.0868
USDSEK	short	21-Jul-09	7.7211
USDNOK	short	21-Jul-09	6.3025
USDJPY	short	20-Aug-09	94.07

Trend Following Model Positions			
	Signal	Date	Entry Level
USDCZK	short	19-May-09	19.709
USDPLN	short	10-Jul-09	3.1049
USDSGD	long	18-Aug-09	1.4522
USDTRY	long	27-Aug-09	1.5093
USDZAR	short	31-Aug-09	7.7525

Chart 1: Japanese Portfolio Flow Data



Market Summary

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FX			Equities		
EUR/USD	1.4264	0.28%	S&P500	994.75	-0.33%
USD/JPY	92.216	-0.76%	DJIA	9280.67	-0.32%
AUD/USD	0.8337	0.93%	FTSE100	4817.55	-0.04%
EUR/GBP	0.8763	-0.45%	Eurostoxx50	2703.76	-0.44%
GBP/EUR	1.1410	0.44%	Shanghai Composite*	2714.97	5.04%
GBP/USD	1.6273	0.70%	*latest price		
GBP/JPY	150.06	-0.08%	Commodities		
GBP/CHF	1.726	0.27%	Crude Oil \$/bl	68.05	0.00%
GBP/AUD	1.952	-0.22%	Gold \$/oz	978.5	2.32%
GBP/CAD	1.798	0.80%	Copper c/lb	282.6	0.27%
GBP/NZD	2.418	1.05%	Silver \$/oz	15.40	2.53%
GBP/NOK	9.908	0.60%	Baltic Dry	2413	-0.41%
GBP/ZAR	12.697	-0.70%	Swaps %		
GBP/CNY	11.116	0.71%	US 5yr	2.641	-6.3
Bonds %			EUR 5yr	2.715	-0.4
		bp	UK 5yr	3.332	-0.1
US 10Yr	3.306	-5.7	Official Rates %		
EUR 10Yr	3.231	-0.4	UK	0.50	
UK10 Yr	3.560	0.5	US	0.25	
Other			EU	1.00	
VIX	28.90	-0.86%	Japan	0.10	
iTraxx XOVER	621.12	5.1			
DJ Agriculture Index	58.56	-0.55%			

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