

Daily Market Strategy

Wednesday, 21st October 2009

Market Strategy

Market Strategy Team

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- Governor King quiet on QE, MPC minutes awaited
- Yields/swaps higher ahead of Fed speakers, Beige Book

Market Outlook

Kenneth Broux

Opening levels (7.15am)
£/\$: 1.6402, €/\$: 1.4938, \$/Y: 90.71
UK 5y sw: 3.23%, US 5y sw: 2.65%, EU 5y sw: 2.75%

Overnight

- Governor King's speech was largely dedicated to financial system reform; said output to remain well below and unemployment above levels of a year ago for some time, inflation to stay volatile; reiterated that asset purchase programme evaluated month by month

In so far as explaining swings in market and economic dynamics to clients and interpreting them on the desk, yesterday was a perfect example of the challenges the market routinely throws at us. For currencies and equities, most would agree that the dynamics have recently been reasonably straightforward (sell USD to buy equities/commodities/high yield FX), assisted by generous liquidity and better corporate earnings (through cost cuts primarily). For bonds, yesterday's US Sep PPI data, surprisingly negative m/m for core and headline during a quarter of rebounding economic activity, gives ammunition to those arguing that a reality check in equities is inevitable as pricing power hasn't recovered. We are not fighting the bull trend but tame CPI/PPI/wage explain why many remain unconvinced and cash is still sitting on the sidelines. Central banks are not done fighting disinflation as the Bank of Canada demonstrated yesterday when it revised down its inflation outlook and reiterated its commitment to support liquidity. We hope for the October MPC minutes to at least partially clarify the BoE intention on QE in two weeks time.

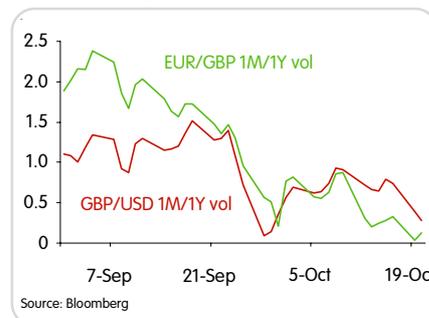
Ahead today: the MPC minutes and the syndicated 2060 gilt issue will overshadow proceedings in the UK. Four Fed members are on the speaking circuit and the Beige Book will be published after the European close.

FX: GBP could be a big mover this morning depending on the October MPC vote. We see no significant threat of a surprise and any other vote than 9-0 could trigger profit-taking in sterling crosses. Short-term, we favour buying dips in GBP crosses ahead of what could be stronger retail sales data tomorrow and positive GDP on Friday. Failure of GBP/USD to test yesterday's 1.6489 high could attract more profit taking and force a pullback below 1.64. For EUR/GBP to extend to the downside, the cross needs to pierce yesterday's 0.9071 low.

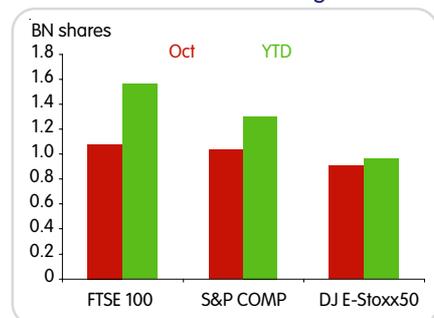
Rates: UK swaps and yields reversed lower yesterday and the decline below 3.27% in 5y swaps (2y/10y swaps curve flat at 203bps) in theory bodes well for a test of 3.20%, potentially followed by 3.17%. However, we stick to our preferred defensive position right now and still see a danger for a bounce back to 3.30%. The BoE will purchase £1.4bn gilts today in the shorter dates.

	Close	Daily Change %
FX		
EUR/GBP	0.9122	0.13%
GBP/USD	1.6382	-0.24%
EUR/USD	1.4945	-0.13%
USD/JPY	90.775	0.25%
AUD/USD	0.9238	-0.58%
Bonds %		bp
US 10Yr	3.341	-4.8
EUR 10Yr	3.235	-6.6
UK10 Yr	3.605	0.6
UK 5yr Swap	3.222	-5.3
Equities		%
S&P500	1091.06	-0.62%
FTSE100	5243.40	-0.72%
Eurostoxx50	2925.08	-0.76%
Shanghai Composite	3078.14	-0.20%
Commodities		%
Crude Oil \$/bl	79.12	-0.62%
Gold \$/oz	1055.2	-0.85%
Copper	293.2	-1.16%
Baltic Dry	2832	2.39%
Other		
VIX	20.90	-2.75%
iTraxx XOVER	499.06	-6.2

Jump in short term GBP vol has caused spreads to narrow



Oct daily average trading volume in stocks is lower vs FY average



Today's Events
UK CBI Industrial Trends, Oct
US MBA Mortgage Applications, Oct-16

Time	Consensus	Previous
11:00	-4.5	-4.8
12:00	n/a	-1.8%

Events
BoE October MPC minutes (09:30)
BoE Agents' Summary of Business Conditions (09:30)
BoE to buy £1.4bn of gilts: UKT_4.5_070313, UKT_8_270913, UKT_2.25_070314, UKT_4.75_070915, UKT_8_071215, UKT_4_070916, UKT_8.75_250817, UKT_5_070318, UKT_4.5_070319, UKT_3.75_070919
Fed speakers: Plosser (01:00), Locker (17:00), Tarullo (18:00), Rosengren (21:30)
Fed Beige Book (19:00)
Earnings: Boeing, Wells Fargo

Technical Analysis

Paul Rodriguez, Senior Technical Analyst

- The strong upward push in equities anticipated yesterday did not transpire and the markets have opened little changed this morning. Where we go from here is a difficult call as the trend continues to look positive, but does give the impression that the market is running in the dark and could hit an obstacle at any time. This does not preclude further upside, but equity bulls should be looking to tread carefully. FTSE futures rejected new highs to settle back in to the range of the past four sessions. Rising low points for each day still imply buying interest, hence a target at 5,400 is still feasible (with 6,000 in the DAX index futures), but this pocket of resistance could do with being left behind. A close below 5,144 would be taken as a trend ending signal (in the FTSE).
- The trend in the US dollar suffers from the same dilemma as equities. Does it continue or reverse? Apart from some signs that the commodity currencies are in a mature phase, the pockets of USD strength are not enough to reverse the trend. 75.15 in the DXY was a key level (see chart below) and having hit a fibonacci support point, the consolidation is not unwarranted. A counter trend test of the AUD and NZD is reflected in the positioning below, but this is just to capture a pullback rather than a major change in strategy. Sterling should continue to push higher and I remain broadly positive as short covering against the key commodity currencies continues. EUR/GBP targets have been revised downwards and GBP/JPY should be ready to take out 150.00 today (stops triggering through 149.45). Cable has paused for thought after breaking the downward trendline at 1.6450. Traders will be eye-balling the 1.6743 major resistance if we can leave this trendline behind.

Chart of the day: US Dollar Index 75.15 is significant support



Key Levels

	EUR	GBP	JPY	EUR/GBP	GBP/EUR
R2	1.5287	1.6743	95.15	0.9520	1.1135
R1	1.4966	1.6490	91.74	0.9482	1.1018
Current Spot	1.4938	1.6396	90.72	0.9112	1.0975
S1	1.4845	1.6125	87.14	0.9076	1.0546
S2	1.4407	1.5709	85.00	0.8981	1.0504

Spot prices as of: 07:31:39 Source: Bloomberg

Technically the trend remains bearish, but the USD has shown some resilience. 75.15 support was flagged yesterday and should be breached this week, otherwise USD shorts will be looking to cover.

	Spot	Bias	Entry	Target	Stop	Comment/Levels
EUR/USD	1.4960	Bullish	1.4650	1.5287	1.4875	Stop raised.
USD/JPY	90.51	Bullish	90.50	94.00	89.40	91.74 key resistance.
USD/CHF	1.0097	Bearish	1.0360	1.0000	1.0260	
GBP/USD	1.6480	Bullish	1.6125	1.6750	1.6275	Stop raised.
EUR/GBP	0.9077	Bearish	current	0.8800	0.9175	Target revised downwards. Eur short re-entered.
GBP/JPY	149.16	Bullish	143.71	153.27	146.10	Continuation pattern implies a push higher today.
EUR/JPY	135.41	Bullish	<u>135.00</u>	138.74	133.65	Entry raised (again).
CAD/JPY	86.36	Bullish	87.20	92.00	86.30	Stop hit
AUD/USD	0.9274	Neutral	<u>0.9300</u>	0.9000	0.9654	Stalling? Looking to sell rally in small to test the trend.
USD/CAD	1.0481	Bearish	-	1.0000	-	USD short covered- consider re-selling against 1.0550.
NZD/USD	0.7568	Bearish	<u>0.7540</u>	0.7200	0.7610	Looking to sell at 0.7540.(S/T trade)
USD/BRL	1.7547	Bearish	-	1.7000	-	Big jump is a USD warning.
USD/PLN	2.7754	Neutral	2.8100	2.7000	2.8230	Failed to extend below 2.7743 key level.
USD/HUF	176.32	Neutral	179.20	175.00	180.65	Closed USD short- Target at 175 is close enough.

Spot prices source: Bloomberg

ENTRY - Targetted

ENTRY - Active

Quantitative Market Analysis

Naeem Wahid, Quantitative Strategist

Canada and Brazil have both voiced concerns over the rapid strengthening in their currencies. The Bank of Canada, having left the overnight lending rate unchanged at 0.25%, noted that heightened volatility and persistent strength in the Canadian dollar are working to slow growth and that the current strength in the C\$ is expected to fully offset the favourable developments since July. This triggered a rapid move higher in USD/CAD.

Brazil went further, announcing the introduction of a 2% tax on foreign portfolio flows (excluding foreign direct investment). This is an important milestone, especially if this is followed by other emerging market nations (particularly those that are managing their currencies). A reduction in portfolio flows would remove some of the upward pressure on the currency, thereby reducing the FX reserve build up at the central bank. A pass through, to a reduction in reserve diversification, would remove some of the demand for developed market currencies against the USD.

The minutes of the October Bank of England MPC meeting are released this morning. A 9-0 vote outcome (for the quantitative easing programme to remain unchanged) is widely expected and therefore should have little impact on sterling – I suspect that the members are unlikely to have changed their views this close to next month's Quarterly Inflation Report. If this is the case, then any discussions around improvement in economic data could provide a short term boost for sterling – I would trade this through EUR/GBP, which recorded a key week reversal last week (a major technical reversal formation).

The trend following model has been busy purchasing USD this morning. In developed market currencies, the model has initiated a long position in USD/CAD. The model has been more active across emerging market currencies, triggering long trades in USD/CZK and USD/ZAR. The reversal of the short position in USD/CZK is significant, given the duration of the position (the model had been short since mid May). A

Table 1: 1-month correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	EURJPY	AUDJPY
2 YR SPD	0.95	0.93	0.79	0.53	0.48	0.80	0.95
10 YR SPD	0.68	0.72	-0.52	0.23	0.47	0.53	0.91
S&P500	0.81	-0.78	0.91	0.56	0.29	0.74	0.90
Gold	0.93	-0.95	0.82	0.20	-0.23	0.33	0.83
Oil	0.88	-0.82	0.87	0.58	0.17	0.64	0.93
CRB	0.95	-0.87	0.92	0.54	0.11	0.63	0.97

Chart 1: Key week reversal formation in EUR/GBP



profit of 14.2% has been booked on the USD/CZK position. In USD/ZAR and USD/CAD a profit of 5.2% and 0.9% respectively, has been booked.

The model now holds a portfolio that is 56% short USD in developed market currencies and 20% short USD in emerging market currencies.

Trend following model signals

Trend Following Model Positions			
	Signal	Date	Entry Level
AUDUSD	long	15-Sep-09	0.8622
NZDUSD	long	10-Jul-09	0.6298
EURUSD	long	09-Sep-09	1.4480
GBPUSD	short	12-Oct-09	1.5842
USDCHF	short	17-Jul-09	1.0730
USDCAD	long	22-Oct-09	1.0593
USDSEK	short	09-Sep-09	7.0444
USDNOK	short	21-Jul-09	6.3025
USDJPY	short	28-Sep-09	89.64
Net-USD portfolio position			-56%

Trend Following Model Positions			
	Signal	Date	Entry Level
USDCZK	long	21-Oct-09	17.260
USDPLN	short	15-Oct-09	2.8237
USDSGD	short	08-Sep-09	1.4337
USDTRY	short	15-Sep-09	1.4939
USDZAR	long	22-Oct-09	7.3665
Net-USD portfolio position			-20%

Market Summary

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FX			Equities		
EUR/USD	1.4945	-0.13%	S&P500	1091.06	-0.62%
USD/JPY	90.78	0.25%	DJIA	10041.48	-0.50%
AUD/USD	0.9238	-0.58%	FTSE100	5243.40	-0.72%
EUR/GBP	0.9122	0.13%	Eurostoxx50	2925.08	-0.76%
GBP/EUR	1.0962	-0.10%	Shanghai Composite*	3078.83	-0.18%
GBP/USD	1.6382	-0.24%	*latest price		
GBP/JPY	148.71	0.01%	Commodities		
GBP/CHF	1.6574	-0.21%			%
GBP/AUD	1.7732	0.35%	Crude Oil \$/bl	79.12	-0.62%
GBP/CAD	1.7191	1.80%	Gold \$/oz	1055.2	-0.85%
GBP/NZD	2.1856	0.72%	Copper c/lb	293.2	-1.16%
GBP/NOK	9.1583	0.36%	Silver \$/oz	17.50	-1.91%
GBP/ZAR	12.0666	0.76%	Baltic Dry	2832	2.39%
GBP/CNY	11.1838	-0.22%			
Bonds %			Swaps %		
		bp			bp
US 10Yr	3.341	-4.8	US 5yr	2.657	-6.1
EUR 10Yr	3.235	-6.6	EUR 5yr	2.743	-5.1
UK10 Yr	3.605	0.6	UK 5yr	3.222	-5.3
Other			Official Rates %		
VIX	20.90	-2.75%	UK	0.50	
iTraxx XOVER	499.06	-6.2	US	0.25	
DJ Agriculture Index	62.58	-0.99%	EU	1.00	
			Japan	0.10	

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