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FX Strategy Weekly

Market Strategy

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Market Outlook:

It takes a brave investor to bet against further downside in GBP/G10 crosses following the brutal sell-off and speedy decline through key technical levels over the last three trading sessions. We remain medium-term USD bulls and GBP bears, but ask whether the lurch lower in EUR/USD is overdone. The threat of a sharp rebound in the US unemployment rate above 10% in February could result in the unwinding of post discount rate hike USD gains, with the EUR separately standing to benefit from a flawless Greek 10y bond auction and more concrete plans of EU debt guarantees. Overall, the failure of major equity indices to challenge recent highs, stagnant commodity prices and speculation of tighter monetary conditions in China still warrant a cautious approach towards pro-risk strategies. With bearish seasonals lurking in March for the JPY, we think the SEK is well positioned within the G10 to extend its stellar performance, supported by hawkish central bank rhetoric and a relative sound fiscal position vis-a-vis other G10 nations. Shrinking UK/G10 rate differentials and talk of a snap UK general election should keep GBP on the defensive, with the tempo of liquidation increasingly characterising fears of a precipitous GBP rout.

Recap

- In the G-10 space this week, the Japanese yen and Swedish krona outperformed versus the US dollar. USD/JPY fell through 90 to end the week at 88.87, the lowest close since 15th Dec, benefiting from the reduced appetite for risk. USD/SEK fell 1.57% as rate hike expectations were brought forward following hawkish central bank minutes and strong Swedish retail sales data.

- Sterling was the worst performer, going through key technical levels versus the euro and the US dollar following dovish comments from MPC members at the Treasury Select Committee hearing. Despite an upward revision to Q4 GDP to 0.3%, GBP/USD hit a nine-month low, briefly trading below 1.52 while EUR/GBP rose 1.6% on the week to 0.8953.

- The euro recovered some poise despite starting off poorly as the four largest banks in Greece were downgraded. Reports of another austerity package and a 10yr bond issue next week in Greece helped EUR/USD to bounce as 1.35 failed to hold. EUR/USD closed up 0.38% at 1.3618. In emerging markets, the Chilean peso outperformed, gaining 1.37% versus the US dollar while CNY 12m non-deliverable forwards were largely unchanged at 6.64.

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Market Outlook

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It takes a brave investor to bet against further downside in GBP/G10 crosses following the brutal sell-off and speedy decline through key technical levels over the last three trading sessions. We remain medium-term USD bulls and GBP bears, but ask whether the lurch lower in EUR/USD is overdone. The threat of a sharp rebound in the US unemployment rate above 10% in February could result in the unwinding of post discount rate hike USD gains, with the EUR separately standing to benefit from a flawless Greek 10y bond auction and more concrete plans of EU debt guarantees. Overall, the failure of major equity indices to challenge recent highs, stagnant commodity prices and speculation of tighter monetary conditions in China still warrant a cautious approach towards pro-risk strategies. With bearish seasonals lurking in March for the JPY, we think the SEK is well positioned within the G10 to extend its stellar performance, supported by hawkish central bank rhetoric and a relative sound fiscal position vis-a-vis other G10 nations. Shrinking UK/G10 rate differentials and talk of a snap UK general election should keep GBP on the defensive, with the tempo of liquidation increasingly characterising fears of a precipitous GBP rout.

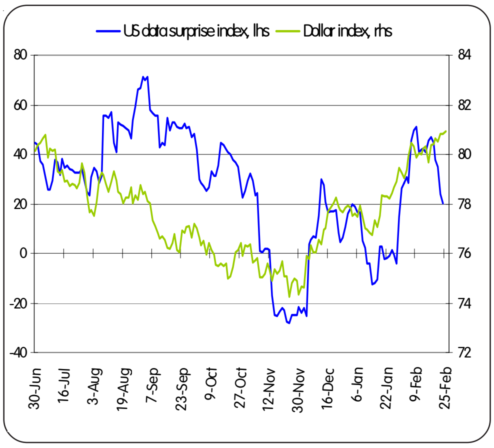
USD

• A turn lower in US economic data for January and resulting lack of conviction to push risk assets convincingly higher have given the USD a lift in the G10 except vs the JPY. Though technically the USD is looking increasingly overbought, negative newsflow from the G10, sovereign debt concerns and the Fed plan to withdraw liquidity are supportive of additional USD gains as we head into March. Strong direct bidding at Treasury auctions should alleviate some of the (debateable) concerns over reduced direct Asian buying. Our medium-target is 83.20.

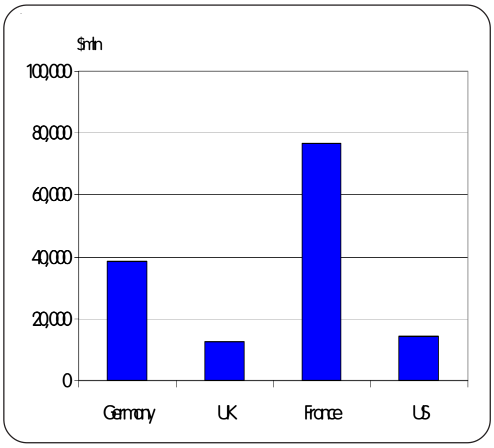
• Arctic January weather is wreaking havoc on US data releases and has resulted in the 'surprise index' turning lower in February (see chart). The question for next week is whether this also applies to the February employment report. The possibility of a return to sharper falls in non-farm employment and a good reception of the Greek 10y auction could stall the USD index in its tracks below 81.0, with profit taking and EUR relief buying knocking the index back through trendline support at 80.382. Support below runs at 80.0, followed by 79.55.

• We took nothing away from Fed chairman Bernanke's testimony last week that we didn't know in terms of exit or Fed funds, with the premise still holding that interest rates will stay low for an 'extended period'. The debate over the timing and sequencing of asset MBS sales and a higher FF rate remains highly uncertain. In the context of the upcoming non-farm payrolls data , US/G10 rate differentials are likely to dictate major fx flows.

Dollar index: targeting further upside above 80.0 even as US data disappoints, safe-haven flows



Foreign claims of BIS reporting banks on Greece, measured on an ultimate risk basis



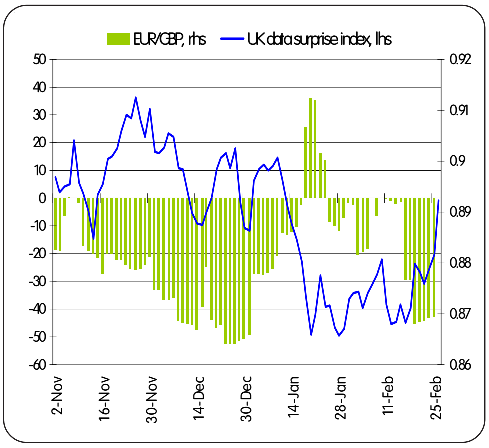
EUR

• As a proxy of risk aversion, the steep drop in EUR/JPY to 119.66 overshadows the relative resilience in EUR/USD around the 1.36 area. As we state above, we are tempted by the upside potential in EUR crosses over the week ahead, particularly against the USD conditional on a tightening in 10y Greece/bund spread towards/below 300bp and a rise in the US jobless rate from 9.7%. EUR/USD 1-month risk reversals have also held up above -1.76, the February 8 low, signalling that bearish momentum is stretched. A test of 1.3688 resistance (21d MA) would attract short covering and pave the way for a move up to 1.3750, with more ambitious targets situated at 1.3850-1.39.

• EUR/USD outperformance vs GBP/USD, month-end flows and gilt dividend redemptions pushed EUR/GBP though 0.8822 (200d MA) and 0.8928 (100d MA) last week, leaving the cross to trade above 0.89 for the first time since mid-January. A compression in the UK/EU 2yr spread to zero supports the bullish set-up, though technicals are looking increasingly overbought (upper Bollinger band). Fears of a hung parliament (Conservatives' lead over Labour cut to 5pts according to latest Ipsos poll) suggest the cross is well placed to extend up to 0.90, with a good Greek 10y auction and tighter sovereign spreads adding upside potential.

• Euro zone data over the week ahead features the final readings of the manufacturing and services PMIs for February, revised Q4-09 GDP (f/cast unrevised at +0.1% q/q). We expect the ECB to leave the key refi rate on hold at 1%. The Bank is also likely to extend unlimited funds at fixed rates into Q3, though disagreement may emerge over whether to cover only the main weekly liquidity operations or longer-term loans.

EUR/GBP: at 2010 high as UK data disappoints



GBP

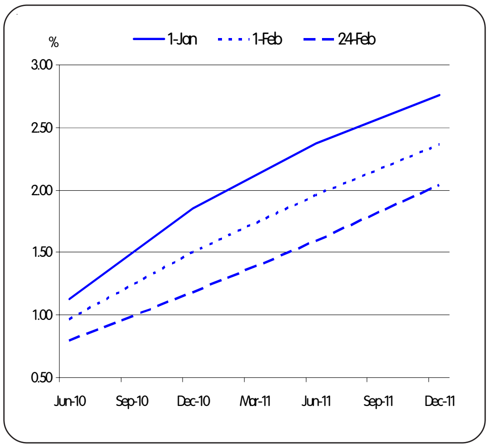
• We don't have high hopes for a relief bounce in the major GBP pairs following the brutal sell-off last week. The collapse through key technical levels leaves no alternative but to remain wary of further selling pressure, especially vs the JPY considering the precarious pro-risk context. Selling rallies is the favoured tactic into Thursday's BoE MPC meeting.

• The market is torn between on the one hand, scepticism over political courage to cut the public deficit, and on the other hand, the fear of a double dip recession in Q1. Sterling's apathy to the upward revised Q4 GDP (+0.3% q/q vs +0.1%) and high correlation with negative data surprises makes us wonder will turn around negative sentiment.

• The rapid descent below 1.55 and 1.5357 does not bode well for the near-term and supports our call for a decline to 1.50. The fact that IMM short GBP contracts are some way off the October 2009 low (56,000 vs 65,300) suggests that from a pure speculative standpoint, further downside in GBP/USD cannot be ruled out. Key support runs at 1.5069, the 61.8% Fibo retracement.

• For next week, we expect the BoE to stand pat on Bank rate (0.50%) and the QE target (£200bn). The February manufacturing and services PMIs will be crucial in shaping confidence about Q1-10 GDP and will impact expectations about a resumption of gilt purchases by the BoE in Q2. The DMO will auction £2bn of 4.25%, 2039 gilts on Tuesday (last b/c 1.74) and £4bn of 2.75%, 2015 paper on Wednesday (last b/c 2.68).

UK rate expectations: in reverse



JPY

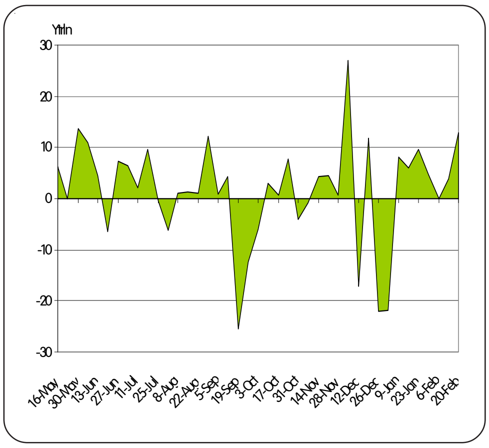
• An impressive rally boosted JPY/G10 last week, clocking up gains of 3.5%-4% against the high yielders on flight-to-quality and lower oil and gold prices. Strong weekly inflows into JPY securities, the highest for nearly 3 months, supported JPY demand, with overseas investors piling in to JGBs and money market securities.

• Speculative IMM long JPY positions are well below historical norms (10,200) contracts) and indicate that JPY/G10 shorts may still have the upper hand. US non-farm payrolls and momentum in equities will set the tone next week. A step-up in risk aversion is necessary to break 88.56 support in USD/JPY, the February 4 low, and 119.66 in EUR/JPY. Downside momentum in EUR/JPY is covered by the slump in the 2y bund/JGB spread to 78bp. The cycle low rests at 76bp. GBP/JPY broke through 135.77 support, putting 130.0 on our radar.

• We remain wary of JPY bearish seasonal trends which tend to develop and favour of short JPY positioning in late February/March. Unless risk appetite returns, optimism for a rally back up to the January highs around 94.0 could swiftly peter out, adding momentum for a break below 88.50 in USD/JPY. Key support for the S&P 500 runs at vs 1,096, the 100d MA.

• Japanese macro data is fairly low key next week and includes unemployment (f/cast unchanged at 5.1% in January) and Q4 capital spending (f/cast 18.4% drop). The Nikkei-225 rests on key trendline support at 10,061. A narrowing trading range for the Nikkei with trendline resistance situated at 10,330 and support at 10,061 suggests a breakout is imminent.

Net JPY inflows highest since early December

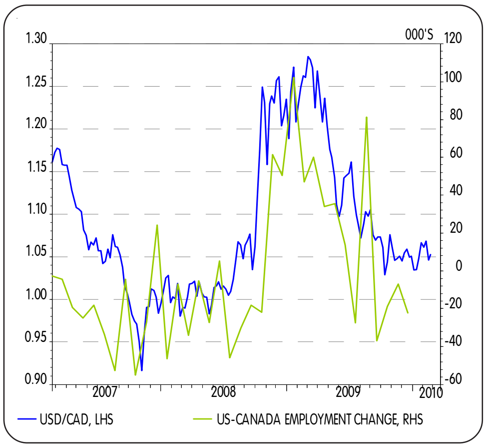


CAD

• Though the CAD remains stuck in a 4-month trading range, signals emerged this week that the currency is potentially starting to buckle under pressure from safe-haven outflows. We are monitoring trends closely, and would be worried for USD/CAD if it edges closer to 1.0730 with Nymex crude close to $80. Key support rests at 1.04. US/CAN 2y rate differentials are locked in a 44-52bp range, offering no clear sense of direction.

• We expect the Bank of Canada to keep its key interest rate on hold at 0.25% next week, and reiterate its verbal intervention against CAD strength. Canadian employment stats for February are due on Friday may underline the resilience of the labour market vs the US (January: +43k vs 20k, see chart). This could tempt CAD bulls to push for as move back to/below 1.05.

Canadian employment leads, USD/CAD sags



AUD

• The RBA meeting and accompanying statement on Wednesday (00:30) are key for near-term direction. With a 25bp rate hike to 4.0% priced in, a dovish statement and hint of a second pause could undermine the relative resilience of the AUD vs the USD and diminish the currency's carry potential compared to the NOK, SEK and CAD.

• Long AUD IMM positions have settled down in late February at less than half the January peak (34,000 vs 83,000, hinting at waning conviction among AUD bulls. Key levels to look out for in AUD/USD are 0.8974, and trendline resistance at 0.9024. Profit talking on the RBA would trigger a move to 0.8625 support, the 200d MA. For EUR/AUD, a widening in AUD longs vs EUR shorts has so far not been translated into additional gains below 1.5043. Upside risk for a rally back up to 1.55 is partly associated with the unfolding of the Greek 10y auction. Beyond the short-term, we favour selling EUR/AUD rallies based on rate differentials, and a 300bp AU/EU central bank spread.

• Ahead of the RBA rate decision, governor Stevens may lift a tip from the Bank's strategy and the latest views on the economy and rates in a speech late on Sunday in Melbourne. The correlation of AUD/USD with gold has continued to lose momentum into late February (0.64 vs 0.95 high in December). A break of gold above $1,127 resistance may negate a more dovish RBA influence and help AUD the re-establish a more bullish footing.

EUR/AUD: finding support at 1.52 ahead of RBA rate decision

SCANDIES

• The impressive pullback in NOK/SEK below 1.2171 support testifies to growing bearish momentum, with selling into the 1.2050 area clearing the way for a move below 1.20 if 1.2007 trendline support is removed.

• Hawkish Riksbank rhetoric was backed up by strong Swedish retail sales data last week (+1.7% m/m in January), and keeps expectations alive for a rate hike as soon as April. Swedish Q4 GDP data is due next week. A positive outcome, forecast +0.3% q/q, would fuel talk of a first Riksbank tightening since September 2008. Disappointing GDP stats would trigger a bounce back over 1.2150. The NO/SWE 2y spread narrowed this week to 45bp, the low end of the range.

• For EUR/SEK, a lot depends on what happens with respect to Greece next week and a relief bounce in EUR/USD. One of the worst performing crosses last month following the plunge from 10.11 to 9.70, the stakes could be raised for SEK bulls regardless of whether Swedish GDP tops consensus forecast. Key resistance levels are situated at 10.29 (100d MA), followed by 10.36 (the 50d MA).

• For USD/NOK, a rally running out steam in the 5.98 area hints at a fading of bullish momentum, with risk of a reversal towards to 5.82 and 5.74 support. Repeated failure to challenge the 6.04 high points to rangebound trading conditions near-term. Wait and see what US non-farm payrolls bring on Friday. Norway's central bank is expected to leave the key deposit rate on hold next Wednesday at 1.75% but reiterate that rates may stilll have to rise to 2.25%, the upper end of the forecast range. Norges Bank has also indicated it plans to make no currency purchases in March for the Government Pension Fund.

NOK/SEK: bounce off key 1.20 support?

Quantitative Market Analysis

Altaz Dagha, Strategist

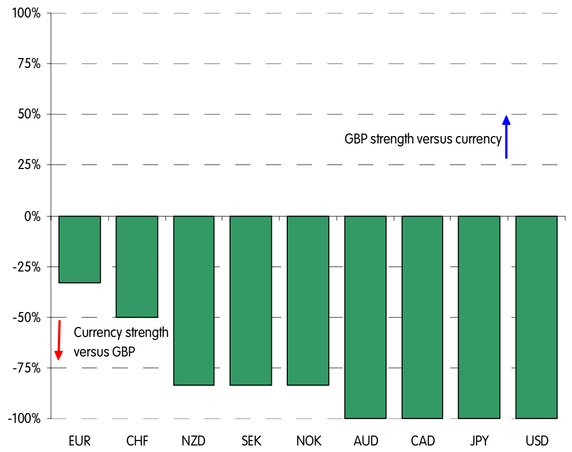
- **Interest rate spreads to be key driver of FX next week**
- **Technicals and trend indicators suggest further downside to sterling**
- **Euro short positioning not as overcrowded as the market thinks**

Contrarian Indicators

Risk Reversal Skews (based on options prices, see page 7) and IMM data (highlighting speculative positioning, see page 6) are used to analyse foreign exchange to understand how stretched currencies may have become.

The last set of IMM data (up until 16th Feb) showed the market has added further to its short EUR and GBP positions. Both GBP/USD and EUR/USD positioning currently lie close to, or at the zero percentile bound. Although there is talk now that the market's short euro position may be overcrowded, it is worth bearing in mind that in May 2007, net long contracts for EUR/USD were twice the amount that are currently net short. This suggests there is still some way lower to go before a major short squeeze higher. GBP/USD positioning shows similar characteristics and as such, we remain comfortable with our strategy of selling into any EUR/USD and GBP/USD strength.

Chart 1: Sterling trend strength indicator



Risk reversal skews (I analyse them by ranking the data over a rolling year) remain stretched in favour of USD calls although there has been some pull back in USD/JPY, reflecting the recent appreciation of the Japanese yen as a result of a more risk averse tone in financial markets.

As risk reversals continue to trend in favour of the US dollar and on a 12-month comparison are close to, or at, highs/lows over the year, this flags the risk of a reversal. As mentioned above, however, we think IMM positioning is not overcrowded as yet and the fundamental backdrop supports this view. As such, while we remain wary of a correction in the US dollar, we expect the theme of broad dollar strength to continue over the coming months.

FX correlations

Market correlations are shown on pages 10-12. 1-month rolling correlations are plotted for G-10 FX against interest rate spreads, S&P500 and commodities (represented through the CRB index).

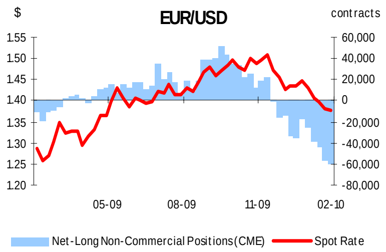
Interest rate spreads have continued to edge in a dollar positive direction although correlations between rate spreads and G-10 FX have come down a touch over the week. EUR/USD, however, remains well correlated with the 1-month correlation at 0.84. Interest rates, however, were clearly the main drivers this week with the relationship between risk assets (equities and commodities) and spot rates breaking down.

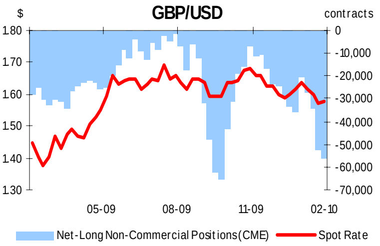
We expect interest rate spreads to be more influential over the next week or so, especially with the all important US employment report next Friday. A positive print combined with the ongoing uncertainty around peripheral eurozone could see a further dollar rally. Much will depend on the Greece 10yr government bond issuance and new austerity package - both expected next week. A successful auction and credible fiscal measure could see some respite for the euro, backing up the near-term bullish price action witnessed over the past couple of sessions.

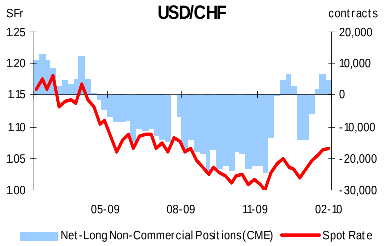
GBP/USD has seen a break of key technical levels also this week, falling through the 50% fibonacci retracement level. Trend indicators also suggest further downside with the 10 and 55 day moving averages having now crossed below the 200 day moving average. Our original target of 1.50 is close. We envisage a move down to 1.4750 if 1.50 fails to hold.

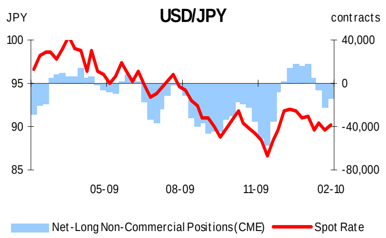
FX & Commodity Futures Positioning

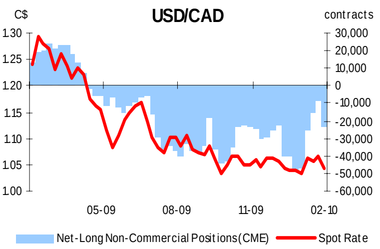
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative side of the market. Extreme net long or net short positions are taken as an indication of the market's vulnerability to a sharp reversal. For a squeeze to occur, however, a separate catalyst such as a piece of fundamental news or a breach of a key technical level is usually required.

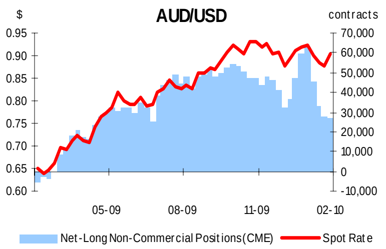


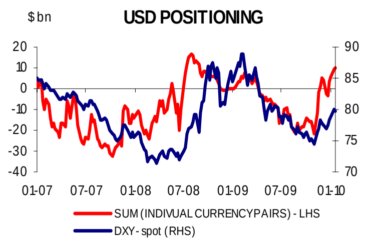


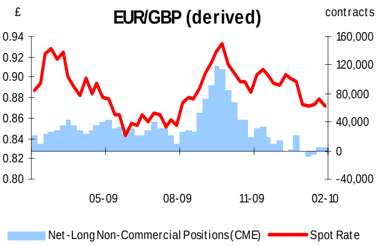


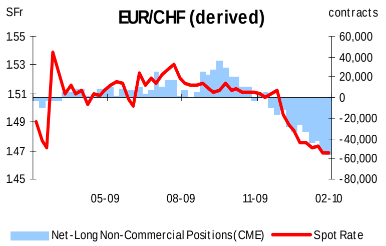


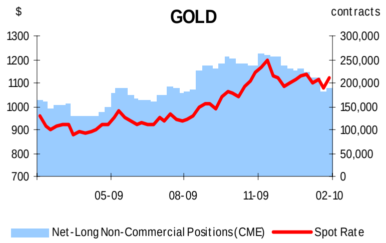


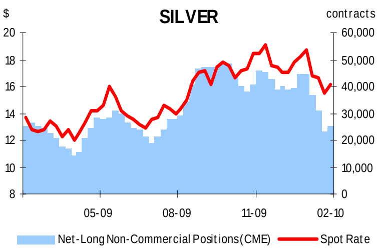


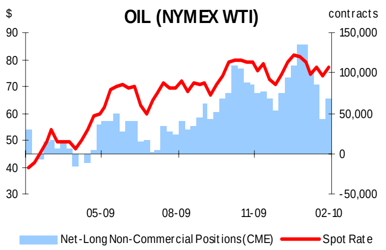


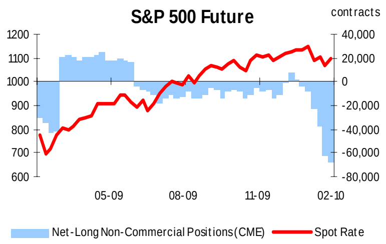


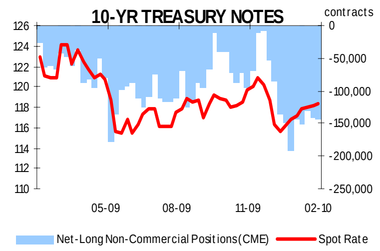


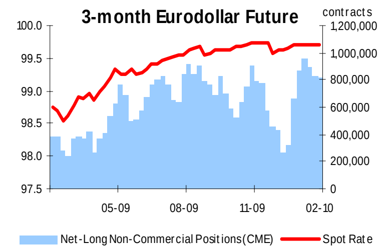








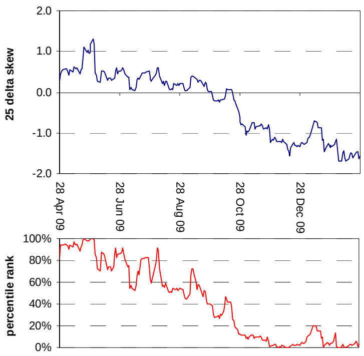




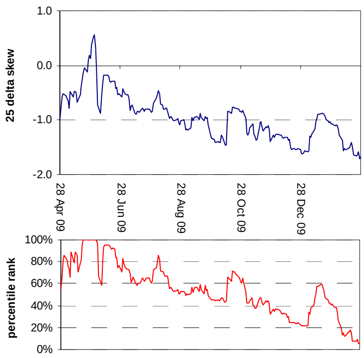
FX Options: Risk Reversal Skews

The risk reversal skew is the difference in volatility between similar out-of-the-money call and out-of-the-money put options. A positive risk reversal means that the implied volatility (used for pricing) of the call is greater than that of the put. In this section, the skew is based on 1-month 25 delta call and put options. The skew has been analysed over a one-year period, with the positioning ranked and charted (in red) underneath the skew. If the skew and positioning are towards an extreme (we use above 75% or below 25% for the percentile rank), the risk of a contra-trend move in the underlying spot rate is high.

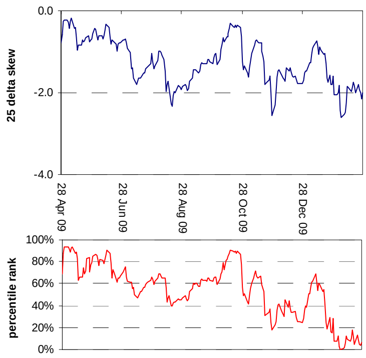
EURUSD



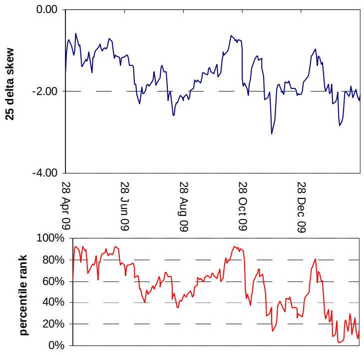
GBPUSD



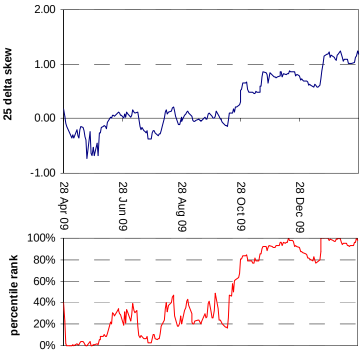
AUDUSD



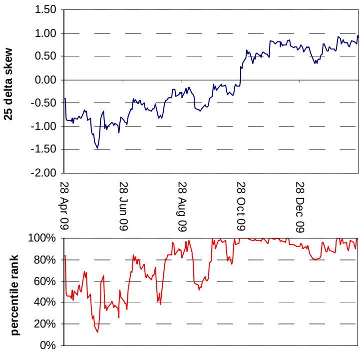
NZDUSD



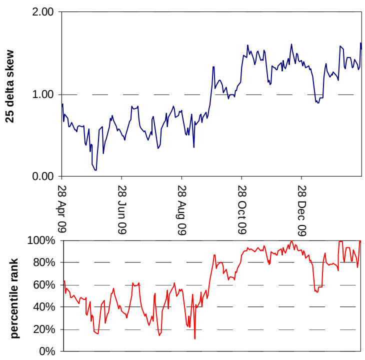
USDCAD



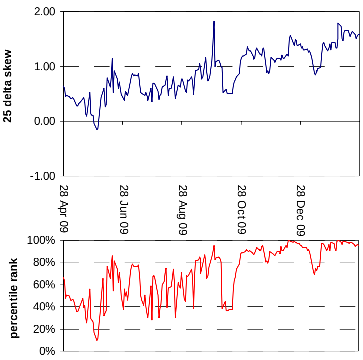
USDCHF



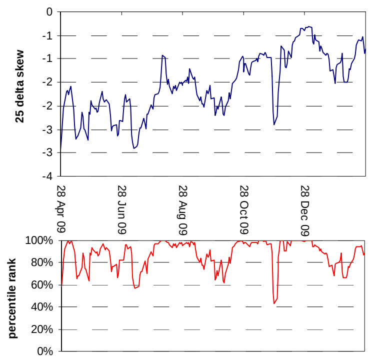
USDSEK



USDNOK

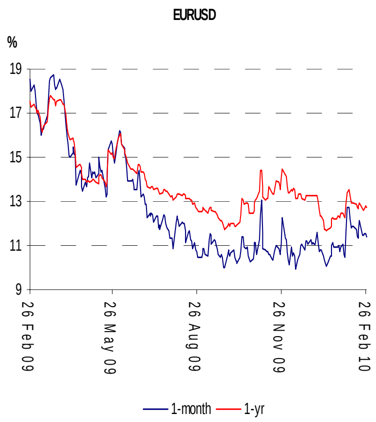


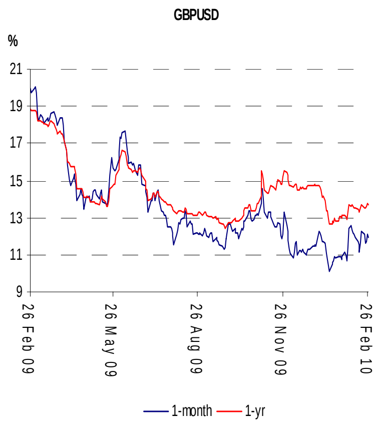
USDJPY

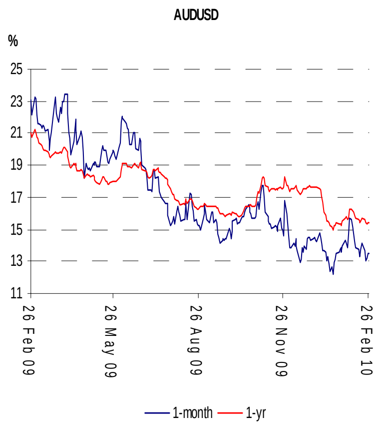


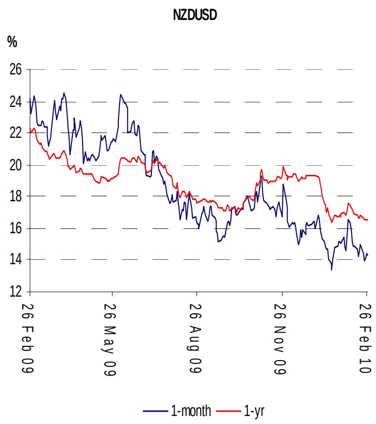
FX Options: Implied volatility

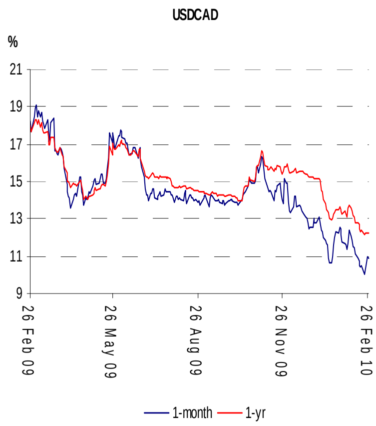
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods of uncertainty or illiquidity, implied volatility will climb higher. One-month and one-year implied volatility is shown in the charts below.

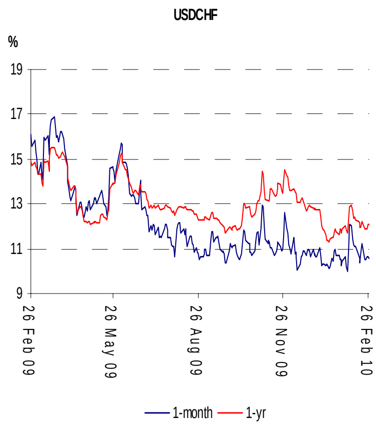


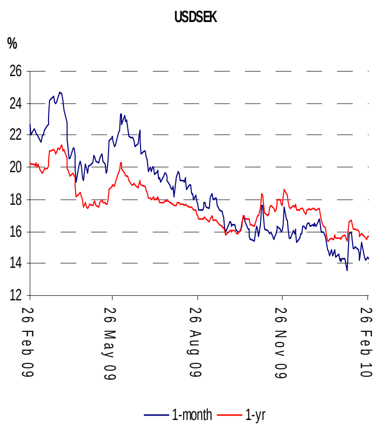


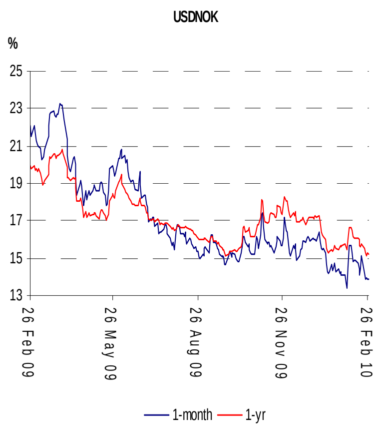


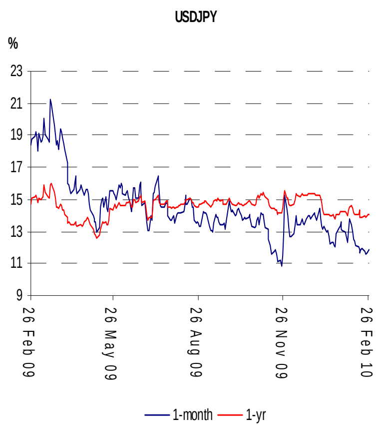






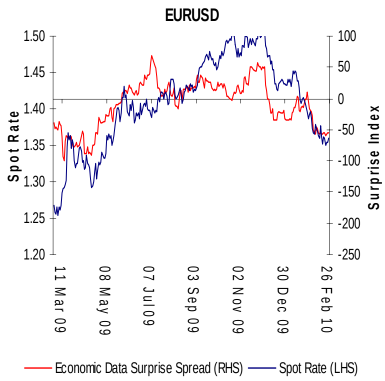


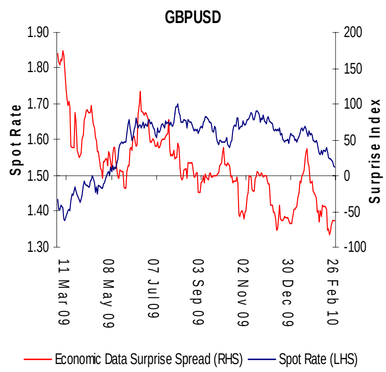


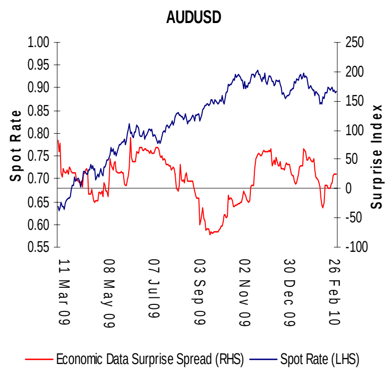


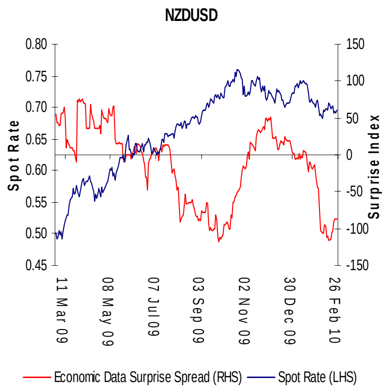
Economic Data Surprises

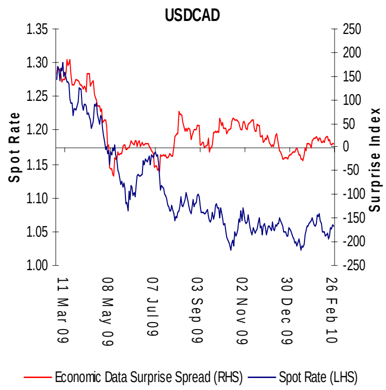
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two countries have been calculated and graphed below.

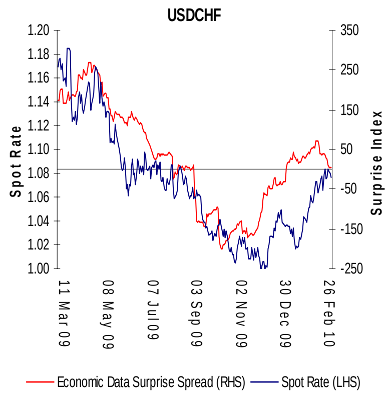


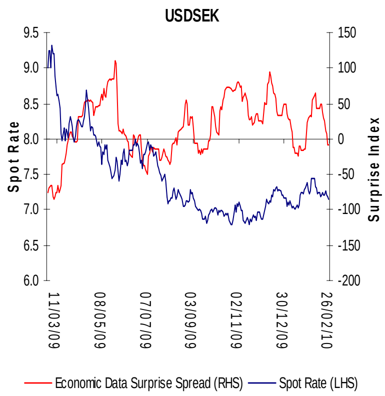


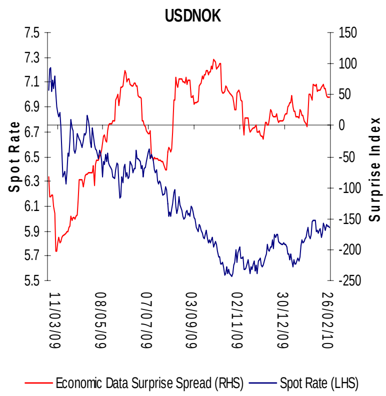


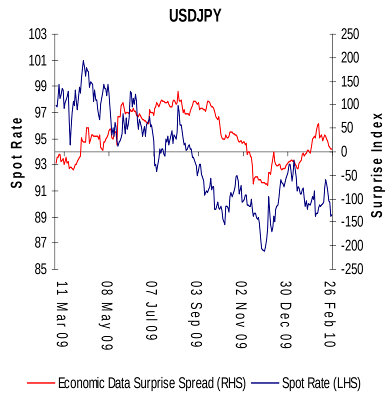






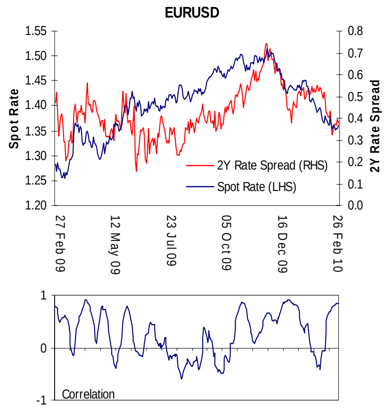


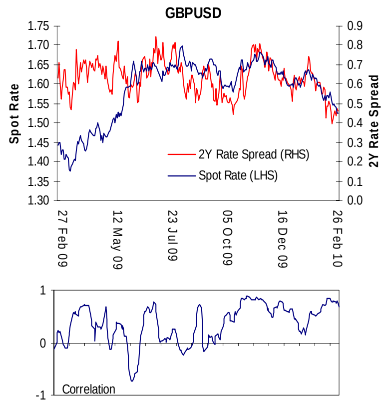


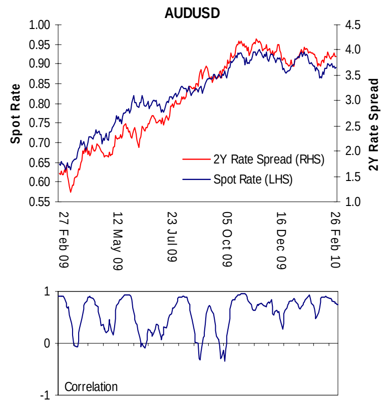


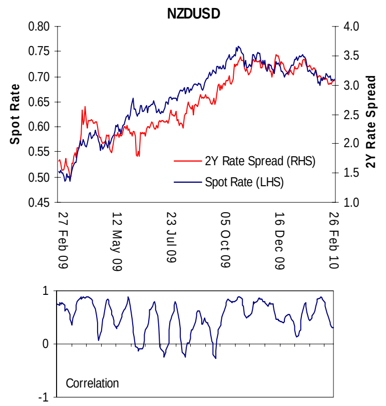
Interest Rate Spreads vs. FX

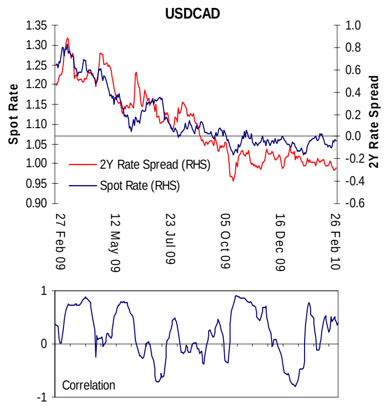
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving FX movements.

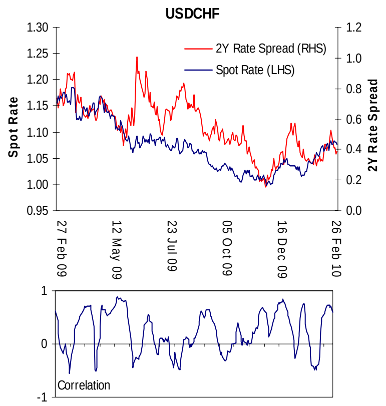


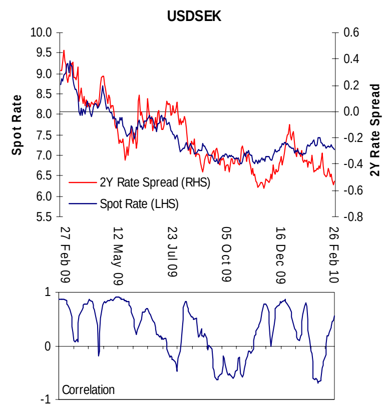


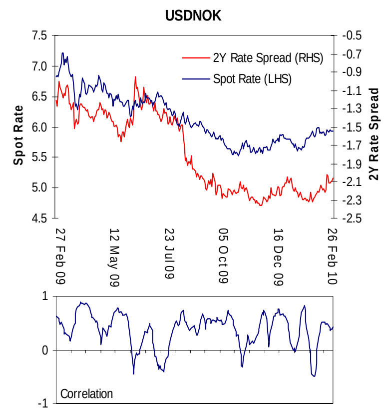


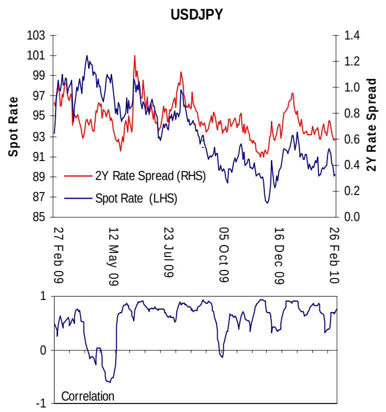






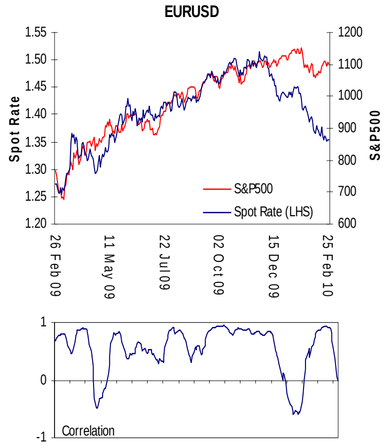


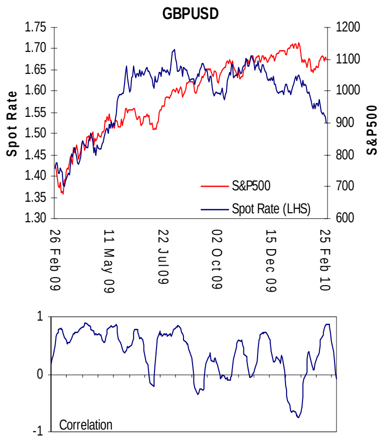


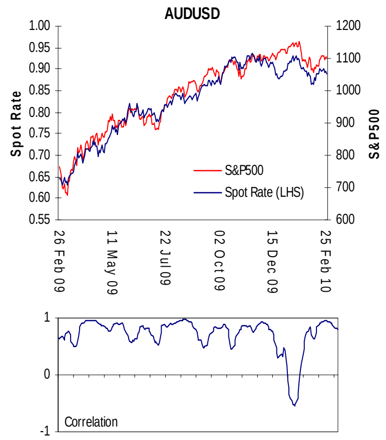


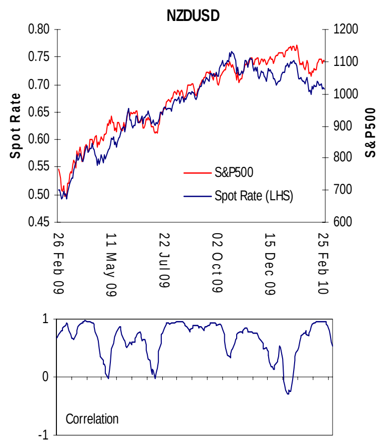
S&P500 vs. FX

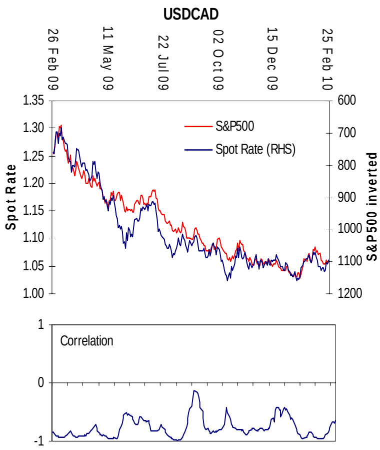
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

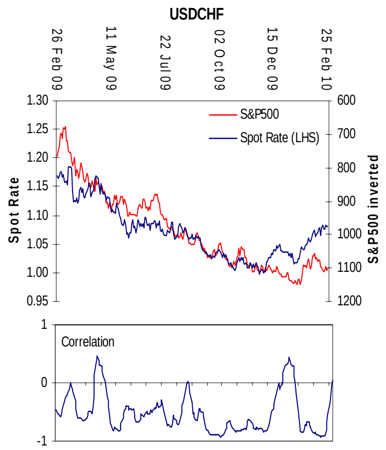


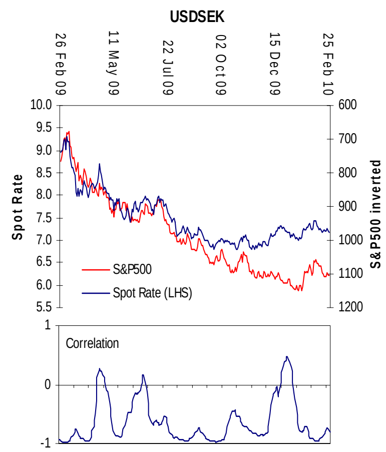


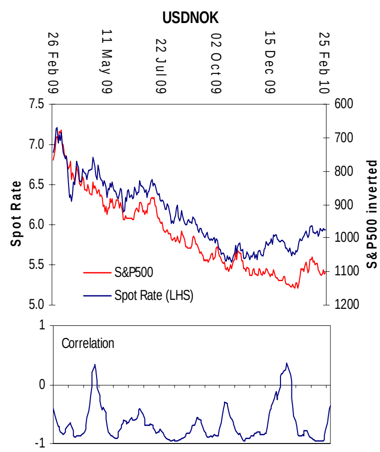


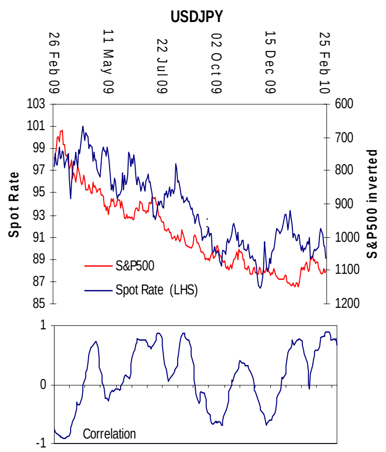






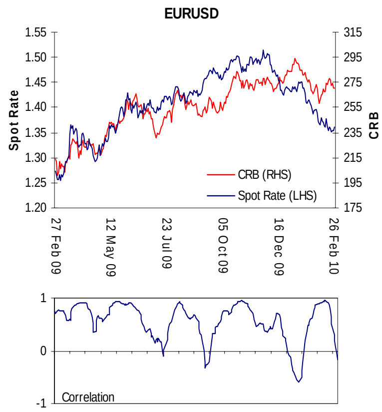


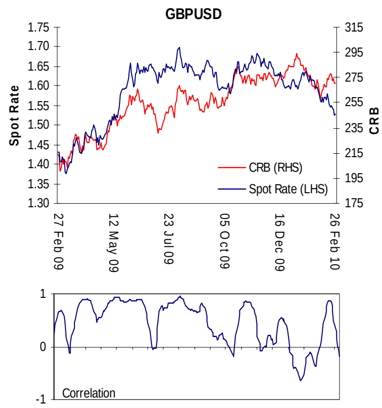


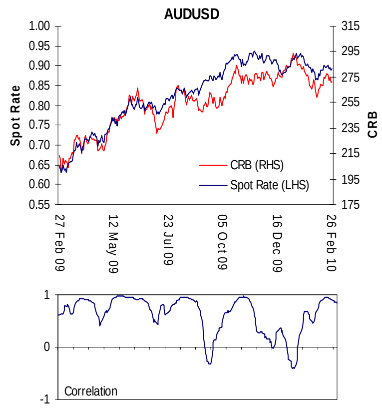


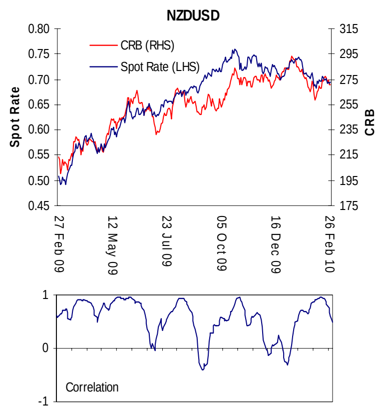
Commodities vs. FX

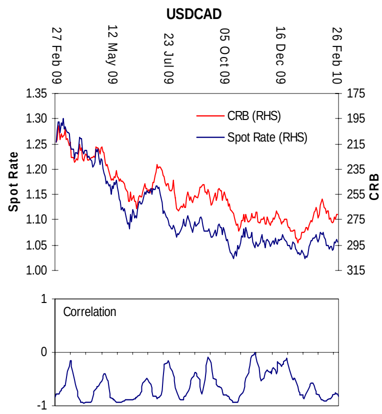
The charts below show the CRB commodity index plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

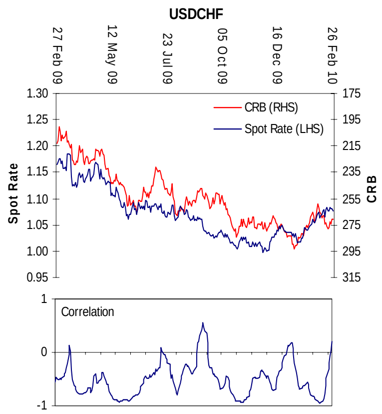


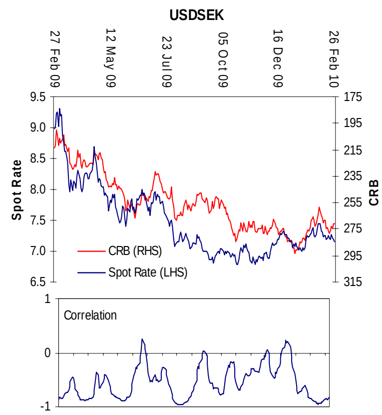


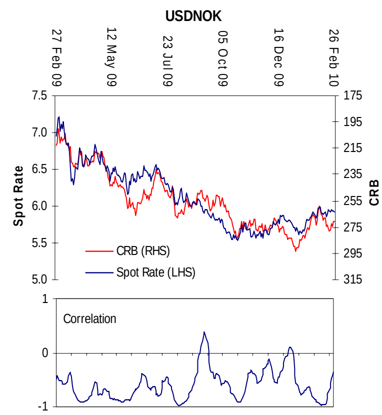


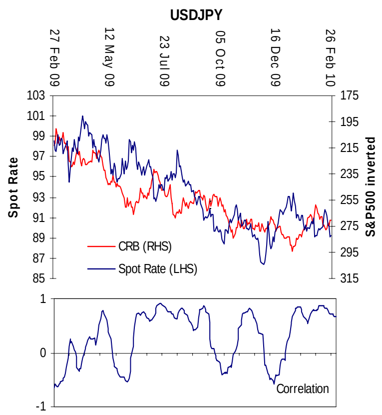








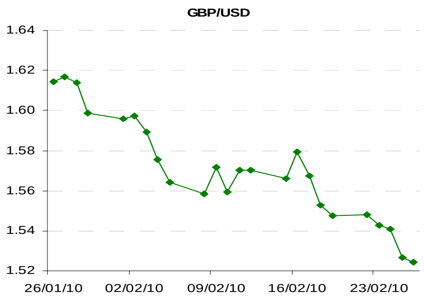


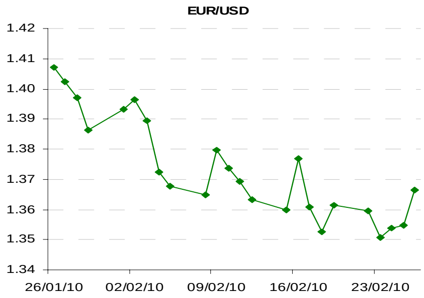


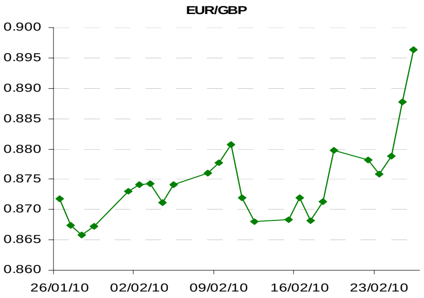
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

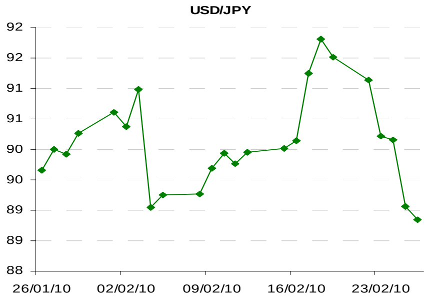
Market Review

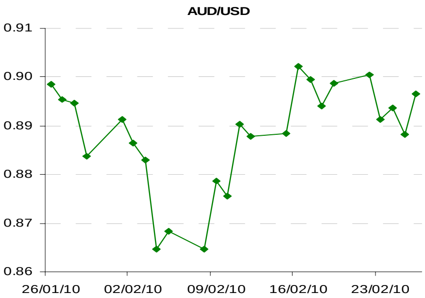
Short-term G-10 FX Charts

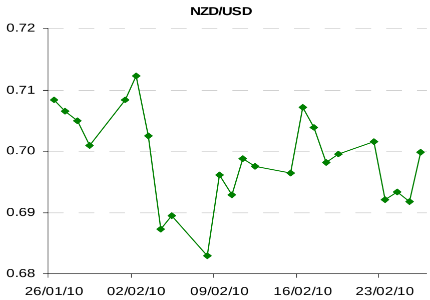


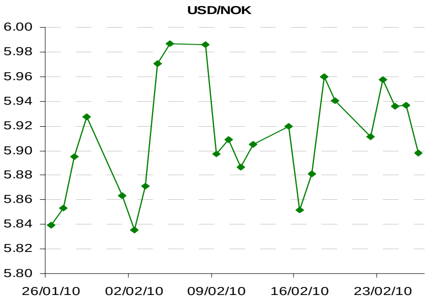


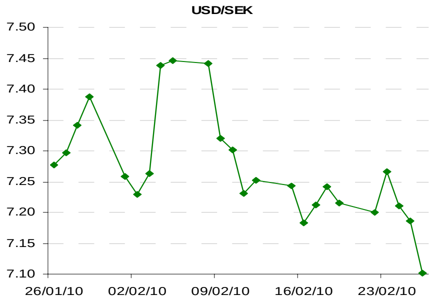


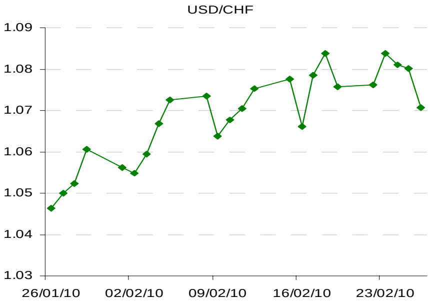


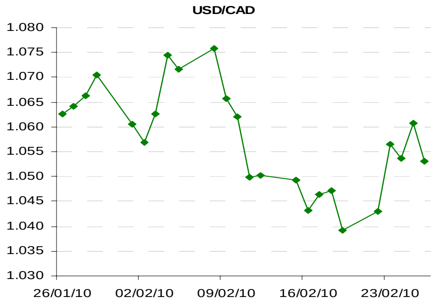




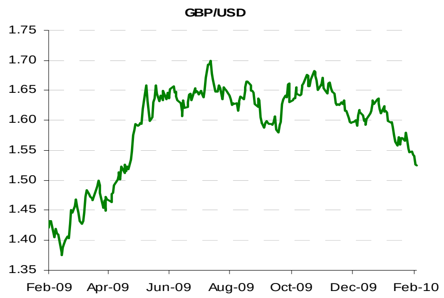


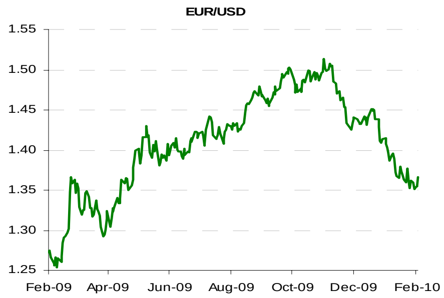


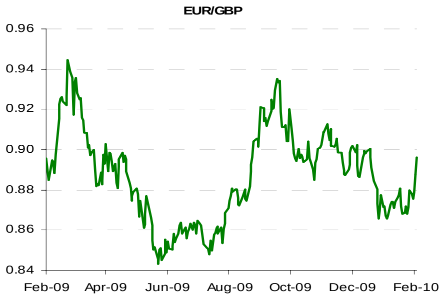


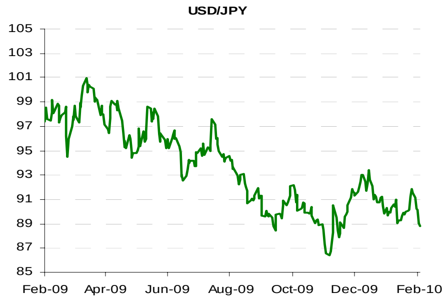


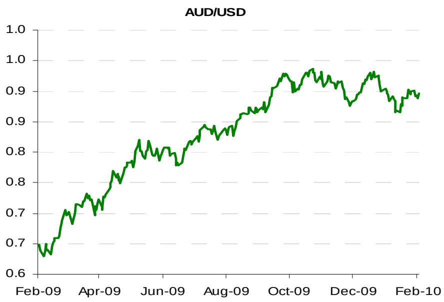
Medium-term G-10 FX Charts

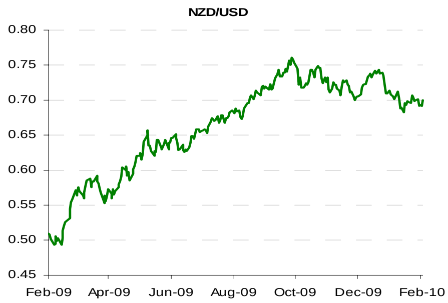


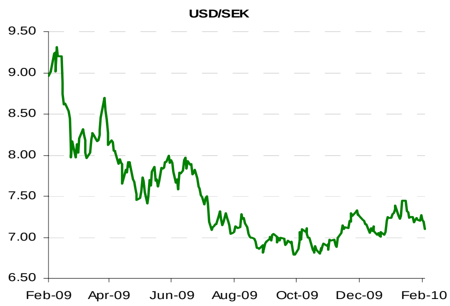


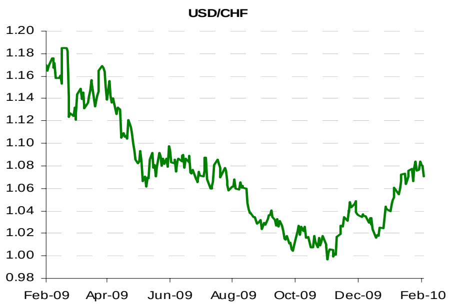


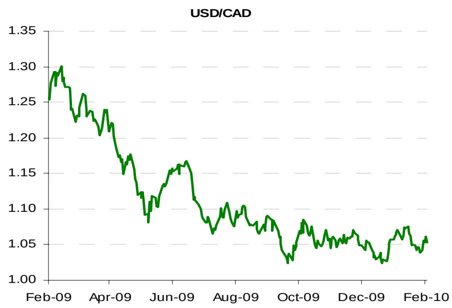






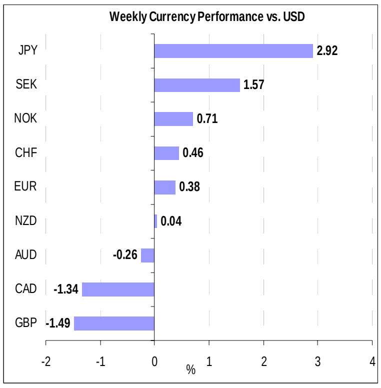


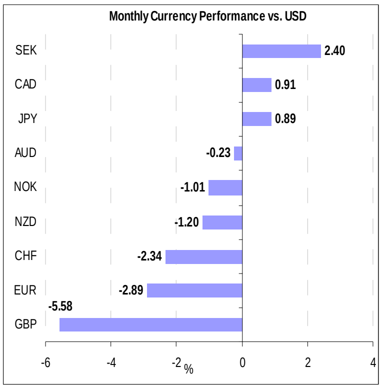


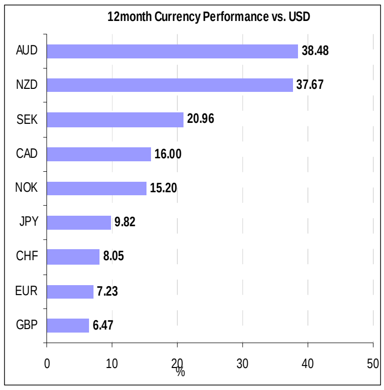


FX Snapshot

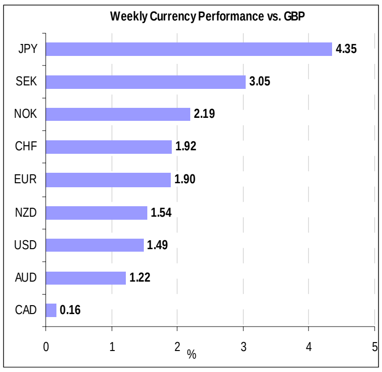
Currency performance vs. USD

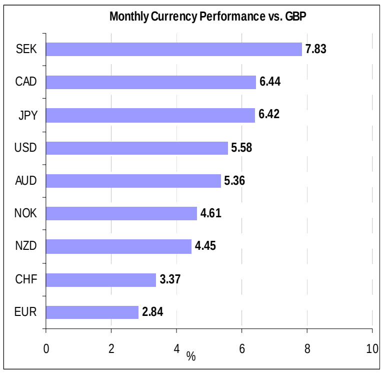


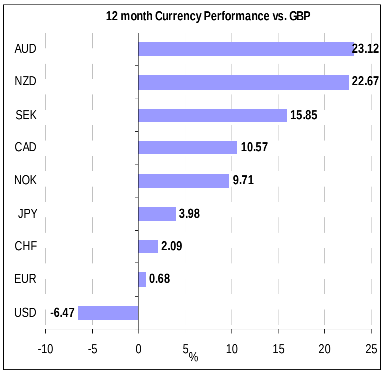




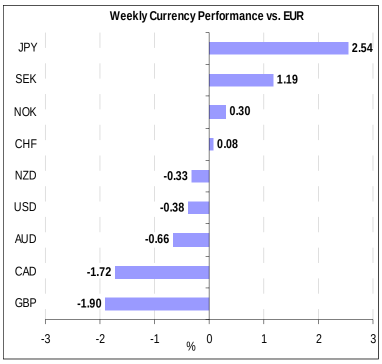
Currency performance vs. GBP

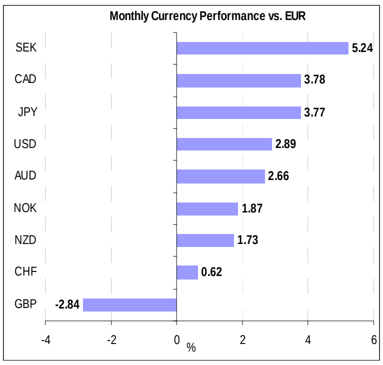


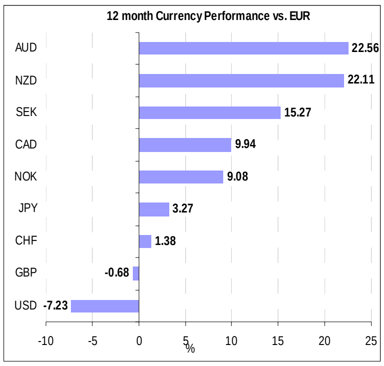




Currency performance vs. EUR







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