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FX Strategy Weekly

Market Strategy

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	Close	Weekly Change
FX		**%**
GBP/EUR	1.1040	-0.64%
GBP/USD	1.5185	0.32%
GBP/JPY	137.22	0.40%
GBP/CHF	1.6094	-1.05%
GBP/AUD	1.6590	-0.52%
GBP/NZD	2.1680	-0.18%
GBP/CAD	1.5467	-0.71%
GBP/NOK	8.8606	-0.70%
GBP/SEK	10.72	-0.40%
EUR/USD	1.3755	0.95%
USD/JPY	90.36	0.09%
AUD/USD	0.9153	0.84%
NZD/USD	0.7005	0.52%
USD/CAD	1.0186	-0.99%
USD/SEK	7.0605	-0.74%
USD/NOK	5.8353	-1.00%
USD/CHF	1.0598	-1.34%
Swaps %		**bp**
2yr	1.624	-6.8
5yr	2.936	-9.9
10yr	3.895	-2.5
Equities		**%**
FTSE100	5625.65	0.46%

• Market Outlook:

Rising inflation expectations in the UK and confirmation that the Budget will be held on March 24 means GBP shorts may be forced to cover positions as government leaks emerge over the next two weeks of UK deficit reduction plans. Ultra-loose monetary policy in the G7 and positive economic data surprises in the G10 are lubricating pro-risk strategies, with higher oil and equity prices supporting rallies, notably for the CAD where strong employment data may force the Bank of Canada to raise rates before the Fed. A shift in the FOMC's stance on low interest rates and 'extended period' rhetoric appears unlikely at the one-day meeting next week, and may put the trading emphasis on the BoJ meeting instead where new measures to counter persistent deflationary pressures may be discussed. For the BoE MPC minutes (Wednesday), we doubt much will come out in terms of major new points of contention on the committee, though the surprise surge in the February services PMI (data trio of dismal retail sales, IP and foreign trade unknown to the MPC at the time) and the strongest Inflation Attitudes survey in two years may reveal a less conciliatory stance with regard to the possible extension of QE, lifting GBP to better levels to sell.

• CNY revaluation: special feature

• Recap

- The US dollar was lower overall this week despite upside surprises to US economic data. A rally in equities taking most major indices back towards the recent highs and the general pro-risk theme stemming from an easing in concerns about Greece (for now) helped some of the more recently maligned currencies, including the euro and sterling to post gains versus the US dollar over the week.

- There was little economic data in the UK this week but the two main reports that were posted much weaker than expected outturns. An unexpectedly wider trade balance and contractions in manufacturing production data for January sent GBP/USD from 1.52 at the start of the week down to 1.4873 on Wednesday. The back end of the week, in particular Friday, saw GBP/USD rally three big figures to return to the 1.52 mark.

- Successful government bonds auctions in Portugal and Spain and further talk of a formalised aid plan for Greece by next week helped keep the euro supported. After bouncing off 1.3550 twice earlier in the week, EUR/USD rallied to close the end of the week at 1.3755.

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Market Outlook

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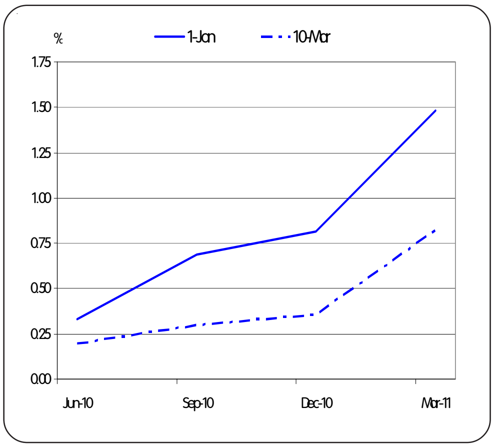
USD

• Fed fund futures have reined in tightening prospects since the start of the year, but this has not held back the USD from strengthening against the G10 bloc except for the JPY. Though speculation has intensified that the Fed may soon agree to make subtle changes in the FOMC statement to give itself leeway to exit from the 'extended period', the resilience of risk assets may keep the USD rangebound for now. Broad investor sentiment towards the greenback remains neutral in the absence of a clear Fed tilt or flight-to-quality, keeping the DXY in a tight 79.50- 81.0 range. The FF future strip is only pricing in one rate hike by December.

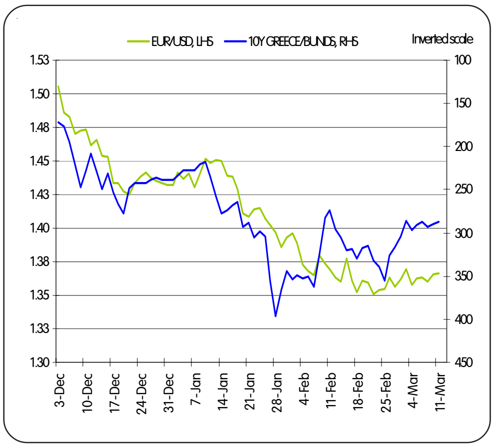
• The one-day Fed meeting on Tuesday obviously takes centre stage. We look for Hoenig to have repeated his opposition against the view that interest rates can stay low for an extended period. The key question for the USD is twofold: (i) did another committee member enter a reservation, and (ii) does the statement make a first overture towards removing the pledge to keep rates low. The deadline of March 31 for agency and MBS purchases will put the spotlight on long-end Treasuries and mortgage rates for signs that the Fed's exit as a principal buyers is pushing up long-term yields.

• TIC capital flows data set of a small storm last month about China trimming Treasury holdings to an 11-month low. China's head of SAFE repeated during a visit to Washington last week that China is fully committed to its Treasuries holdings, so evidence of rebound in Chinese purchases in January (data due Monday) may put to rest diversification concerns. February CPI data are due on Thursday.

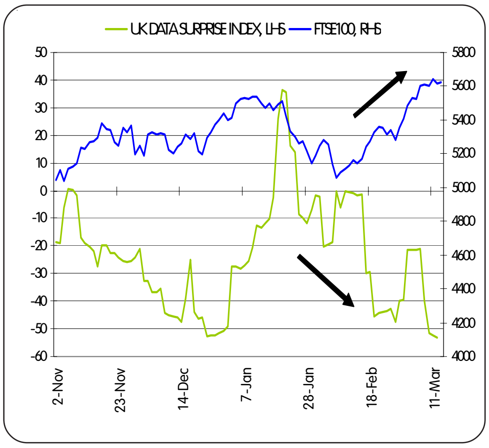
Fed funds: tightening prospects scaled back



EUR/USD finding a base with 10y Greece/bunds



FTSE100: ignoring negative UK data surprises



EUR

• Sovereign funding concerns in the euro area have drifted into the background as EU ministers mull a bond sales plan, giving the euro a degree of breathing space since the start of the month. The resulting fall in euro volatility is translated into handsome gains vs the JPY, USD and GBP. Disagreement at the ECB over proposals to set up a European Monetary Fund may keep the euro hostage as doubts linger over the sizeable Q2 funding requirement. We reiterate our defensive position on EUR/USD, targeting 1.3250 in the medium term. We fade a relief rally in the 1.3839 area, the February 9 high.

• EUR/USD is trapped in a 1.3436-1.3839 trading range since early February. Though event risk from the euro zone has dissipated near-term, appetite to reduce EUR shorts by the speculative community is low. (69,000 contracts last vs 78,200 previously). The correlation of the EUR with risk assets is non-existent and leaves EUR/USD exposed to downside pressure on profit taking in stocks. One-month risk reversals have edged up to -1.04, a 4-week high. 1-month vol has collapsed below 10.0.

• EU-16 February CPI and January foreign trade data, and the German ZEW survey will offer some clues about the state of the economy next week, but are unlikely to cause too much of a distraction in a market still very much conditioned by trends in peripheral bond spreads and G10 interest rate differentials. Greece is reportedly planning to issue two more bonds this month and is also looking to issue in Asia or the US.

GBP

• Rising inflation expectations threaten to complicate the outlook for the BoE but may have temporarily averted a further breakdown in GBP crosses. Inflation expectations rose to 2.5% from 2.4% according to the latest BoE Inflation Attitudes survey, the highest since 2008.

• Confirmation that March 24 is Budget day may force sterling shorts to trim overweight positions, with tactical leaks in the next two weeks pledging a deficit reduction potentially relieving GBP from 'ratings downgrade fever'. This should set GBP up for better levels to sell going into the General Election. Our medium-term target is for a decline in GBP/USD to 1.44.

• Declines for GBP/USD below 1.50 are a magnet for relief bounces, but heavy resistance in the 1.5150-96 region stands in the way of a more convincing rally. Following a short squeeze late on Friday above 1.52, we are keeping a close eye on 1.5279, the 50% Fibo retracement. IMM positioning shows still shows overwhelmingly bearish GBP/USD positioning. Support runs at 1.4830.

• A worsening of the UK macro backdrop is evident from a trio of dismal January reports of retail sales, foreign trade and industrial output data. This reminds us of the historical tendency of the economy to slow in the run-up to the general election. With higher oil prices/weak GBP eroding purchasing power and fiscal tightening forthcoming, we doubt whether exports and business investment can kick start stronger growth.

• For EUR/GBP, heavy resistance in the 0.91 area is keeping the cross from making a move to 0.9141 where trendline resistance is situated. We target a return to the 100d MA at 0.8916. Guidance from UK/EU 2y rate differentials is insignificant, but may need revisiting next week if UK yields gain traction from less dovish March MPC minutes.

• A big week for data and events features February data releases of unemployment, public finances and preliminary M4 data. The minutes of the March MPC meeting are due on Wednesday. We doubt much will come out of this in terms of fundamental policy changes, though the surprise surge in the February services PMI and rising inflation expectations may reveal less dovish tendencies (GBP positive) and greater determination to keep the APF at £200bn. The report on Thursday of a rise in M4 money supply growth may buoy optimism that QE is working.

JPY

• The bi-weekly BoJ meetings have been a rather dull affair since the Bank decided last December to 'further enhance easy monetary conditions' by introducing a new funds supplying operation. Speculation has been rife since the Nikkei reported a week ago that the BoJ will mull new measures in March before taking a decision to implement a new liquidity initiative in April to combat deflationary pressures.

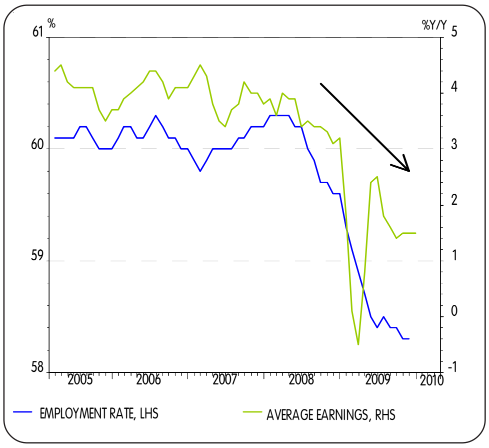
• Next week's meeting (March 16) comes before the March 31 end of an unlimited collateralised loan facility. The Nikkei reports that the BoJ may expand the 3-month lending programme from 10tln to 20tln yen, though broader measures will reportedly be saved until April (new fiscal year) allowing the BoJ to bide its time until after Q1 Tankan survey on April 4.

• It must be said that the JPY has been holding up rather well especially vs the USD despite the rally in risk assets, the negative JAP/US 3-month libor spread, and seasonal factors that typically weigh on JPY this time of year. USD/JPY 1-month risk reversals have ticked up to 2 1/2 month highs (-0.33). 1-month vol dropped to a near 4-month low below 11.0.

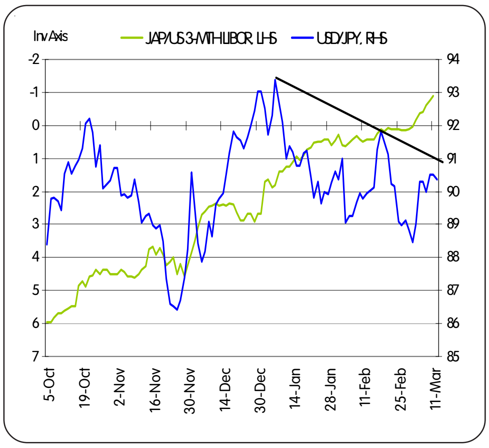
• For USD/JPY, upside is capped in the 91.80-91.35 area, with the 50d MA (90.46) acting as major pivot. Speculation about new measures in China to tighten credit and monetary policy following a round of strong February economic data (CPI at 2.7%) effectively means the PBoC is dictating the next move in JPY crosses. See our weekly special on CNY revaluation for more analysis of the impact on G10 fx.

• For EUR/JPY, follow through buying has emerged on EUR/USD outperformance vs USD/JPY, with the cross making steady progress towards 125.28 resistance as EU sovereign funding concerns drift into the background. For GBP/JPY, we look for the uptrend to reverse before the cross hits 138.50.

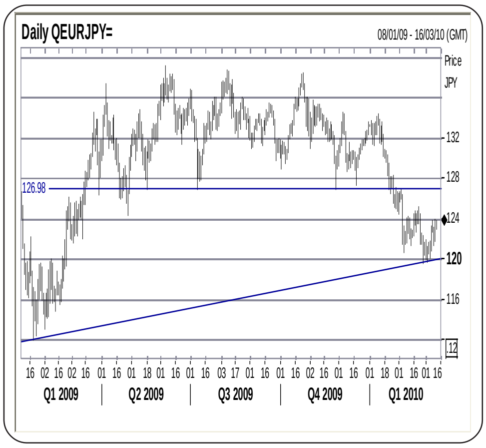
UK employment, wage growth trending down



USD/JPY: trendline resistance in 91.40 area



EUR/JPY: set for rally to 127.0



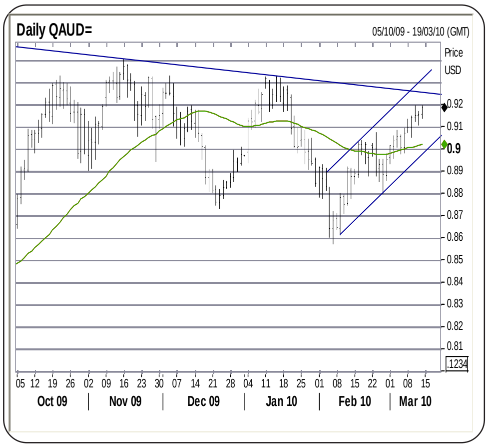
AUD

• Correlation with risk assets remains overall positive but is off the highs and losing traction as we move into the second part of March. Instead, a widening in AU/US 2y rate differentials to 394bp is supplying bullish momentum, guiding the cross to near two-month highs at 0.9190.

• AUD/USD has done well to overcome resistance in the 0.9085 area and now finds itself in the middle of an ascending channel with momentum building for a rally up to 92.50 trendline resistance. What the FOMC says or doesn't say next week may be pivotal for near-term direction, with a bounce in US 2y rates potentially knocking AUD/USD back for a retracement towards 0.9058, the 100d MA. We fade GBP/AUD rallies in the 1.6750 area and target a test of 84.0 in AUD/JPY for a move up to the January high (86.20).

• A quiet week ahead features a speech by RBA deputy governor Edey on Monday, the RBA minutes on Tuesday, and a panel discussion with RBA governor Debelle on Wednesday. The next RBA meeting is not scheduled until April 6. At 64,000 contracts, long AUD IMM positions are the highest since January 19th.

USD/AUD: targeting 92.50 resistance

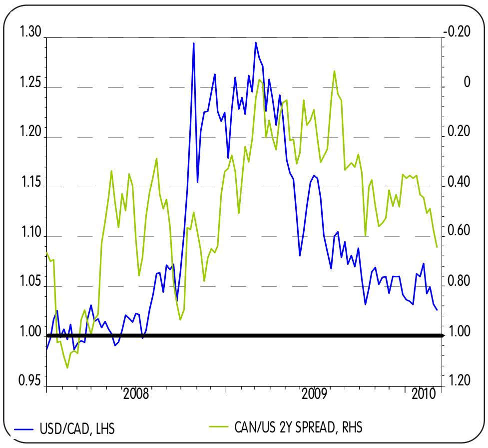


CAD

• We are CAD bulls vs most G10 currencies, taking direction from IMM positioning (CAD longs still rising) and our positive bias on CAN/G10 rate differentials. We are also coming around the view that the Bank of Canada may start raising the overnight lending rate sooner rather than later. The case for the BoC to move ahead of the Fed received a major boost from the latest labour markets statistics. Full time employment surged by 60,000 in February, and the unemployment rate fell to 8.2%, marking a second successive drop.

• Supported by the recent shift in Bank of Canada inflation rhetoric and a bounce in Nymex crude through $82.50, we like buying dips in CAD/G10. Conditions on the Fed keeping extended period in the FOMC statement on Tuesday, we target a short-term move to parity for USD/CAD. The cross took out key support levels at 1.0225 and 1.02 last week, with offers emerging in the 1.0160 area. US/CAN 2y rate differentials continue to hit resistance in the 64bp area ahead of Tuesday's FOMC. For CAD/JPY, we target a test of the January 8 high (90.63).

USD/CAD: parity looming?



Quantitative Market Analysis

Altaz Dagha, Strategist

- **Rate spreads driving FX ahead of monetary policy meetings next week**
- **Net GBP/USD and EUR/USD shorts remain close to record levels**

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.

EUR/USD saw a modest reduction in net short contracts during the latest weekly data from the IMM. From a record of 71.6k net short contracts, positioning is now slightly less at 66.8k. GBP/USD, on the other hand, continues to suffer with short positioning having increased to a record level of 67.6k, overtaking the previous record set in October last year. Price action in both currency pairs suggest a short-term base may have been formed. While concerns over Greece are likely to remain for some time, the recent successful Greek government bond auction and announcement of extra austerity measures have eased the most immediate fears. Similarly with sterling, confirmation that the budget will be held on 24th March implying a widely expected General Election date of 6th May, could see GBP/USD drift modestly higher or at least tread water up until then.

Overall, there was a slight reduction in dollar longs, with CAD and JPY the main beneficiaries. USD/JPY shorts increased sharply over the week to the biggest this year (32.5k from just 1.7k) as markets anticipate a possible tightening move by China. The move in the underlying spot rate, however, has been limited as 3mth yen libor dropped below 3mth US libor, increasing the attractiveness of the yen as a funding currency and keeping USD/JPY supported.

Risk reversal skews (I analyse them by ranking the data over a rolling year) continue to show a broad bid for dollar calls although the recent pull back has extended in most of the currency pairs. Whereas a month ago, most skews were at their most stretched on a 1-year historical basis, recent moves have seen them retreat from the extremes.

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).

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	EURJPY	AUDJPY
2 YR SPD	0.68	**0.84**	0.14	0.19	0.66	**0.93**	0.34
10 YR SPD	0.42	0.49	0.25	-0.41	**0.92**	**0.79**	0.70
S&P500	**0.94**	**-0.90**	-0.07	**-0.84**	0.07	0.03	**0.75**
Gold	0.71	-0.72	-0.20	-0.66	-0.21	-0.31	0.42
Oil	**0.87**	**-0.79**	-0.19	**-0.80**	0.09	-0.02	0.71
CRB	0.70	-0.64	-0.31	-0.51	0.21	0.01	0.64
Relative Yield Curve	0.66	**0.85**	-0.38	0.33	-0.38	0.12	0.16

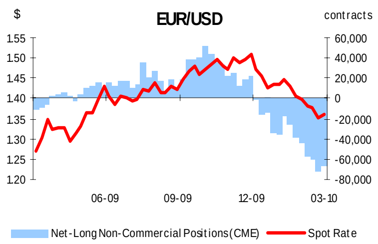
1-month correlations between interest rate spreads and G-10 FX have improved across the board over the week except for GBP/USD which continues to have little correlation with spreads. The 2yr UK/US interest rate spread narrowed around 6bps over the week but GBP/USD has held up fairly well considering and is pretty much flat on the week. Some of this may be explained by the lack of UK economic data out this past week but in general, rate spreads have shown little correlation with GBP/USD over the past year. There is some scope for the relationship to reassert itself next week with the minutes of the MPC and labour market data due but on the whole, the main driver for sterling over the medium term will likely be the outcome of the election and the fiscal outlook.

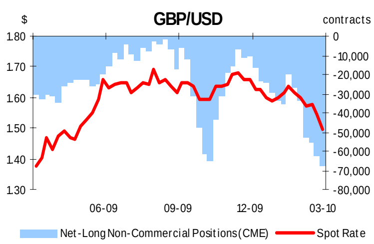
Commodity currencies continue to exhibit a high correlation with equity markets and as such have performed well this week, in line with equity markets.

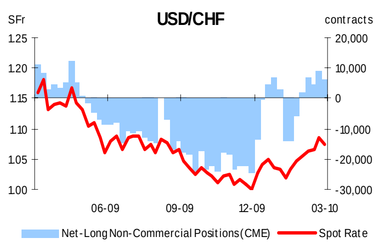
While the economic calendar is busier next week, focus will also be on monetary policy with the BoJ and the Fed both announcing decisions and the MPC publishing the minutes from their latest policy meeting.

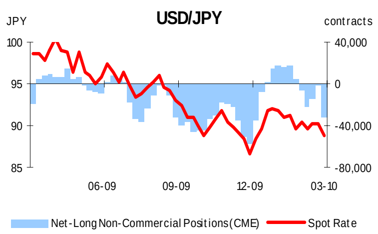
FX & Commodity Futures Positioning

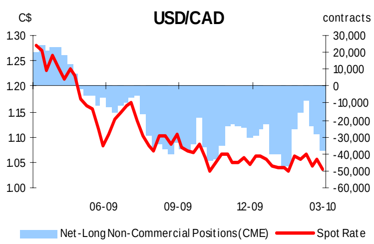
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative 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.

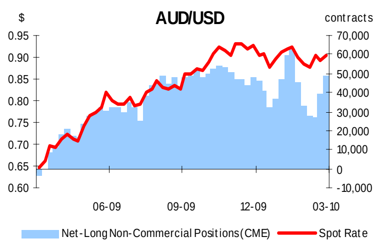


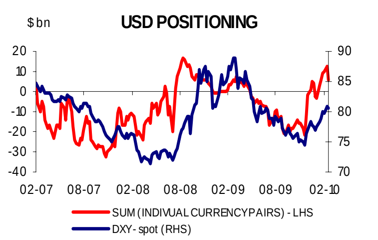


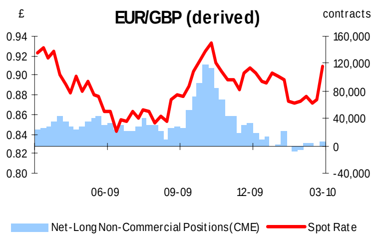


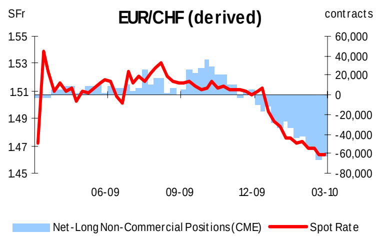


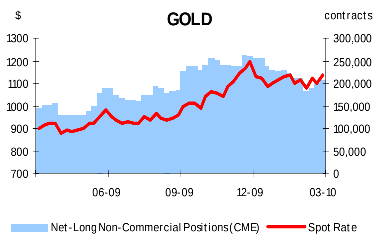


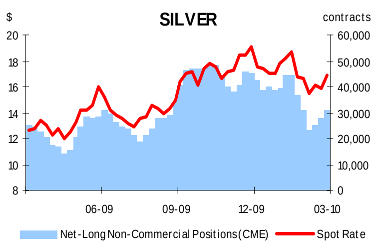


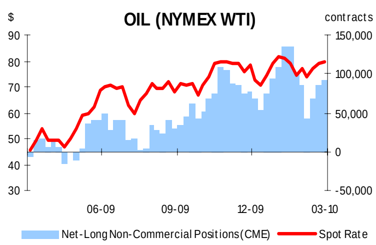


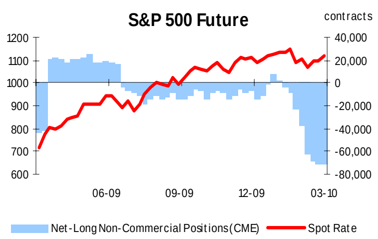


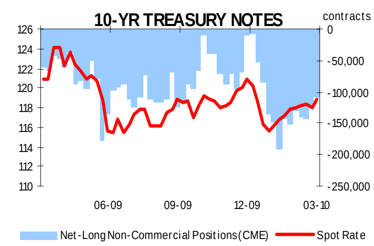


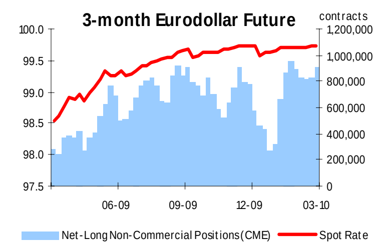








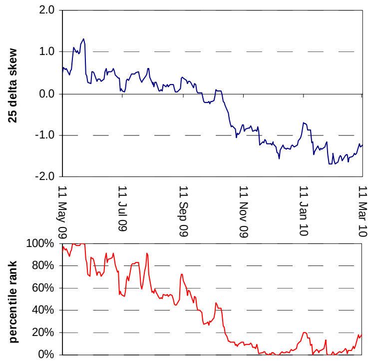




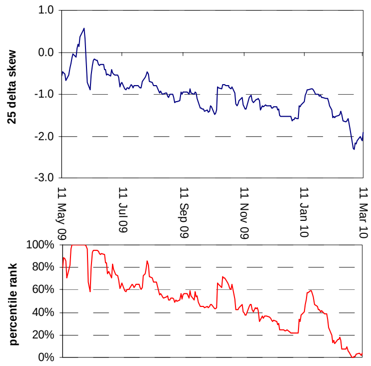
FX Options: Risk Reversal Skews

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.

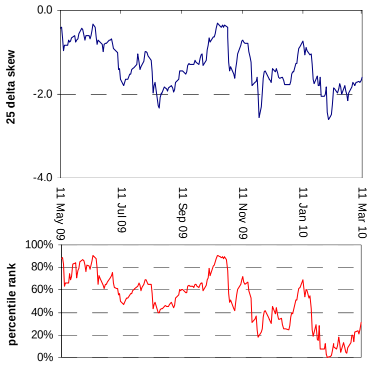
EURUSD



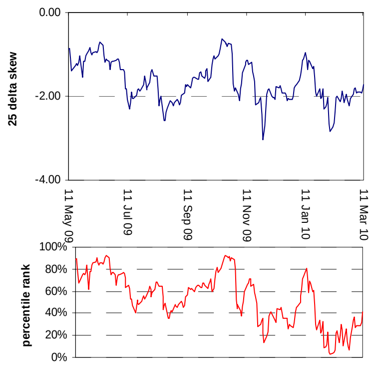
GBPUSD



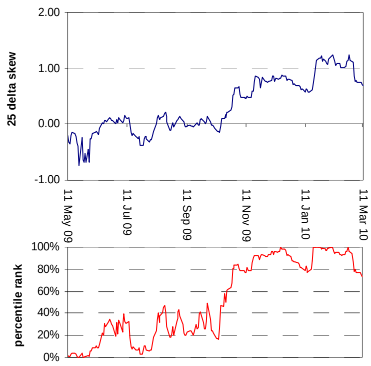
AUDUSD



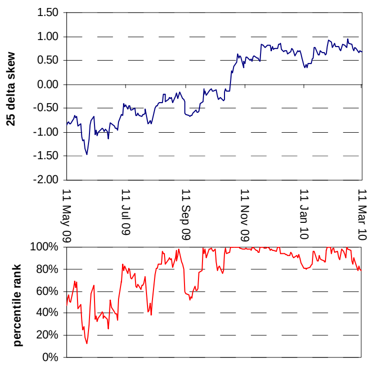
NZDUSD



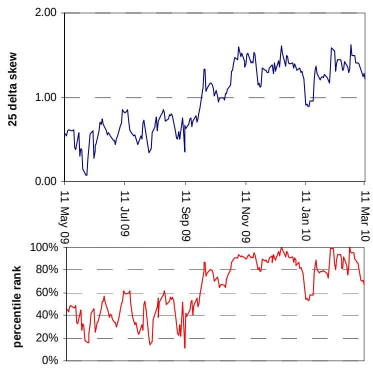
USDCAD



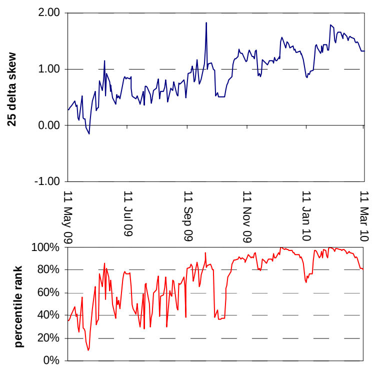
USDCHF



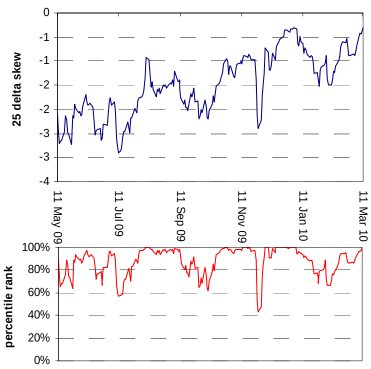
USDSEK



USDNOK

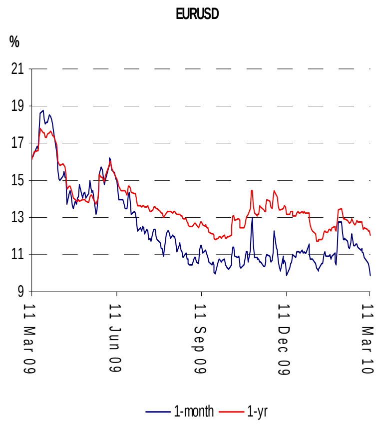


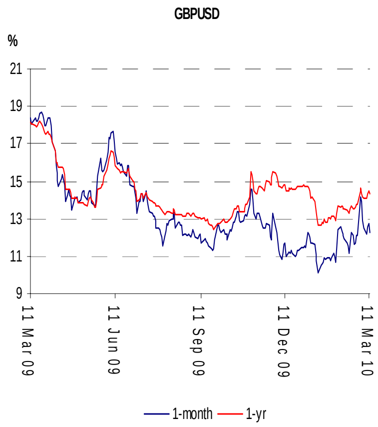
USDJPY

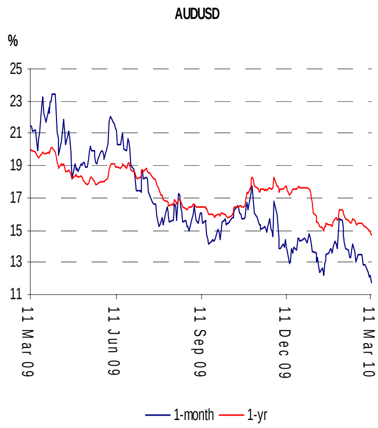


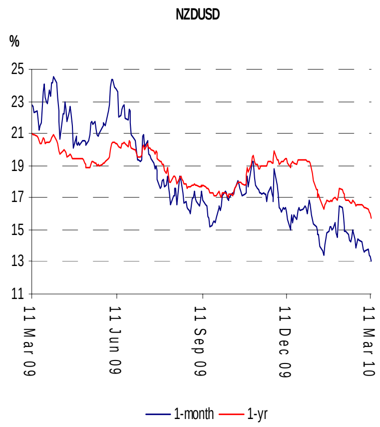
FX Options: Implied volatility

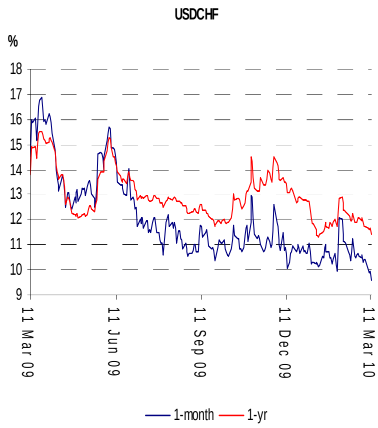
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

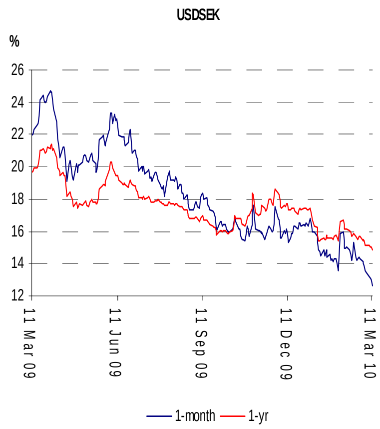


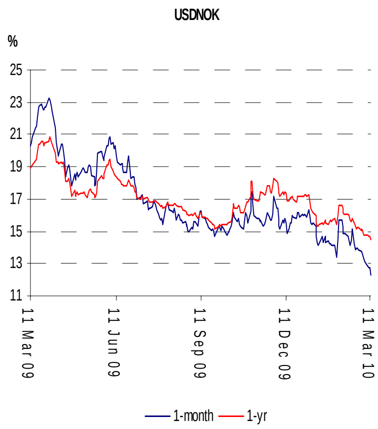


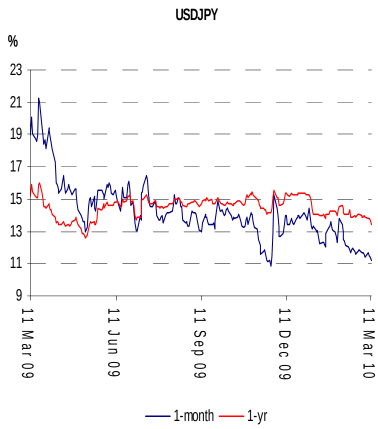






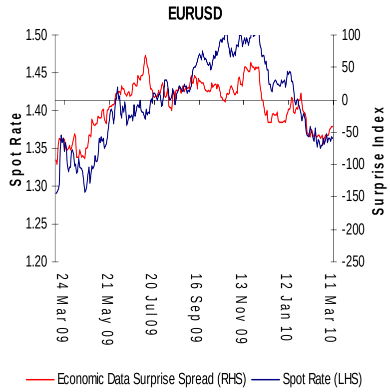


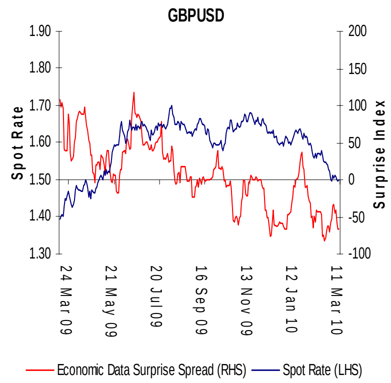


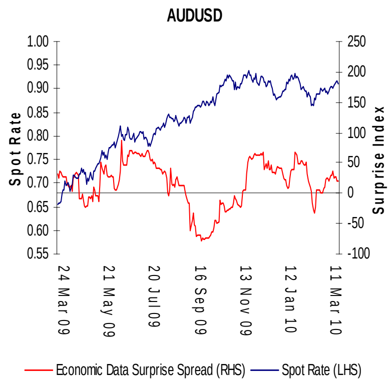


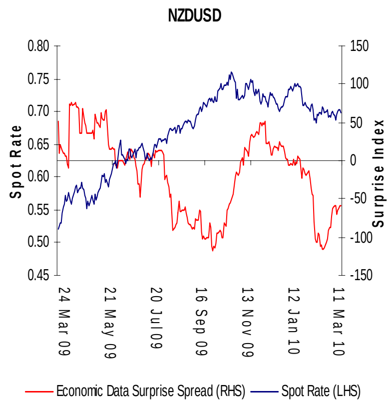
Economic Data Surprises

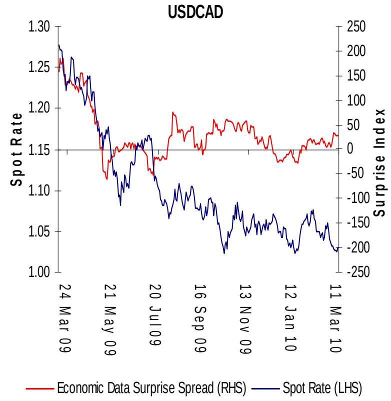
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

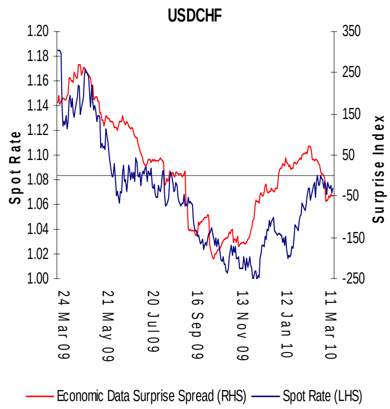


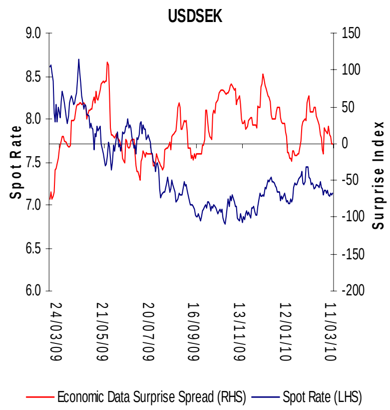


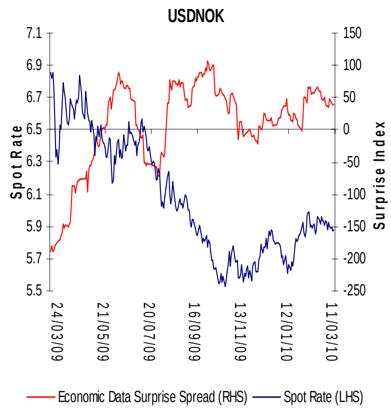


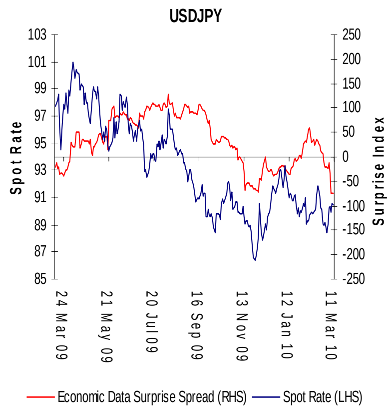






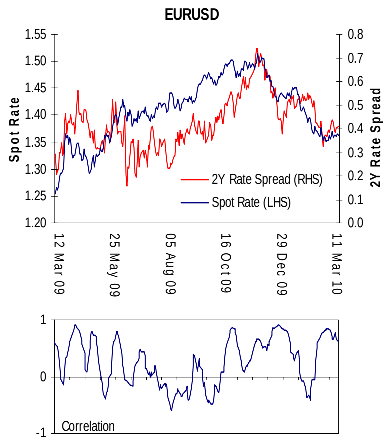


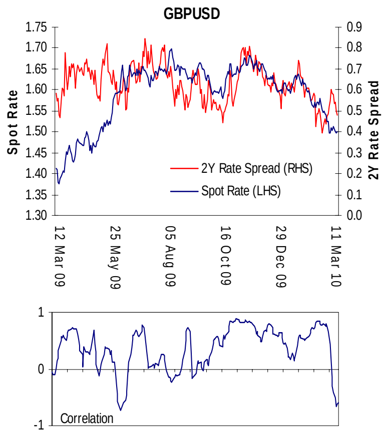


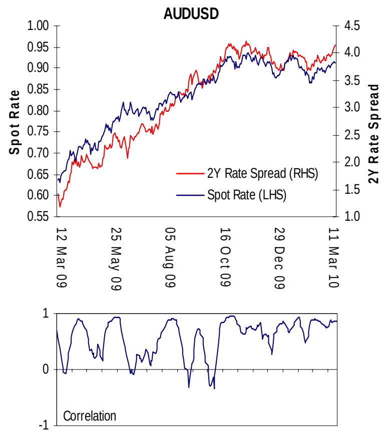


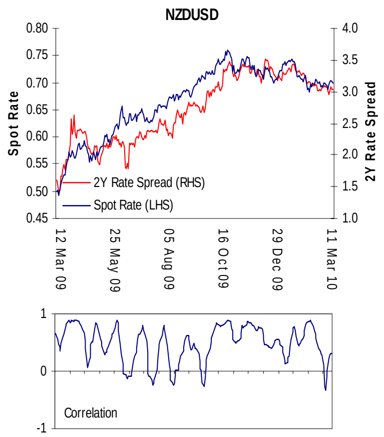
Interest Rate Spreads vs. FX

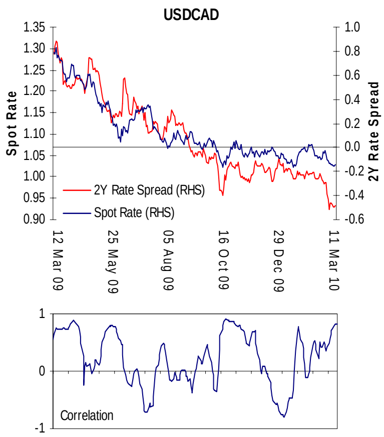
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

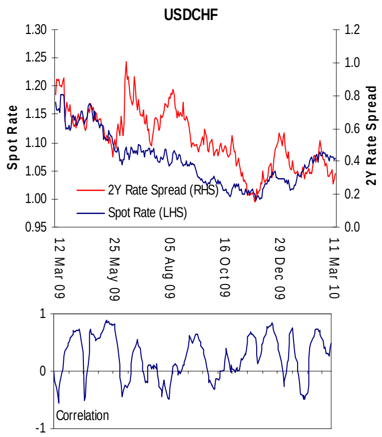


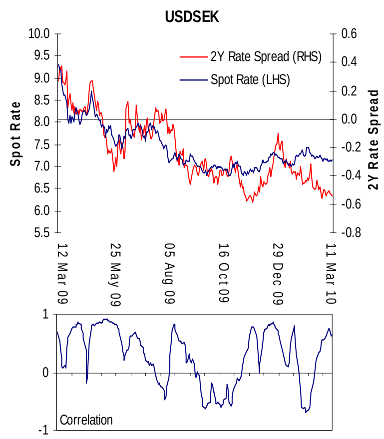


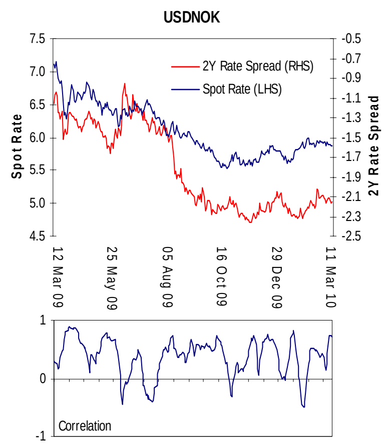


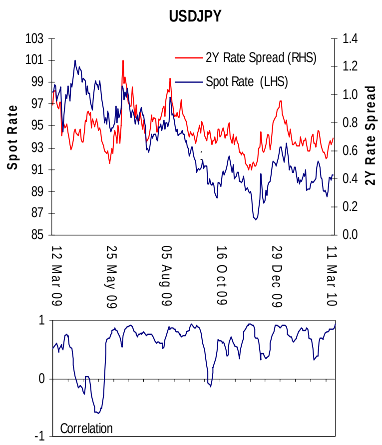






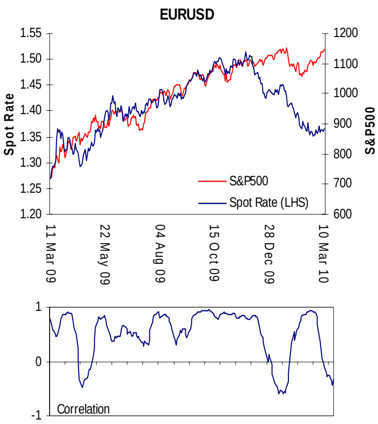


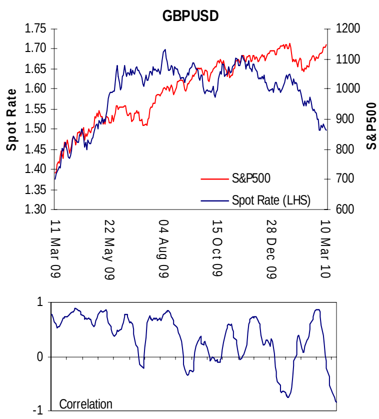


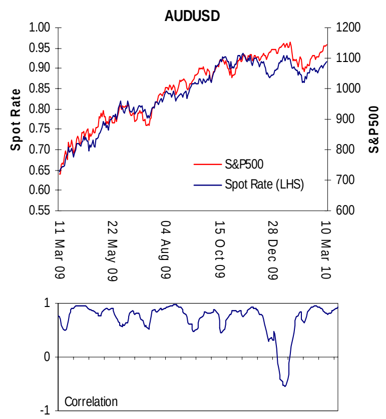


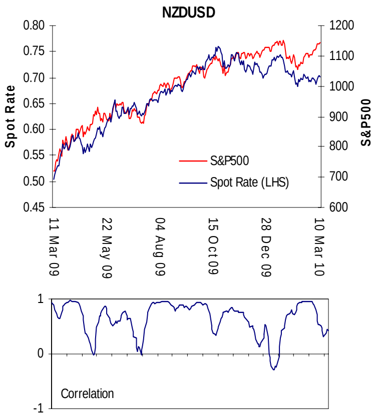
S&P500 vs. FX

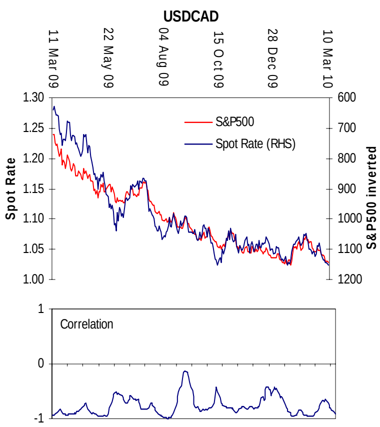
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

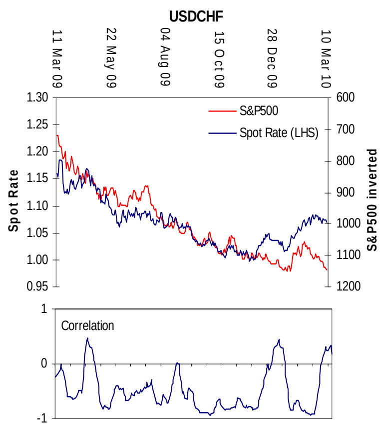


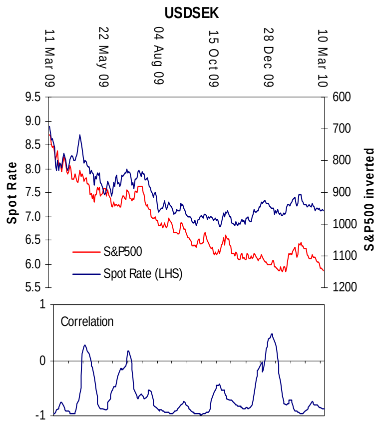


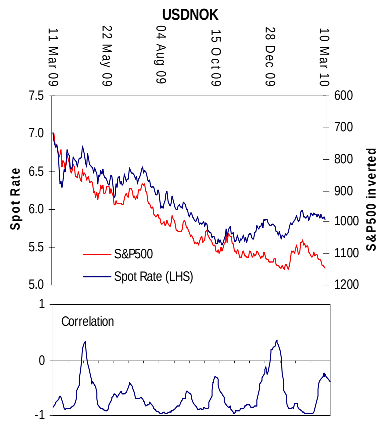


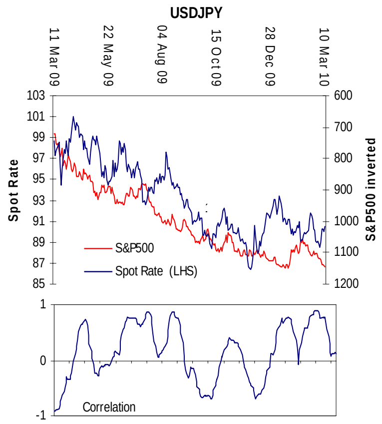






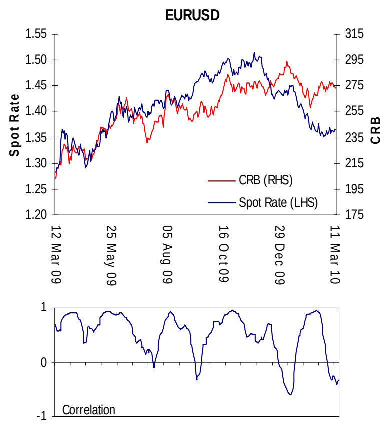


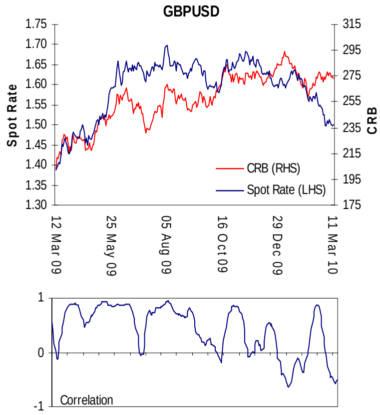


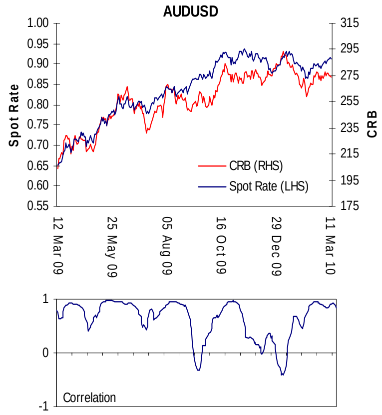


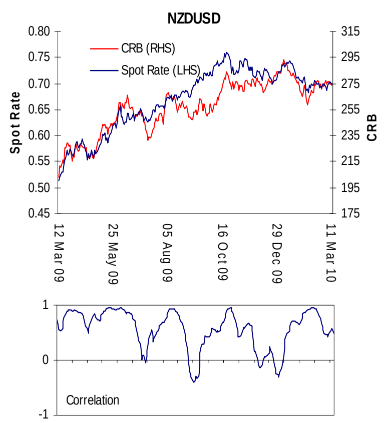
Commodities vs. FX

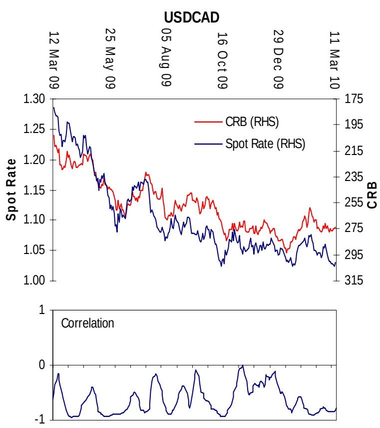
The charts below show the CRB commodity index plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

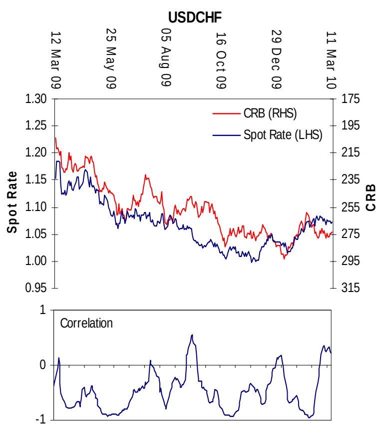


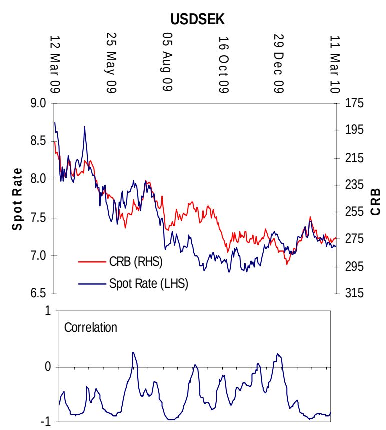


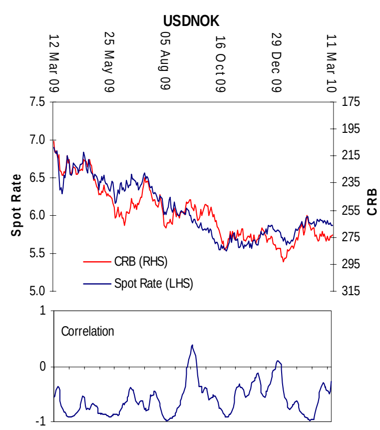


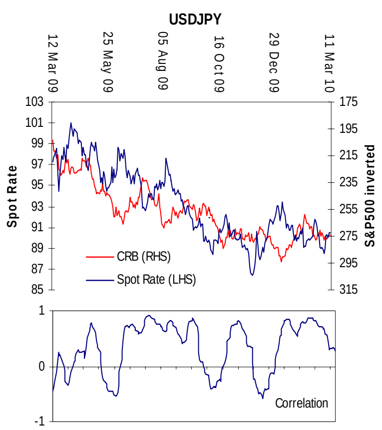












*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

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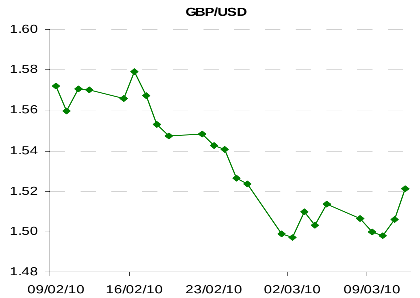
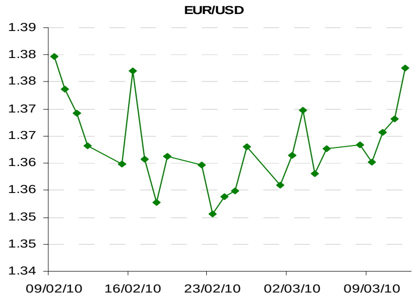
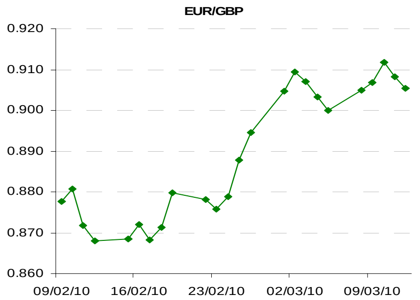
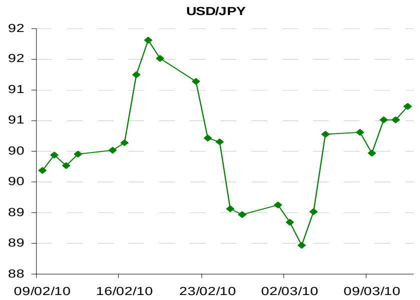
Market Review

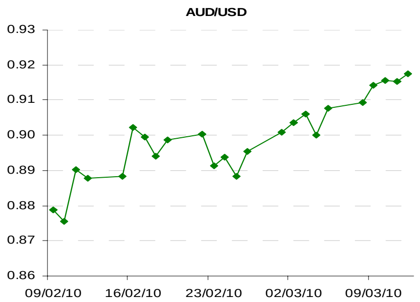
Short-term G-10 FX Charts

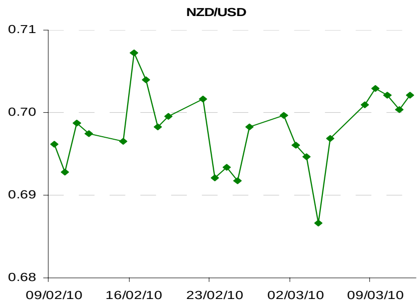


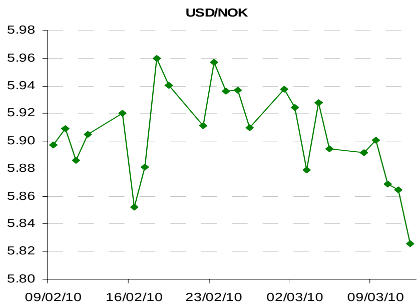


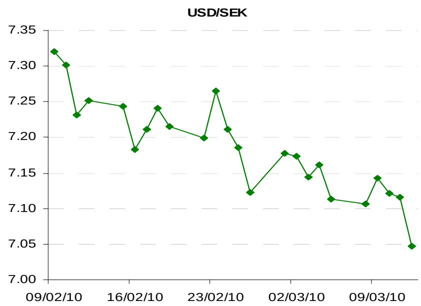


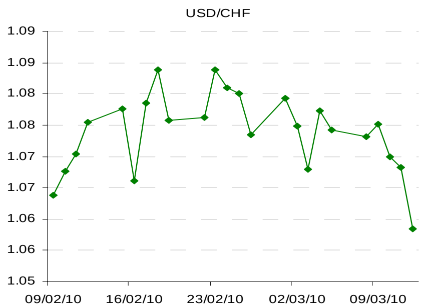


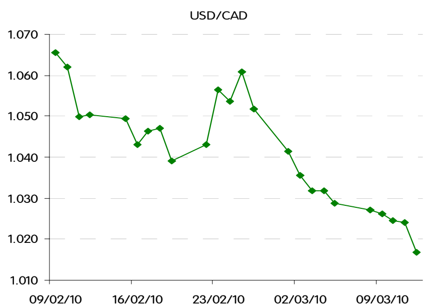




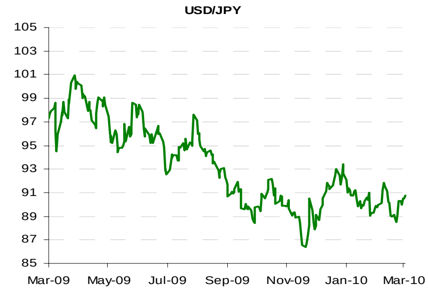


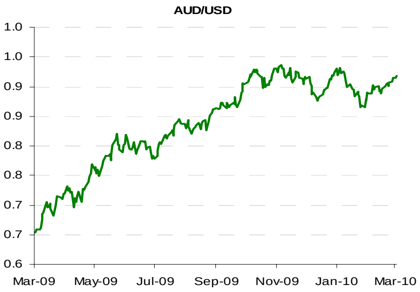


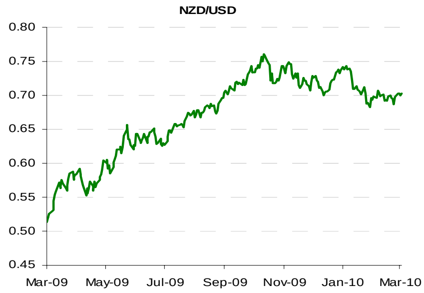


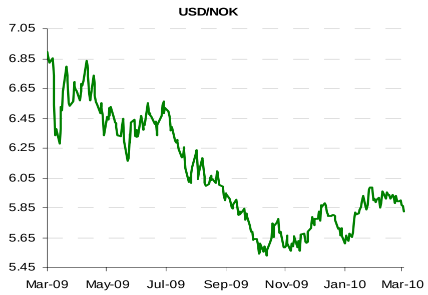


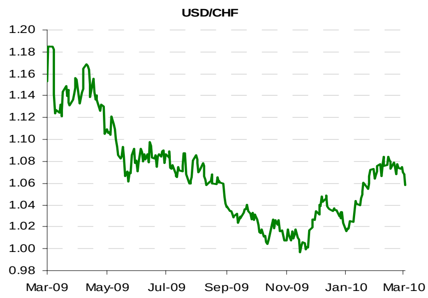
Medium-term G-10 FX Charts

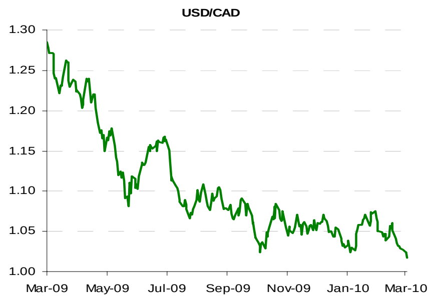












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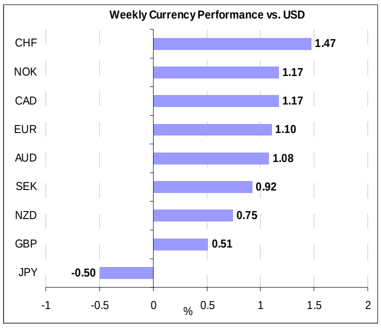
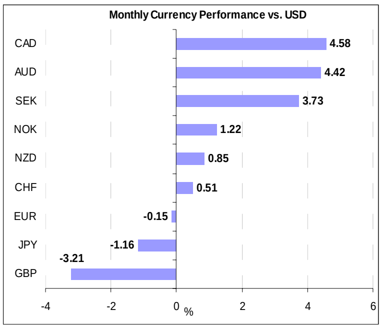
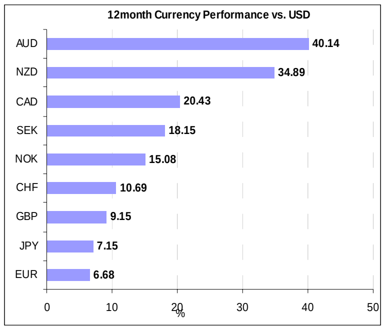
FX Snapshot

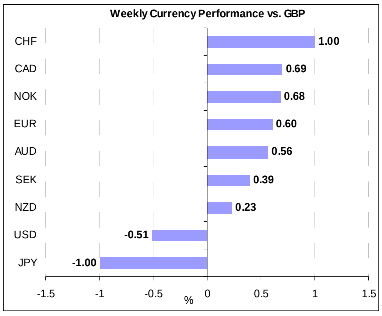
Currency performance vs. USD

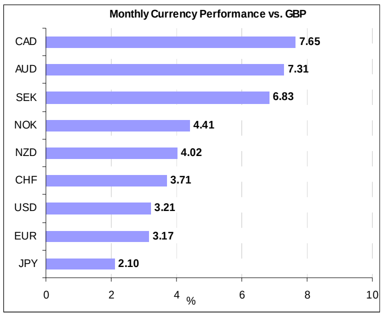


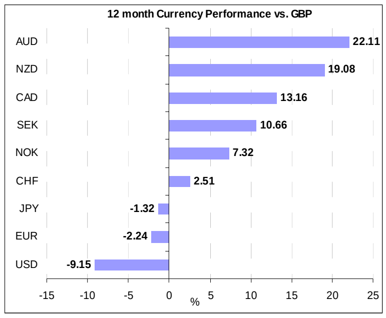




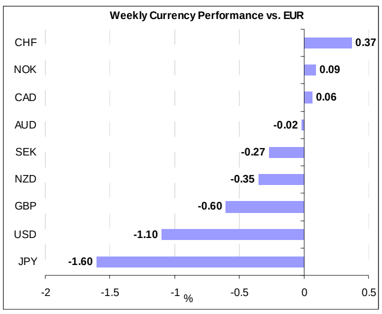
Currency performance vs. GBP

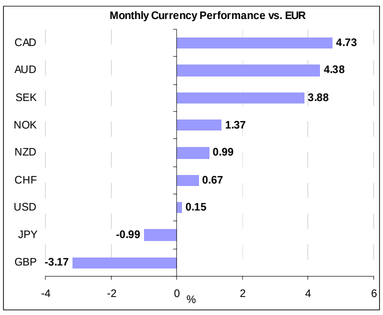


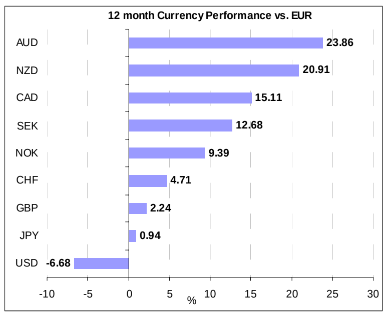




Currency performance vs. EUR







Kenneth Broux
Altaz Dagha
9 March 2010

CNY REVALUATION?

Still fragile global recovery may delay yuan move

We examine the price action of 2005 and current set-up in G10 currencies to understand what fluctuations can realistically be expected if China decided to revalue the yuan today.

The PBoC has supported a policy of gradual appreciation of the yuan since the currency was revalued by 2% vs the USD in 2005. The implementation of a two-year $590bn fiscal stimulus package last year (equivalent to 16% of GDP) along with aggressive bank lending and robust demand from Asian developing economies helped China to weather the severe headwinds from the recession in the developed economies. This has attracted speculative investment flows looking to capitalise on further yuan appreciation, resulting in unprecedented increases in Chinese real estate valuations.

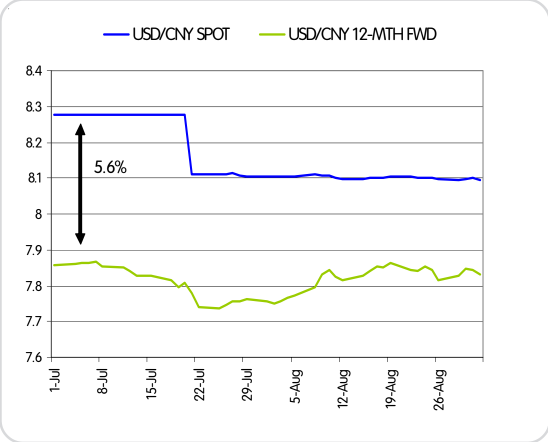
Premier Wen Jibao last week set out China's 2010 economic agenda and listed a tightening in credit policy and a determination to keep the yuan stable among the government's priorities. Alas, speculation of yuan revaluation has only escalated since the start of this year based on the view that China will step up the tightening in monetary conditions beyond the previously imposed increases in reserve lending requirements. The objective is to keep a lid on inflation as the economy expands at the fastest rate in two years (10.7% y/y in Q4-09). The PBoC controls inflation by sterilising currency flows (i.e. selling yuan denominated bonds to drain excess liquidity). But not all of the increase in currency reserves is sterilised, there is also an increase in liquidity, accompanied by strong credit growth. CPI inflation in China has accelerated from a low of -1.8% last July to 1.5% in January, and is forecast to keep rising in the months ahead. M2 money supply growth is currently averaging 25% y/y.

Back in 2005, USD/CNY 12-month forwards were trading at 7.8090 vs 8.2765 for spot, effectively pricing in a revaluation of 5.6%. In the event, the 2% appreciation on July 21 was a major disappointment and did not trigger major short-term fluctuations in G10 fx, resulting in only limited directional repercussions for the medium. Within the G10, the JPY posted the largest intra-day gain, firming 2.3% vs the USD. The AUD and NZD strengthened 1.3%. The worst performers on the day were the CAD, NOK and SEK, resulting in a fairly fragmented flows within the G10 vs the USD (see table). Gold closed the day 0.6% higher.

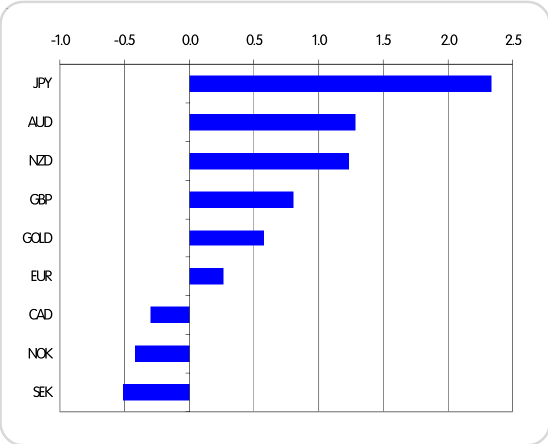
The reaction in USD/JPY warrants greater scrutiny. A closer look at the individual JPY crosses (see table) shows the biggest declines (JPY gains) were concentrated in EUR/JPY and CAD/JPY. The fluctuations suggest that the JPY again would stand to benefit most from a yuan revaluation today, regardless of the size of the PBoC's intervention. However, unless the revaluation is significantly higher than what forwards are currently pricing in, rate differentials should help currencies like the CAD to absorb the knee-jerk selling quite comfortably.

Taking events and market reaction of 2005 into account, CNY forwards are pricing in a more conservative yuan move this time around, perhaps pinning their hopes for the PBoC to 'under promise' and 'over deliver'. USD/CNY has declined steadily since 2005 and hit a 6.8061 low in September 2008.

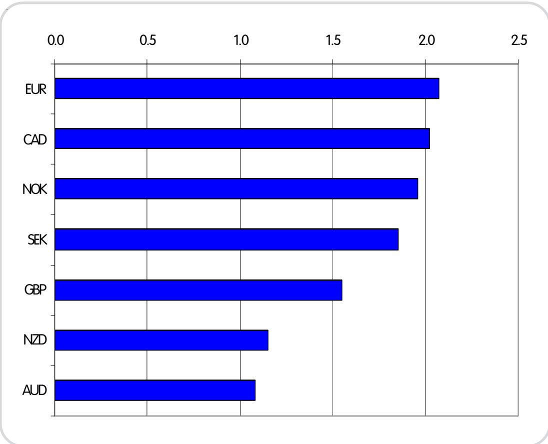
21 July 2005: China revalues CNY/USD by 2%



21 July 2005: percent change in USD/G10, gold



21 July 2005: JPY gains across the board



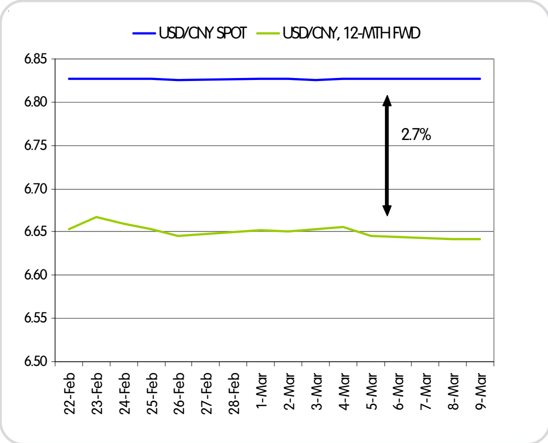
Since the spike up to 6.8846 in December 2008, the trading corridor has tightened perceptibly since Q4-09 to 6.8235-76.

USD/CNY 12-month forwards are trading at 6.6413 vs 6.8263 for spot, effectively discounting a 2.7% revaluation. Extrapolating the implications for G10 from 2005, whilst perhaps useful to determine short-term flows, may not be representative of longer term trends, simply because of the completely different G10 constellation of interest rate differentials, central bank exit strategies and growth outlooks. In addition, the vast increase since 2005 in China's currency reserves to over $2tln may also have changed the composition of China's holdings and its appetite for non G7 currencies. This has been mostly evident from the quarterly IMF Cofer data, with developing economies exhibiting a greater appetite for other currencies than USD, EUR, JPY or CHF. Putting these considerations and BoJ plans to increase monetary easing aside, it is advised from a tactical viewpoint to express a yuan revaluation strategy through long JPY positions, preferably vs EUR and GBP.

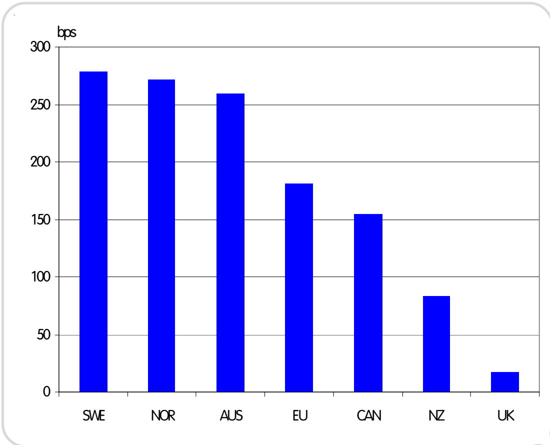
The size of a revaluation would obviously dictate the overall magnitude of the moves across G10. A greater adjustment by the PBoC than priced in by CNY forwards would (temporarily?) divert speculative Chinese investment flows and would in all likelihood slow the pace of currency reserve accumulation. Generally speaking, we would expect greater tailwinds to materialise for the USD, though sizeable swings in US/G10 rate spreads since 2005 (see table) put the SEK and NOK in an enviable position.

Finally, a revaluation of the CNY on a similar scale of 2005 would favour long JPY positions, but begs the question whether under the current risk-on/risk off context, GBP and EUR would also be bid higher and long CAD positions would be closed. Because of reserve diversification flows, our view is that GBP and the EUR would probably find themselves on the other end of the scale, recording intra-day losses vs the USD. Profit taking in CAD and SEK are opportunities to reinstate longs at cheaper levels. Because of the exposure of commodity exporters in general to a booming Chinese economy characterised by rising private sector demand, a yuan revaluation would probably help to offset any reserve related selling of AUD and CAD.

2010: CNY 12-mth forward discounts a 2.7% revaluation



Change in 2Y rate spreads vs US since July 2005



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