Lloyds TSB | Corporate Markets

Friday, 26th March 2010

FX Strategy Weekly

Market Strategy

Kenneth Broux
Market Economist
0207 158 1750
kenneth.broux@lloydstsb.co.uk

Altaz Dagha
Strategist
0207 158 1747
altaz.dagha@lloydstsb.co.uk

FX	Close	Weekly Change %
GBP/EUR	1.1110	0.13%
GBP/USD	1.4874	-0.93%
GBP/JPY	137.75	1.34%
GBP/CHF	1.5861	-0.47%
GBP/AUD	1.6504	0.63%
GBP/NZD	2.1185	-0.07%
GBP/CAD	1.5301	0.18%
GBP/NOK	8.9950	1.29%
GBP/SEK	10.81	0.33%
EUR/USD	1.3389	-1.04%
USD/JPY	92.61	2.29%
AUD/USD	0.9013	-1.54%
NZD/USD	0.7021	-0.86%
USD/CAD	1.0287	1.12%
USD/SEK	7.2688	1.32%
USD/NOK	6.0474	2.23%
USD/CHF	1.0664	0.48%
Swaps %		**bp**
2yr	1.583	-3.4
5yr	2.898	-4.0
10yr	3.845	-1.2
Equities		**%**
FTSE100	5703.02	0.94%

Market Outlook:

Disappointing US treasury auctions and widening US/G10 yields differentials have given currency markets something to think about as we approach the end of Q1 and look ahead to the trading themes for Q2. Our two-week view calls for the dollar index to stay well supported, bolstered by a return to positive US employment growth in March. We hold out for a move up to 83.0 if next week Friday's payrolls data come in roughly in line with the consensus forecast of 187,000. Though the Fed reiterates it is no hurry to raise interest rates, a change in FOMC language in April and ongoing speculation of a yuan revaluation should keep the dollar in the ascent vs the EUR and GBP, with the former unlikely to draw much sympathy overseas from this week's EU/IMF accord on Greece. With the Budget in the UK now behind us, campaigning for the General Election gets underway in earnest and is set to put economic data in the shade. We target further downside in GBP/CAD and GBP/CHF over the pre-election period, and reiterate our negative medium term view for GBP/USD. The start of the new fiscal year in Japan on April 1 and the unwinding of corporate repatriation flows could drag the JPY lower vs G10 currencies over the next two weeks, potentially aided by stronger equities and the return of carry trade flows.

Recap

- The JPY and the NOK were among the worst performing currencies in the G10 this week, registering losses of over 2% vs the USD. An agreement in the EU over Greece pulled EUR crosses off their lows, but concerns that he ECB's independence may have been undermined by the participation of the IMF into a Franco/German accord may sow some doubts overseas over the long term stability of the single currency zone. EUR/CHF slumped below 1.43 to a new all-time low of 1.4233. GBP showed good resilience on Monday and Tuesday but succumbed to selling pressure after the Budget on Wednesday, closing the week near the intra-week low sub 1.49 vs the USD and over 0.90 vs the EUR. GBP/CHF extended its downtrend below 1.5850, leading us to lower our medium-target to 1.55.
- UK CPI slowed to 3% y/y in February vs 3.5% in January, fuelling hopes that inflation has peaked. RPI was unchanged at 3.7% y/y but core CPI dropped to 2.9% from 3.1%. February retail sales surprised to the upside with a 1.6% m/m gain but a marked downward revision to the January data (-2.1% vs -1.2%) took the gloss of the headline February data. The Chancellor revised down this year's borrowing estimate by £11bn to £167bn. He also cut his forecast range for GDP growth in 2011 by 0.25% to 3-3.50%, leaving this year's projection unchanged at 1-1.25%.
- UK 10y yields tested 3.91% but rebounded from oversold conditions on Budget day, touching 3.99%. Disappointing US 5y and 7y note auctions tailed 4bp and added upside pressure on yields, leading 2y/10y curves to resume their steepening bias. UK 2y/10y spread widened to 284bp, a two-week high. The 2y/10y swap spread widened to 226bp, still within recent territory. 5y swaps drifted in a narrow range around 2.90% pivot. 10y swap spreads widened to -19bp. Based on the latest government borrowing estimates, the DMO set an issuance target of £187.3bn for 2010/11, £40.3bn less compared to 2009, but putting greater emphasis on index-linked sales and mini-tenders.

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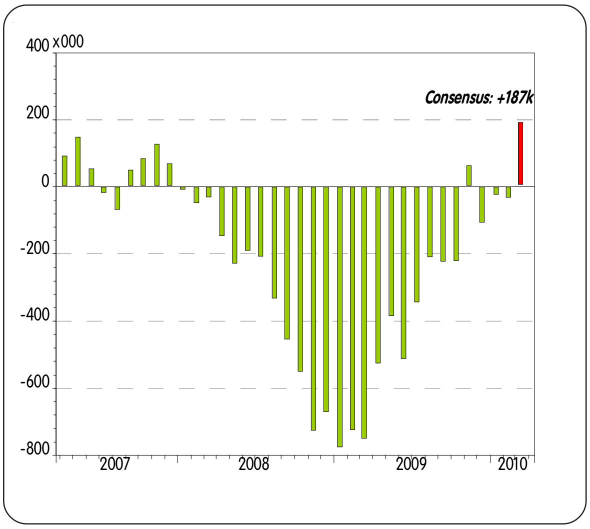
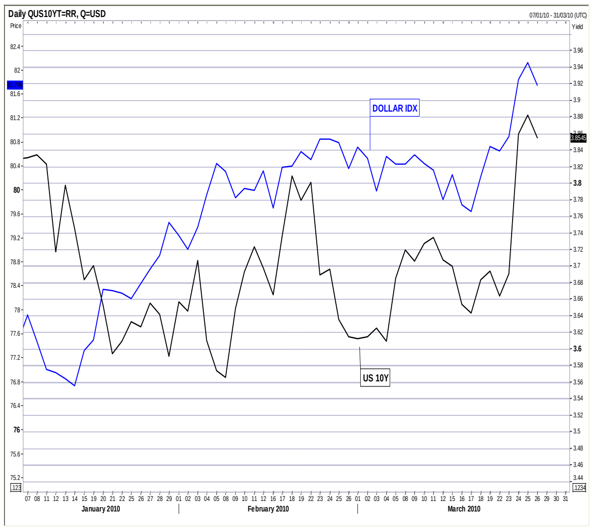
The next edition of the FX Weekly Strategy is scheduled for April 9.

Census, weather to boost March US payrolls



US 10y yield vs dollar index: synchronised rally



USD

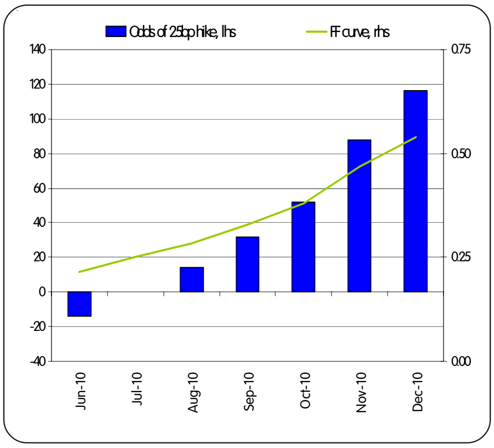
• Disappointing US 5y and 7y treasury auctions and widening US/G10 yields differentials have given currency markets something to think about as we approach the end of Q1 and look ahead to the trading themes for Q2. The dollar index succeeded in extending gains above 81.50, building on gains originally sparked to weeks ago. The DXY is up 5% since Jan 1.

• Our two-week view calls for the dollar index to stay well supported, bolstered by a return to positive US employment growth in March. We target a test of 82.2 and hold out for a move up to 83.0 if next week Friday's payrolls data come in roughly in line or beat consensus forecast of 187,000 (US bond market open for half day on Good Friday). Though Fed chairman Bernanke repeated in Congress that monetary policy will stay accommodative, a (Census/weather) related bounce in employment will inevitably bolster speculation of 'extended period' disappearing from the FOMC statement on April 28.

• A widening in US/G10 yield differentials has been observed over the last week, led by US/JGB 10y spread hitting 250bp. The cause of higher US yields is partly attributed to weak participation at US government bond auctions, and could offset the bullish USD argument of higher yields if signs of supply indigestion intensify and higher yields threaten housing and mortgage market activity. The benchmark 30y, 4.5% Fannie Mae, is up 30bp in March, approaching 4.50%.

• Aside from payrolls, next week sees reports of March consumer confidence, the Chicago PMI and the manufacturing ISM. Fed fund futures currently price in 52% odds of a 25bp hike ahead of the mid-terms.

FF futures: dead cert of 25bp hike by December



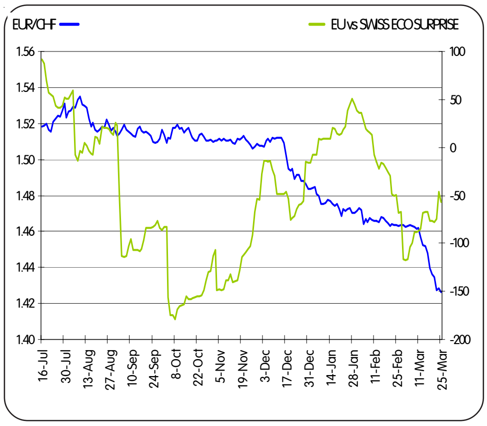
EUR

• EU-16 governments finally rallied around Greece, bringing the IMF and bi-lateral loans into the equation to assist Greece if debt refunding plans run into trouble in April and May. However, the ECB's independence appears to have been undermined in the negotiations, with the decision to abandon an increase in minimum collateral requirements in 2011 marking a departure from the ECB's official position only three weeks ago, and with president Trichet and members Weber and Bini Smaghi bowing to political pressure. This, along with a widening in 10y US/bund spread to 78bp, may dissuade global currency portfolio managers from buying dips in EUR/USD despite the 8.3% sell-off since January.

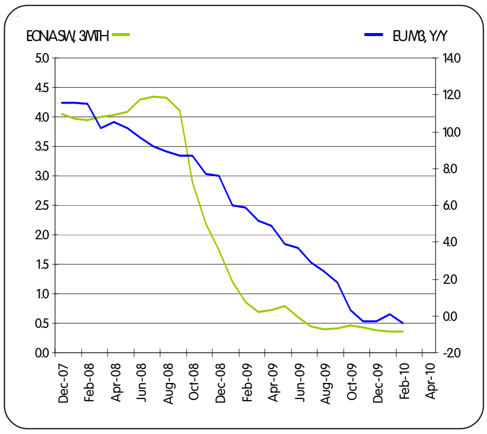
• The outperformance of EUR/NOK and EUR/JPY last week contrasts with the selling in EUR/USD and EUR/CHF. The moves could have further to run in the context of a more dovish statement by Norges Bank and broad-based JPY selling. However, the relatively small up-tick in EUR/NOK 1mth risk reversals (0.64) may testify to a reluctance to push the cross through 8.13. For EUR/JPY, 1mth risk reversals are near 5mth highs (-1.28). A move through trendline resistance at 123.66 clears the path for a rally up to 125.30, the upper end of the 2mth trading range.

• A relatively quiet week is lined up and will allow markets to take a closer look at the details of the EU/Greece plan (size of EU loans, IMF assistance, member state veto, etc.). We would also like to hear from the EC how the agreement to closer 'economic cooperation' differentiates from the existing surveillance of economic fiscal policies. Business confidence surveys in Germany have sprinted higher in March, capitalising on what could be attributed on the euro weakness. This should give German exports a lift in Q2. Euro zone flash CPI estimate for March (Wednesday) is forecast to have edged up to 1.1% vs 0.9%, a 13-month high. An unexpected drop in annual M3 growth in January to -0.4% confirms that price pressures from credit growth are absent.

No relief for EUR/CHF despite stronger EU data



M3 money growth: drifting along the bottom



GBP

• Sterling put in a decent effort over the past week losing ground only vs the USD and the CHF, and gaining 1.4% v the JPY and more than 1% vs the NOK, incidentally the two worst performing currencies of the G10. US/UK rate differentials have not been a great driver of GBP/USD (see chart) in contrast to other US/G10 spreads like USD/JPY, putting emphasis on different factors to determine GBP direction.

• With the Budget now behind us, campaigning for the general election gets underway in earnest and is set to put economic data in the shade until the next release of CPI (maybe) and the first release of Q1 GDP on April 27. We have been advocating selling GBP rallies and see continued merit in this strategy ahead of an election where the outcome remains too close to call.

• Our bearish medium-term GBP/USD view is partially predicated on optimism with regard to March US payrolls data and the ongoing, albeit reduced pace of accumulation of short GBP positions. We look for GBP/USD to test the low end of the range at 1.4784 for a deeper pullback to 1.45. 1mth risk reversals have stabilised at -1.87. We also target further downside in GBP/CAD, recommending to sell rallies as the cross approaches 1.55 with a 1.50 target. The CAN/UK 2y spread hit 50bp, surpassing the early March high of 42bp. A rally up to 70bp is aggressive but achievable, we think, over a longe-term horizon.

• A fairly busy week ahead for data and events but GBP crosses may be fixated on swings in the election polls and BoE MPC meeting in the week after next. Mortgage approvals and consumer credit data for February and the final read of Q4 GDP are the highlights, whilst M4 lending to OFCs will be scrutinised for evidence that QE is 'working'. The BoE publishes its latest Credit Conditions survey on Thursday. MPC members Dale and Haldane are scheduled to speak.

• For EUR/GBP, failure to make headway below the 100d MA at 0.8916 underlines the nervousness and the reluctance to close out long positions despite the mixed market response to the EU/IMF solution for Greece. Election polls will set the early tone next week, but early indications that Labour is closing the gap with the Conservatives (increased risk of hung parliament) may add near-term upside for EUR/GBP, with the upper end of the range at 0.91 targeted.

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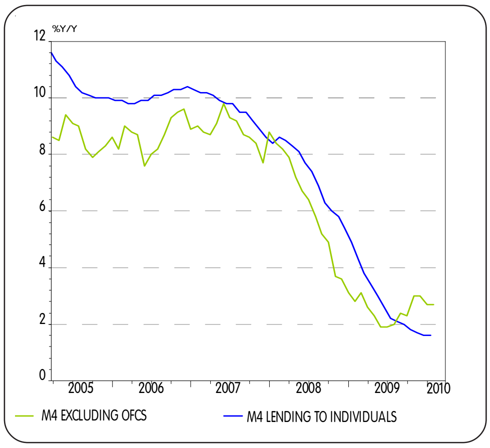
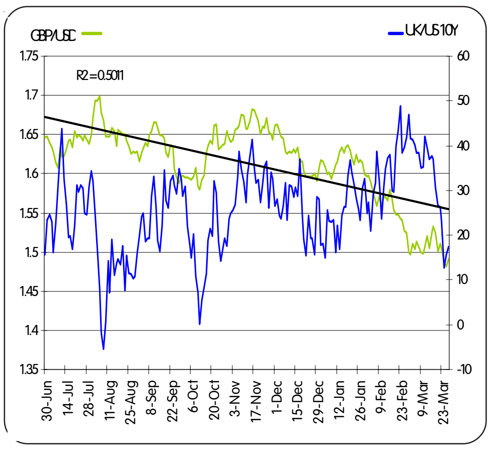
UK M4 lending: where is the turn?



US/UK10y yield: no great fit with GBP/USD



JPY

• A range break in USD/JPY was triggered by a steep rise in US/JAP rate differentials from 3mth libor out to 10y notes. Though we had warned of typically bearish JPY seasonals taking the upper hand in March in previous editions of our Weekly Notes, the move has taken longer to materialize and involved BoJ and MoF policy decisions (added liquidity, increased fiscal spending). The start of the new fiscal year on April 1 and the unwinding of Japanese repatriation flows could drag the JPY lower vs G10 currencies over the next two weeks, potentially aided by stronger equities and the return of carry trade flows.

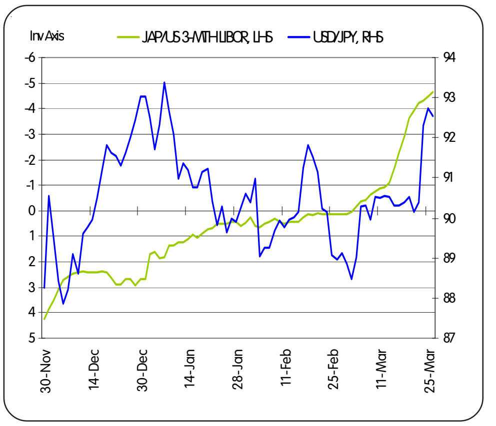
• A break in USD/JPY of trendline resistance at 90.93 and the Feb 19 high of 92.15 propelled the pair to 92.93, aided by a widening in US/JAP 3mth libor spread to 5bp and in 10y Treasury/JGB spread to 251bp. Considering the still long JPY positioning (IMM data:+15,000) and a step up in overseas selling of Japanese securities, further upside for USD/JPY is possible. We are keeping a close eye on 10y JGB yields for direction. A test of 1.40% in 10y yields adds momentum for a move up to trendline resistance in the 1.42% area.

• Foreign investors bought Y127bn worth of Japanese stocks last week but sold Y528bn worth of JGBs, resulting in a net sale of Y400bn. This marks the second successive week of selling from overseas of Japanese securities (excl money market instruments). Overseas selling of JGB's totalled Y528bn, the highest since 9 January.

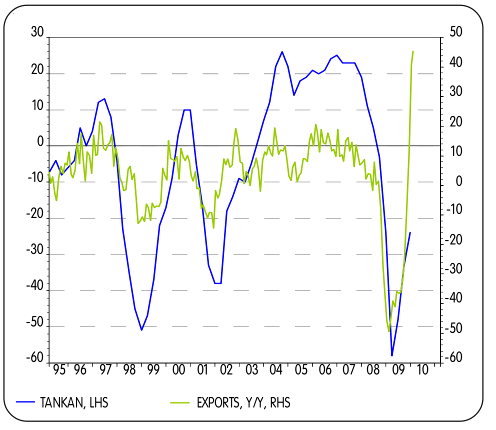
• CAD/JPY and AUD/JPY in particular look poised to do well and extend recent gains if equities continue their bullish form. Boosted by positive interest rate differentials and the start of the new fiscal year for Japanese corporates, we look for a consolidation in CAD/JPY after piercing trendline resistance at 90.82. We target a move up to 96.50 over 3 months.

• The Q1 Tankan survey and February unemployment data are the highlights of a busy week for Japanese indicators. The next BoJ meeting takes place on April 5-6, where concerns over falls in CPI are set to keep the BoJ in expansionary policy mode. A spillover from rising US Treasury yields could offset the BoJ's recent efforts to encourage a decline in long-term yields, manifested in a rise in 10y JGB yields to 1.40%.

USD/JPY: good traction with Treas/JGB spread



Q1 Tankan: boost from rising exports?



Quantitative Market Analysis

- **Extreme bearsh euro sentiment subsides**
- **Market looks for further US dollar strength**

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.

Overall net short GBP positioning remained relatively stable over the past week with a slight increase in net shorts to -63.9k from -63.5k the previous week. There was a more notable shift in EUR/USD positioning, however, with a sharp reduction in net shorts following increased speculation of a Greek aid package (since confirmed). Speculators also added to short positions in USD/CAD as the currency pair approached parity. USD/CAD has, however, rebounded over the past few days as the US DXY index broke through key resistance. AUD/USD longs continue to increase albeit at a slower pace than over the previous month. When compared with the performance over the past three years, positioning currently lies at the 89th percentile. The underlying spot rate has looked toppish over the past few days however, failing to break to new highs. This increases the risk of a sharper reversal over the next week as speculators close out positions.

There was a clear shift back towards a positive US dollar bias in risk reversals this week after two weeks of moves against the US dollar. EUR/USD risk reversals sunk once again, despite the confirmation of a back up Greek aid plan, suggesting the market is not entirely convinced that this is the end of the matter while there also remains concerns over the fiscal situation of some of the other peripheral eurozone countries.

After the previous week's swings back towards historical norms in relative percentile ranks for USD/CHF, USD/NOK, EUR/USD and USD/CAD, the past week has seen a shift back towards extreme demand for USD calls/currency puts. All the G-10 currency risk reversal skews currently lie at extreme levels when compared with performance over the past year.

Implied volatility bounced sharply in the 1-month maturity across the G10 relative to 1-year, resulting in a flattening of volatility curves. The biggest rises were noted for EUR/USD, GBP/USD and USD/CHF.

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	EURJPY	AUDJPY
2 YR SPD	**0.80**	**0.84**	**0.77**	0.31	**0.94**	**0.86**	**0.94**
10 YR SPD	0.71	0.13	**0.83**	0.55	**0.84**	0.14	**0.89**
S&P500	**0.85**	**-0.91**	-0.15	-0.45	0.67	0.67	**0.94**
Gold	0.08	-0.07	0.62	0.17	-0.70	-0.26	-0.41
Oil	**0.84**	**-0.80**	0.31	-0.09	0.31	0.67	0.70
CRB	0.12	-0.01	0.72	0.45	-0.67	-0.12	-0.37
Relative Yield Curve	0.14	0.66	-0.11	-0.26	0.40	0.50	**0.92**

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).

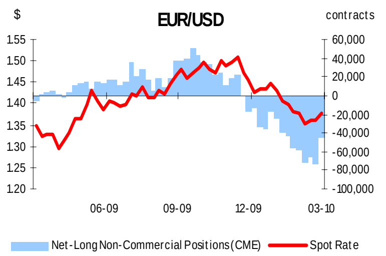
1-month correlations between interest rates and G10 spot rates continue to show a good fit between EUR/USD (back towards the highs), AUD/USD and USD/CAD (although just off the high). USD/SEK and USD/NOK correlations have increased close to 100%.

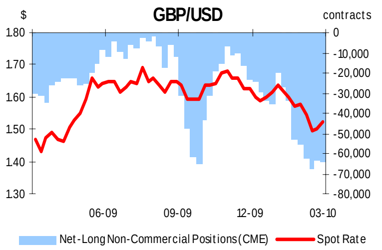
The correlation with rates has now broken down completely in the case of NZD/USD but has turned positive, albeit only just, with GBP/USD after the Budget.

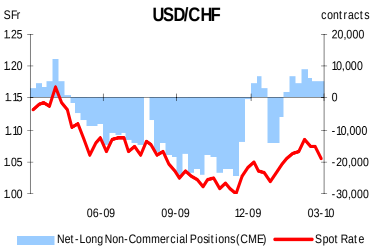
In terms of correlation with risk assets (S&P 500), we continue to see extreme positive traction in AUD/USD, USD/SEK and USD/CAD in comparison to the rest of the G10. The correlation with GBP/USD has now nearly fully inverted. Correlations with other risk assets, namely commodities, have broken down somewhat over the past week, particularly in AUD/USD.

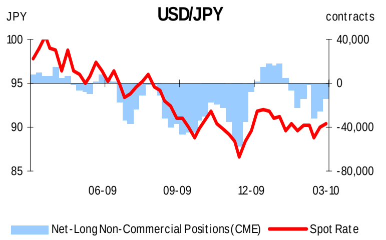
FX & Commodity Futures Positioning

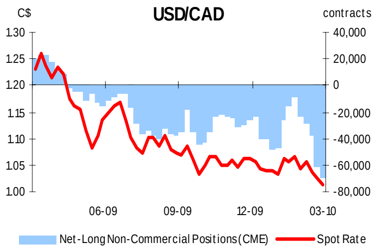
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

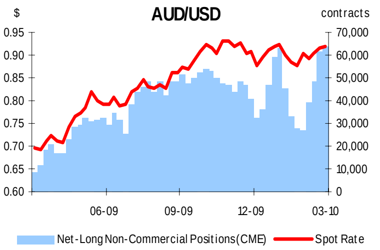


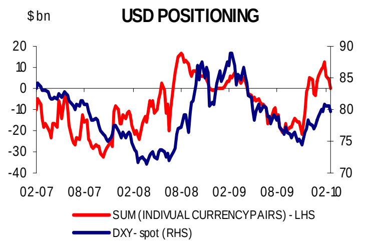


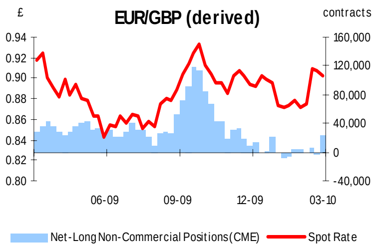


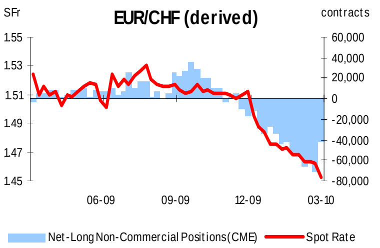


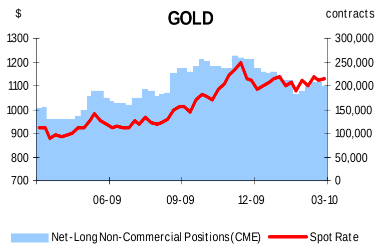


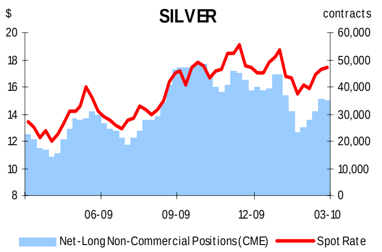


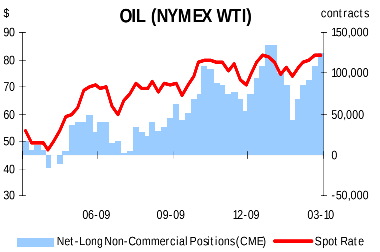


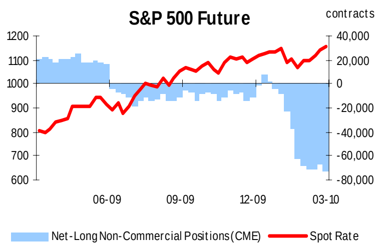


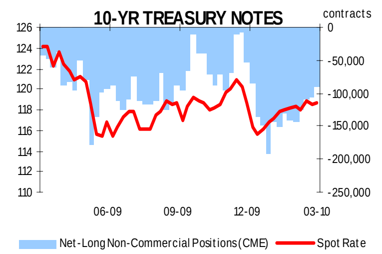


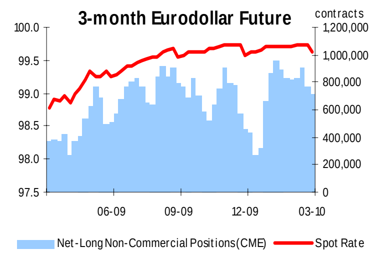








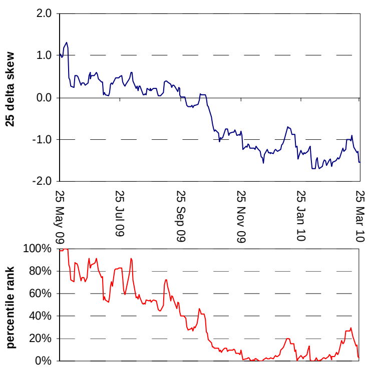




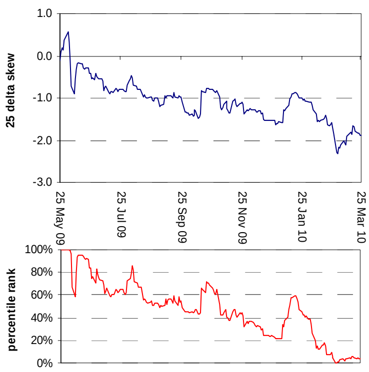
FX Options: Risk Reversal Skews

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.

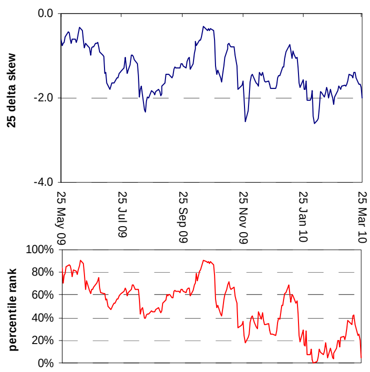
EURUSD



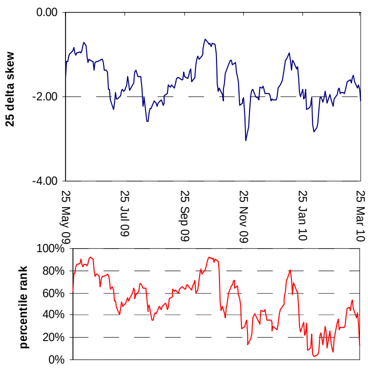
GBPUSD



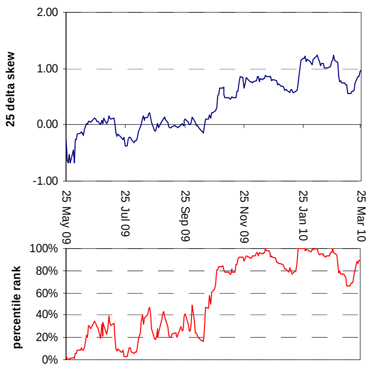
AUDUSD



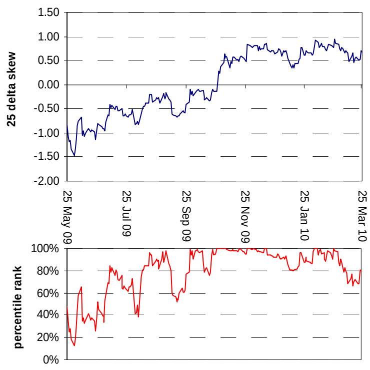
NZDUSD



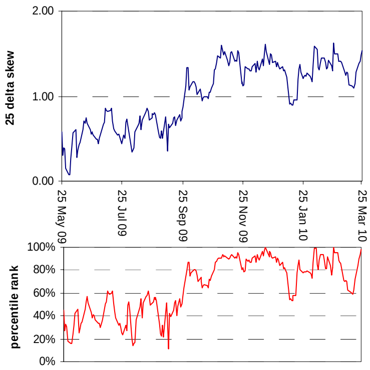
USDCAD



USDCHF



USDSEK



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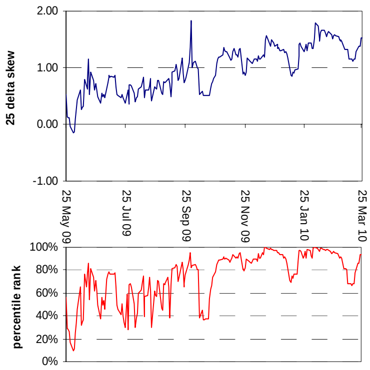
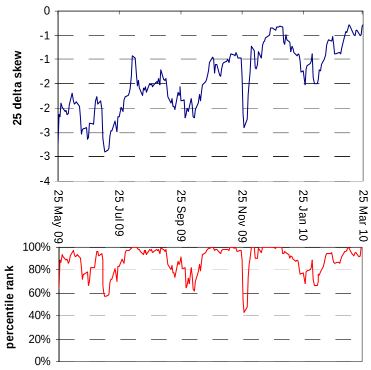
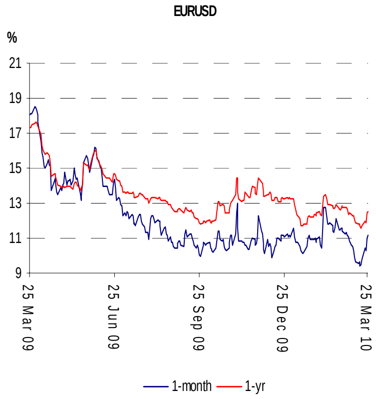


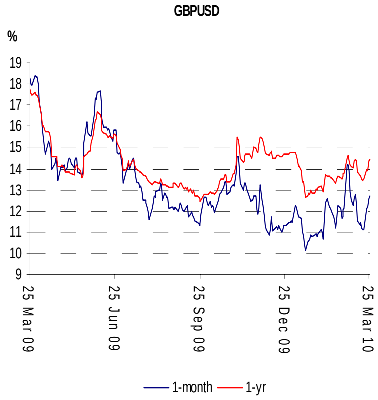
USDJPY

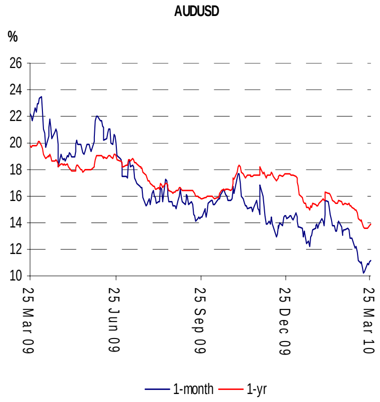


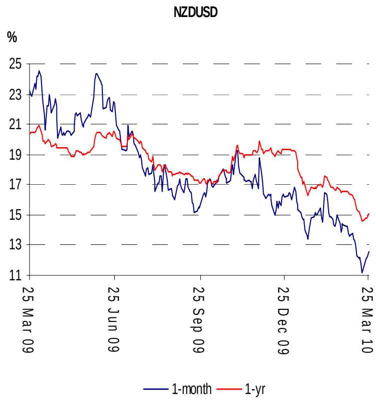
FX Options: Implied volatility

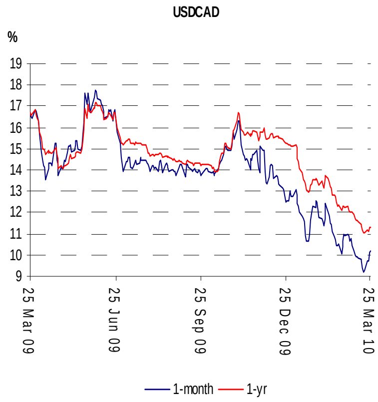
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

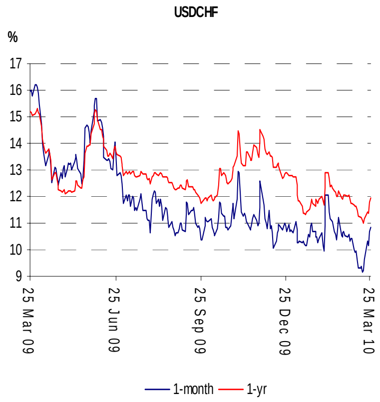


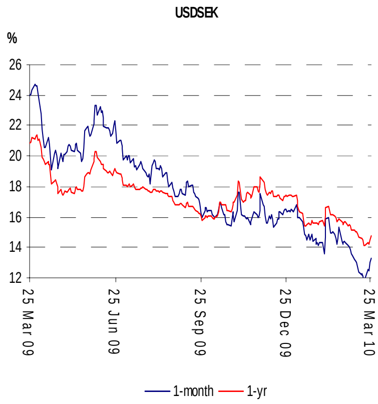


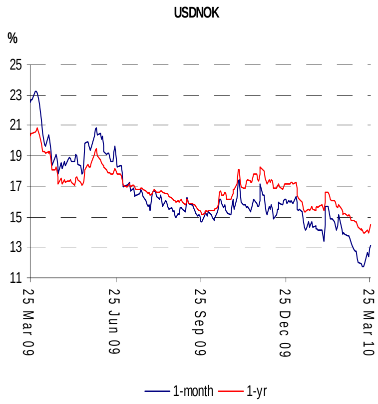


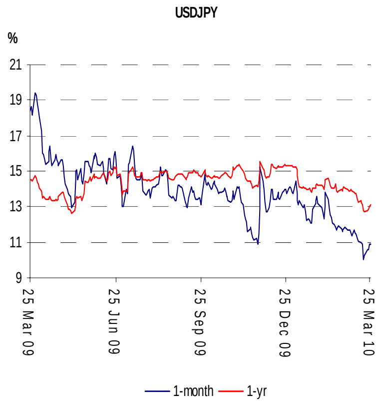






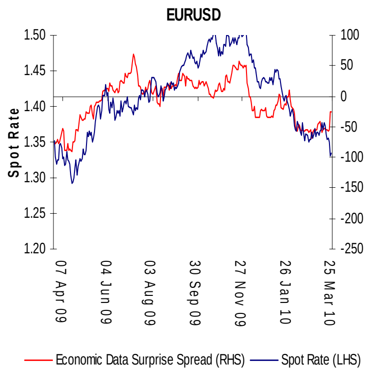


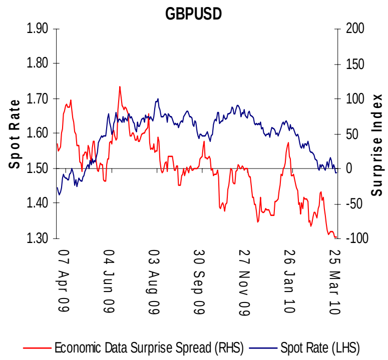


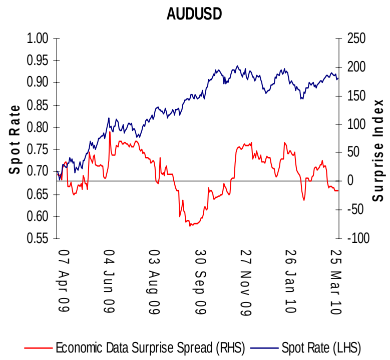


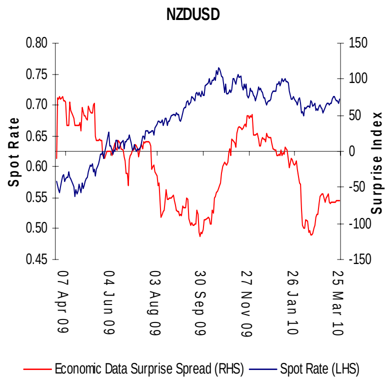
Economic Data Surprises

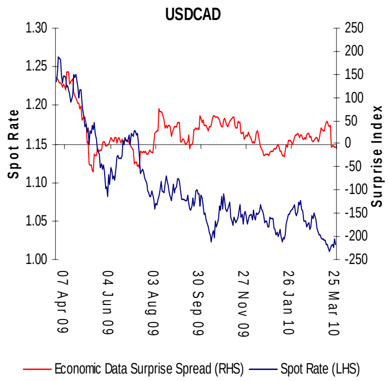
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

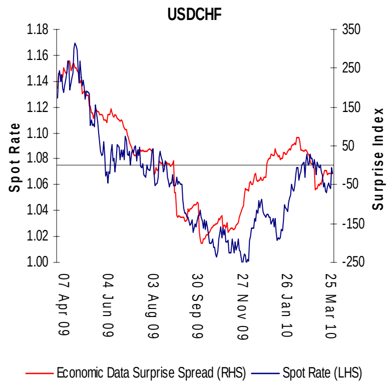


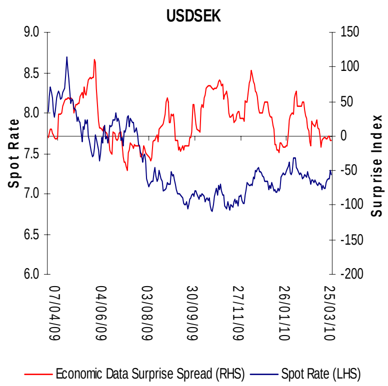


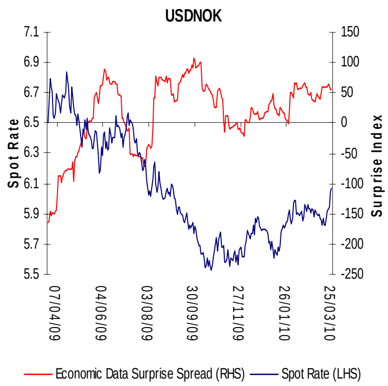


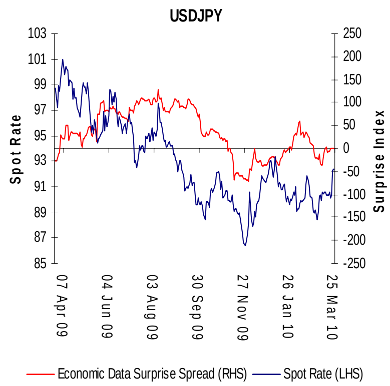






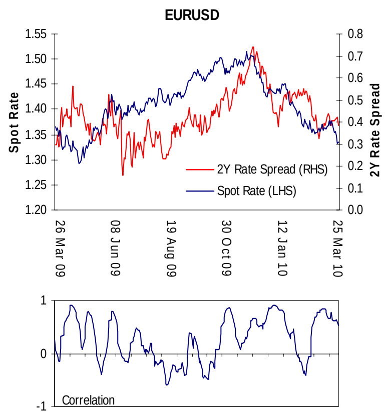


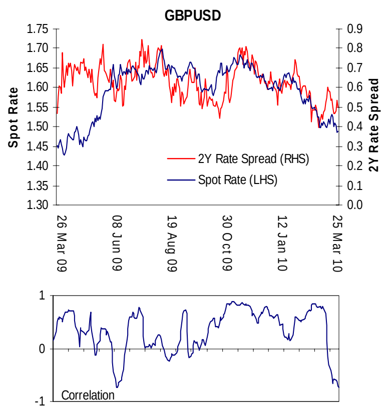


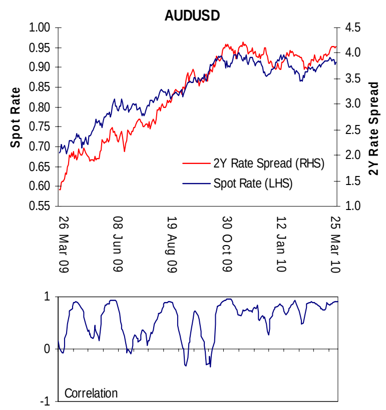


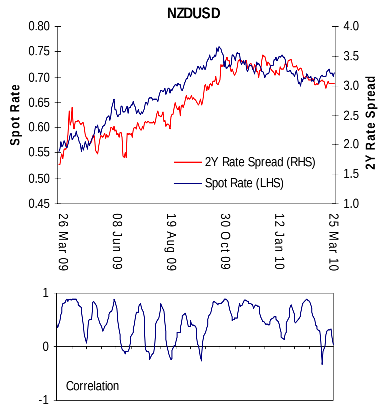
Interest Rate Spreads vs. FX

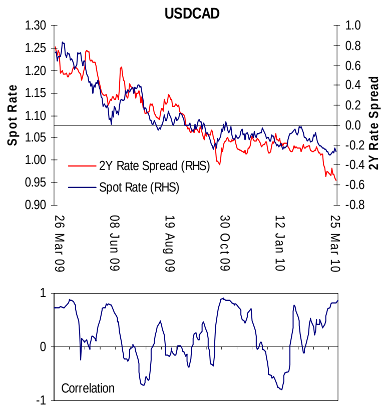
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

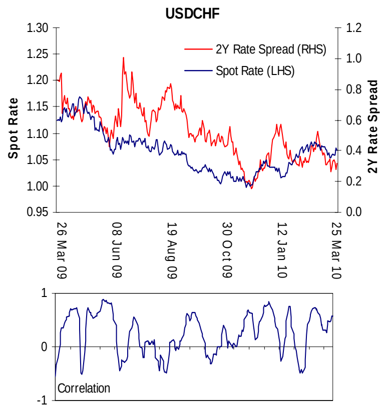


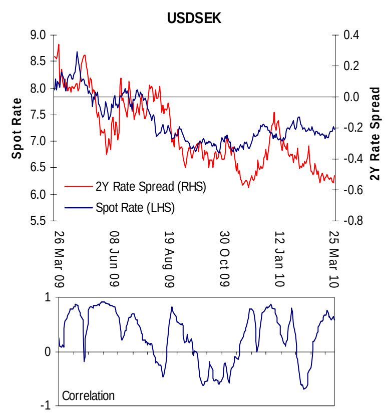


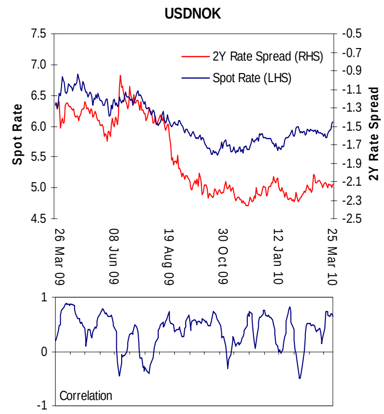


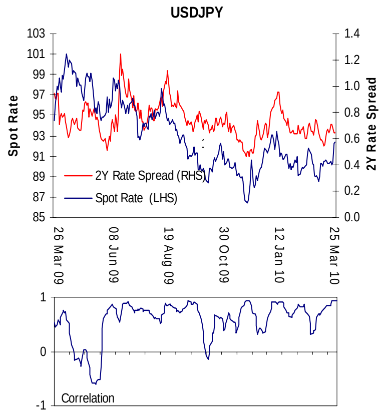






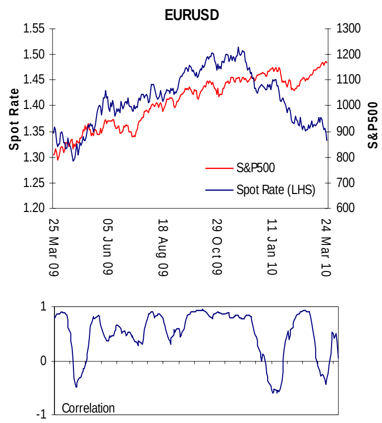


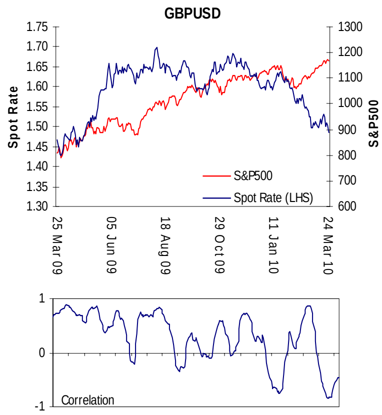


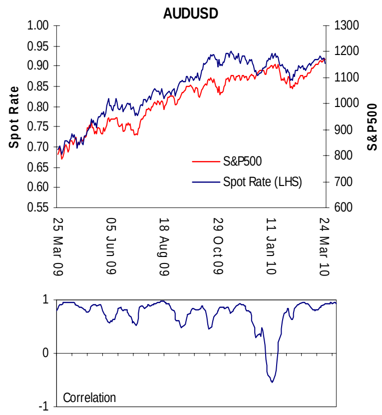


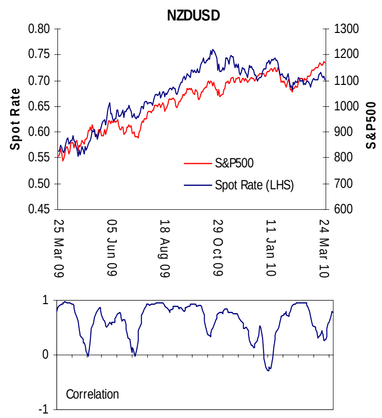
S&P500 vs. FX

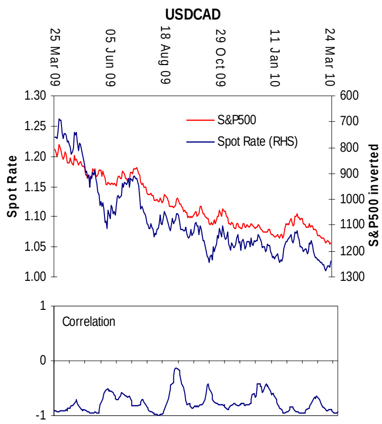
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

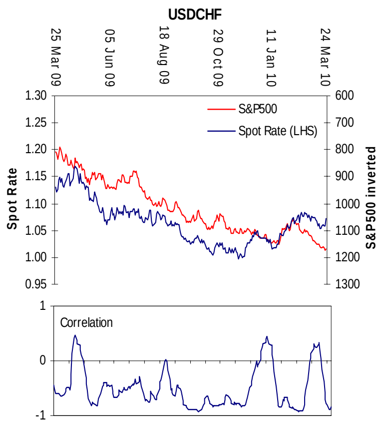


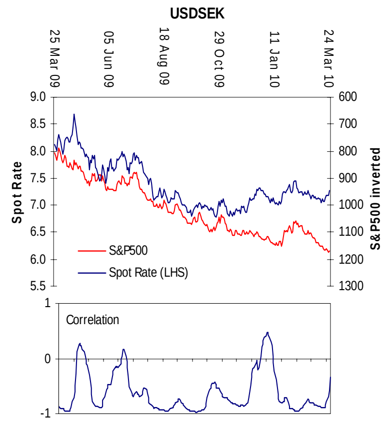


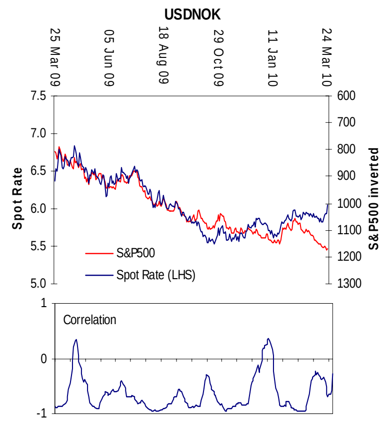


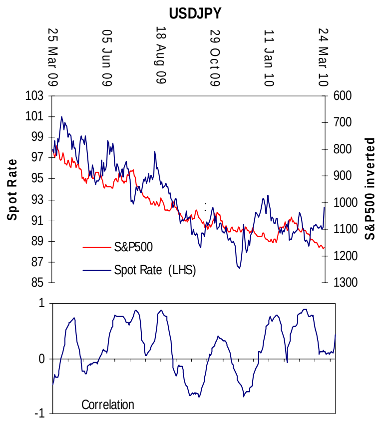






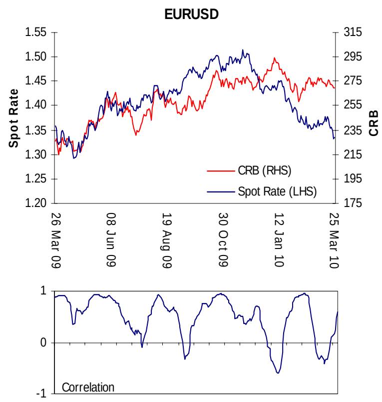


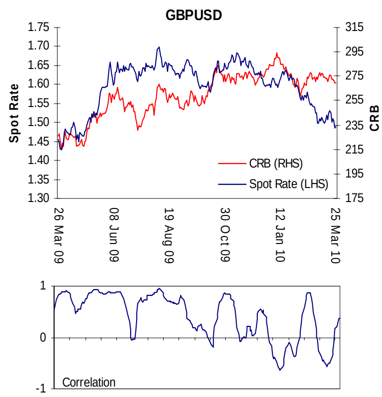


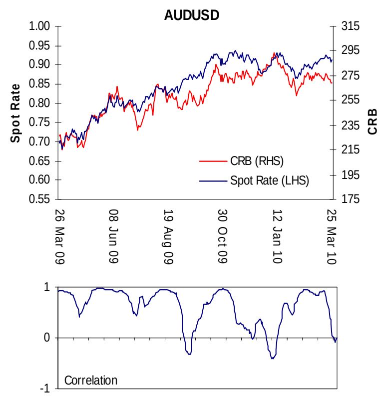


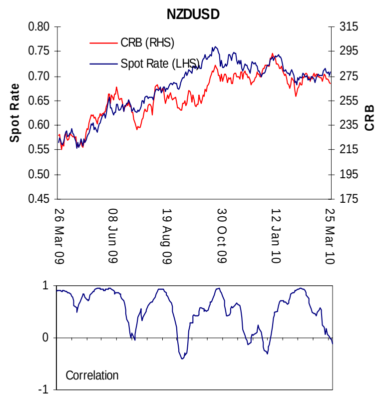
Commodities vs. FX

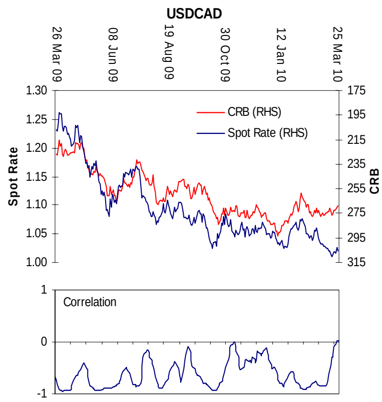
The charts below show the CRB commodity index plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

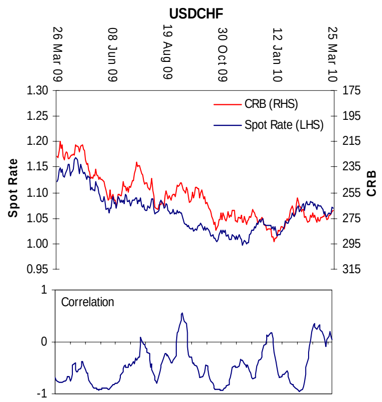


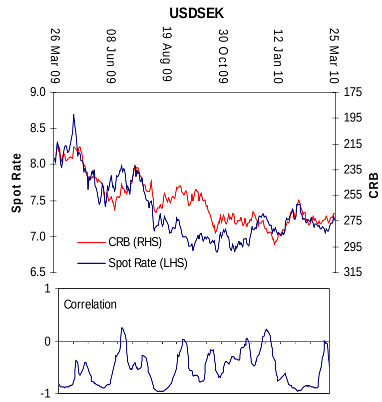


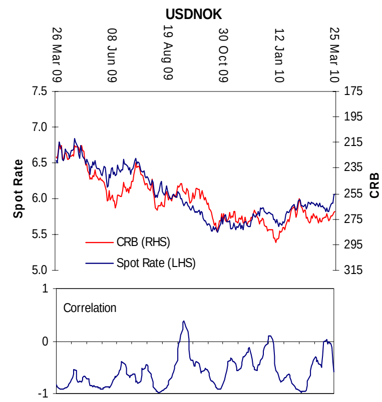


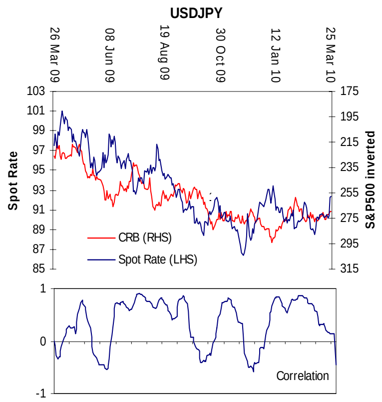








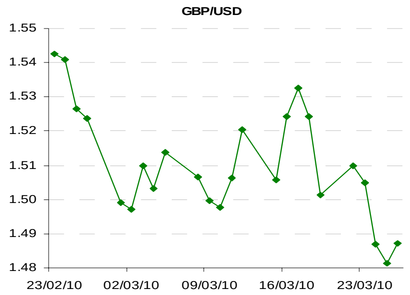


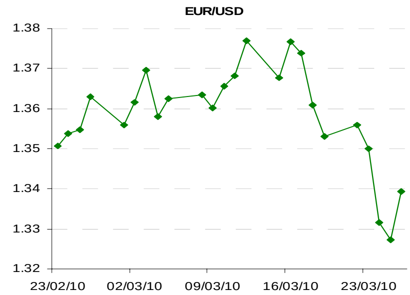


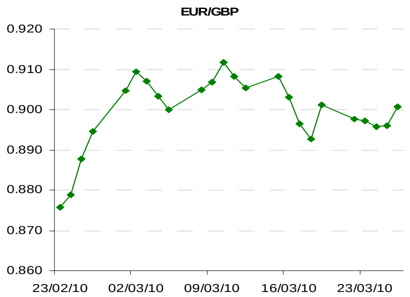
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

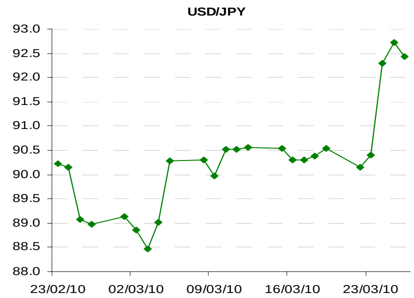
Market Review

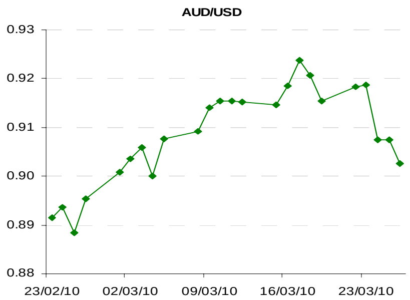
Short-term G-10 FX Charts

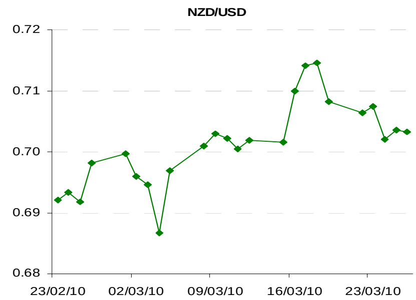


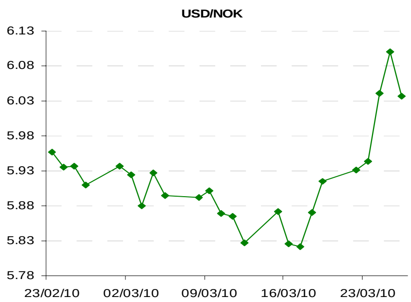


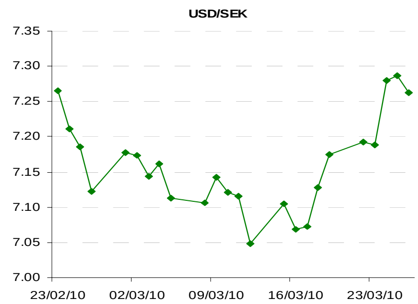


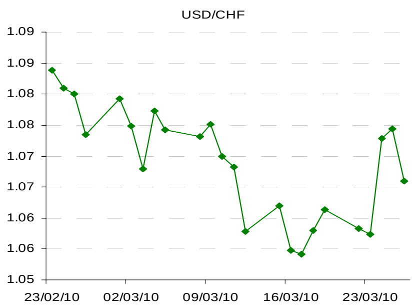


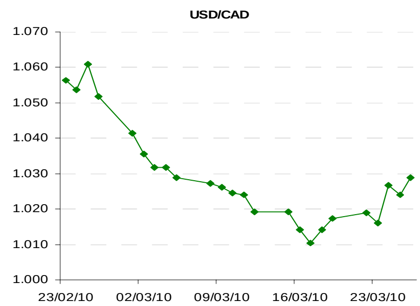




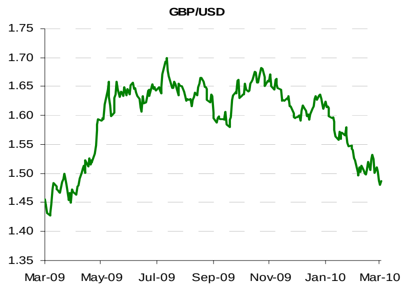


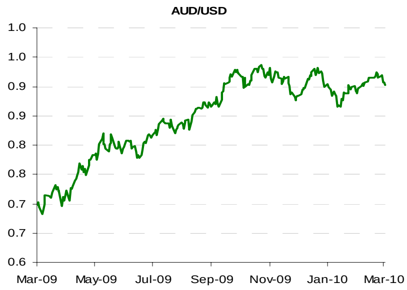


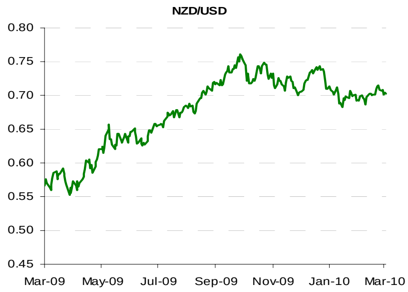


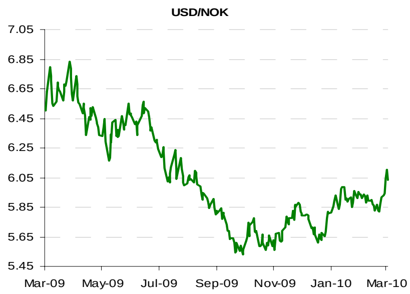


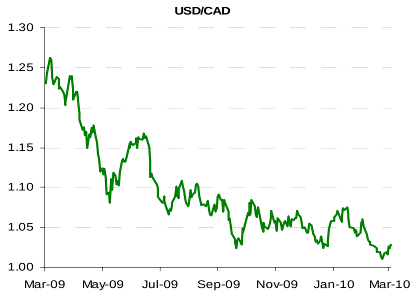
Medium-term G-10 FX Charts





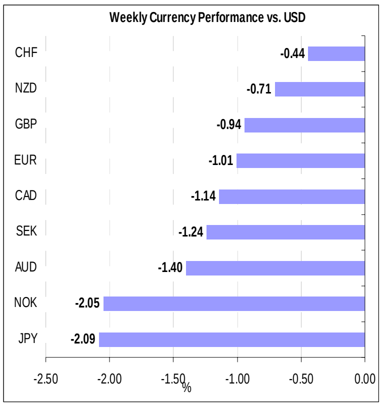


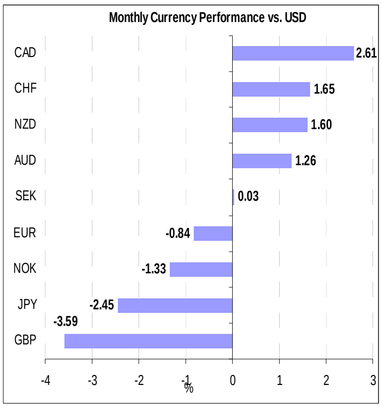


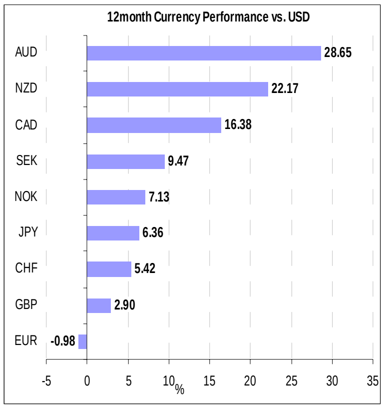


FX Snapshot

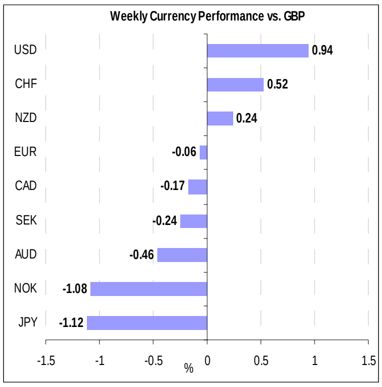
Currency performance vs. USD

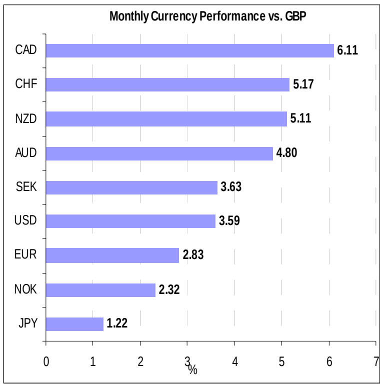


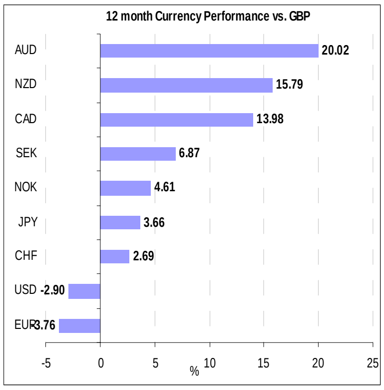




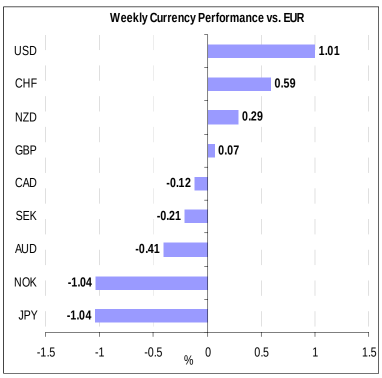
Currency performance vs. GBP

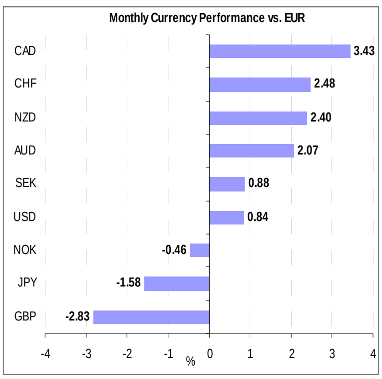


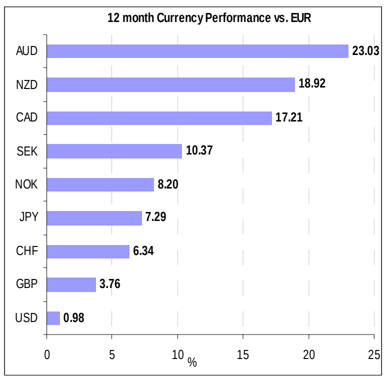




Currency performance vs. EUR







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