Lloyds TSB | Corporate Markets

Friday, 9th April 2010

FX Strategy Weekly

Market Strategy

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• Market Outlook

A strong bid in commodity prices, low volatility and optimism over the global economic recovery added fuel to the rally in risk assets this week resulting in a good overall performance for the AUD and NZD. The start of US Q1 reporting season, speculation of a currency shift in China and the possible activation of an EU rescue for Greece are set to take centre stage next week. EU intervention in Greece, with the IMF a key funding partner, may soon be a fait accompli after the latest episode of turmoil in Greek government debt and CDS spreads. The UK economic calendar is fairly thin next week and means that election polls, Party manifestos and gilt auctions will attract close scrutiny. Near-term uncertainty over the direction in sterling remains unusually high, and clouded by the mandate of the nect government to impose rigorous fiscal discipline. We think fears of a hung parliament may be misplaced, and in the event, could be offset by gradual a shift in BoE rhetoric as inflation expectations accelerate and the economy steers towards a second successive quarter of growth.

• Recap

- The JPY rallied against all the G10 currencies this week, posting its biggest gain vs the Swiss franc (+2.1%). The AUD and NZD firmed 0.3% vs GBP and 1.4% vs the USD. Profit taking in the USD on Friday knocked the dollar index DXY back to 81.03, the 20d MA and lifted GBP/USD to 1.5392, the highest since late February. Optimism that the EU will finally announce more details of its financial support for Greece lifted EUR/USD back over 1.34. The downgrade of Greece by Fitch to BBB- late on Friday triggered no major reaction as talk circulated of an EU announcement. A two-week decline in EUR/GBP came to a halt on Friday, after the pair bounced off a 0.8706 low to close above 0.8750.

- The BoE and ECB left key interest rates unchanged at 0.50% and 1% respectively. The BoE reiterated that it will keep its £200bn asset purchase facility under review. The ECB announced changes to its collateral framework, introducing a sliding scale of haircuts designed to make a distinction between member state credits. The new plan effectively extends the special measures taken by the ECB in the middle of the credit crisis two years ago.

- UK 10y yields touched the upper end of the trading range at 4.06% but below 4% reversed after a strong reception of 10y and 30y auctions in the US. Yields ended the week near their highs, supported by higher commodity prices and a rally in equities,. Bond auctions in the UK and the euro zone also drew solid demand. UK 5y swaps oscillated around 2.90% but closed the week at 2.93%, the upper end of the trading range. The 2y/10y swaps spread was rangebound and closed virtually flat at 227bp. UK 10y swap spreads closed the week 4bp wider at -16bp. A sell-off in Greek government debt squeezed 10y yields to 7.50%, causing the spread over bunds to climb over 450bp, the highest level since the inception of the euro.

FX	Close	Weekly Change %
GBP/EUR	1.1412	1.30%
GBP/USD	1.5373	1.08%
GBP/JPY	143.26	-0.42%
GBP/CHF	1.6397	1.62%
GBP/AUD	1.6492	-0.32%
GBP/NZD	2.1504	-0.15%
GBP/CAD	1.5471	0.62%
GBP/NOK	9.0918	0.67%
GBP/SEK	11.08	1.52%
EUR/USD	1.3471	-0.24%
USD/JPY	93.19	-1.50%
AUD/USD	0.9322	1.39%
NZD/USD	0.7149	1.26%
USD/CAD	1.0064	-0.46%
USD/SEK	7.2105	0.39%
USD/NOK	5.9141	-0.44%
USD/CHF	1.0666	0.58%
Swaps %		**bp**
2yr	1.603	4.3
5yr	2.933	8.7
10yr	3.876	8.3
Equities		**%**
FTSE100	5770.98	1.61%

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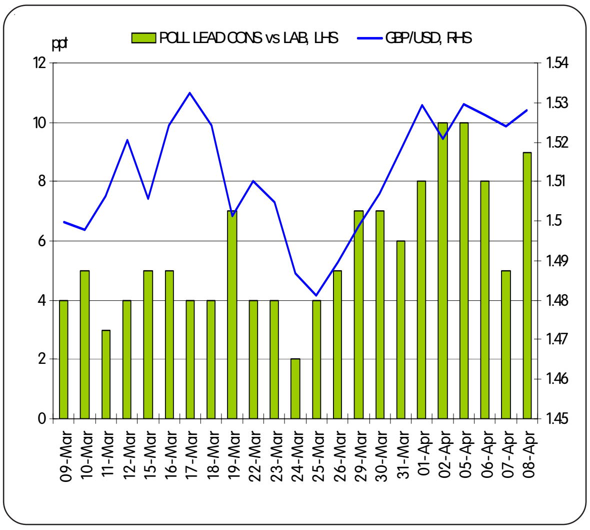
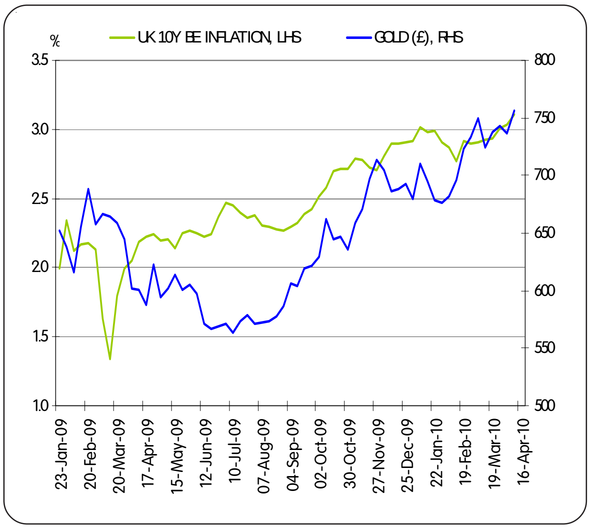
GBP/USD: supported by Conservative lead in the polls

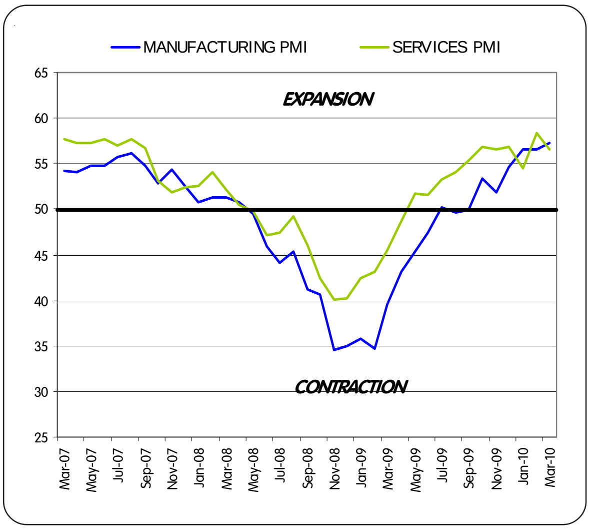


source: YouGov

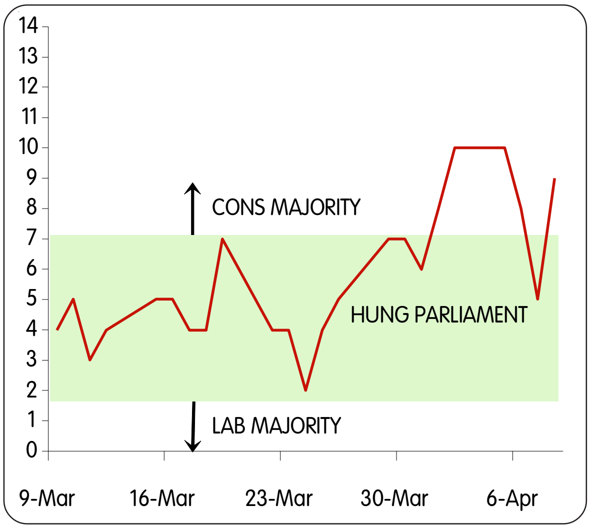
UK Inflation expectations are rising



UK economy: back in expansion territory



Latest poill shows bigger chance of Conservative majority



<u>Key data and events ahead</u>

12-13-14 April: Parties present election manifestos
20 April: CPI, March
21 April: minutes of April MPC meeting; labour market stats, March
23 April: GDP, Q1 first release
4 May: Manufacturing PMI, April
6 May: Services PMI, April
6 May: General Election
10 May: BoE rate decision

GBP/USD: ascending trendline offers good support, building a base above 1.50

EUR/GBP: support at 0.8650

Quantitative Market Analysis

- **Bearish sterling sentiment ebbs**
- **Commodities boost AUD, CAD**

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 dropped for the first time in four weeks, with the total number of short GBP contracts reduced by 6,500. Reported speculative positions fell by 4,000 to -67,000, still the second highest level since March 4. There was no let-up in the build-up of short EUR positions, however. A sharp rise in reported EUR shorts by 10,000 to -85,000 underlines the still very bearish sentiment vis-a-vis the single currency as market participants react to the fragmented position of different EU member states towards Greece. The ECB will publish details of a new collateral framework in July, based on a sliding scale of increased haircuts and more punitive terms for the lowest rates sovereign credits. Speculators swung aggressively from (marginal) long to short JPY positions by no less than 52,000 contracts, providing cover for the surge in USD/JPY through 94.0. The market hasn't been outright short JPY since February 23. Participants also flipped their 1,900 long CHF positions to outright short 6,700 contracts, a three-week low.

In the commodity and high yield space, participants marginally reduced overweight holdings of CAD and AUD. Overall positioning remains above historical norms and positive traction of AUD/JPY with stocks (0.86 correlation) means net AUD vs JPY positioning is likely to stay near historical wides (186,000 contracts). The US DXY index hit a 81.907 high earlier in the week but subsequently pulled back to the 20d MA at 81.0, within recent ranges. The rally in gold through $1,150 potentially hints at a window of profit taking in the US dollar as the Fed stays sidelined.

The positive US dollar bias, evident from risk reversals, belies the pullback in the dollar late in the week through EUR/USD and GBP/USD. Though EUR and GBP risk reversals vs the USD are still pinned near historical lows, this has not stopped relief rallies from materialising in underlying spot. Uncertainty surrounding the UK election and the refunding hump for Greece in April and May are unlikely to skew risk reversals significantly away from EUR and GBP puts.

G10 currency risk reversal skews moved away from extreme levels in AUD/USD, NZD/USD, USD/CHF, USD/JPY and USD/NOK, but remain near historical levels for USD/CAD.

Implied volatility rose in the 1-month maturity relative to 1-year for EUR/USD and GBP/USD, resulting in a flattening of volatility curves. A widening in vol spreads was registered for USD/JPY, USD/CHF, USD/NZD, AUD/USD.

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	0.07	0.65	**0.79**	-0.09	**0.83**	**0.76**	-0.53
10 YR SPD	0.11	0.02	**0.75**	-0.12	**0.93**	**0.90**	-0.22
S&P500	0.58	**-0.76**	-0.65	0.50	**0.79**	**0.86**	0.55
Gold	**0.79**	**-0.79**	-0.13	**0.78**	0.41	0.62	0.45
Oil	**0.81**	**-0.87**	-0.30	**0.75**	0.71	**0.88**	0.72
Relative Yield Curve	-0.10	0.47	-0.43	0.15	**-0.81**	-0.34	-0.52
CRB	**0.83**	**-0.80**	0.14	**0.83**	0.33	0.57	0.56

FX correlations

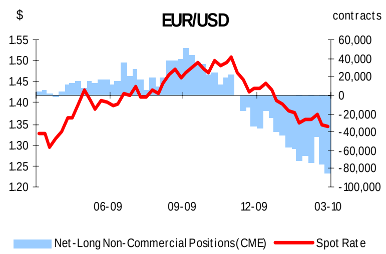
Market correlations are shown on pages 10-12. 1-month rolling correlations are plotted for G-10 FX against interest rate spreads, S&P500 and commodities (represented through the CRB index).

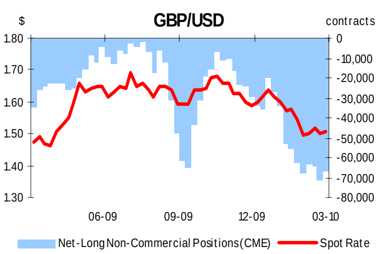
1-month correlations between interest rates and G10 spot rates show a dramatic reversal between AUD/USD from 0.89 two weeks ago to -0.10. A smaller, albeit still statistically significant shift is also observed in GBP/USD from 0.49 to -0.10. In other words, rate differentials are no longer relevant to gauge direction in AUD/USD. This is in contrast to EUR/GBP, where a marked rise in correlation with the 2y spread has been observed. The correlation with USD/JPY remains equally statistically significant at 0.80.

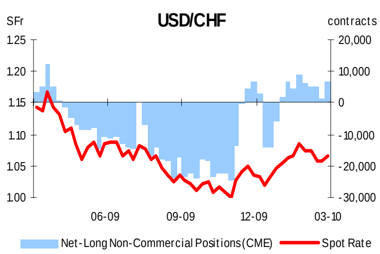
In terms of correlation with risk assets (S&P 500), traction in AUD/USD has eased from extreme levels to 0.58, but remains elevated in USD/CAD, USD/JPY and AUD/JPY. The correlation with USD/SEK has improved markedly and is still elevated in USD/JPY. Commodities and gold continue to track well with AUD/USD, USD/CAD and increasingly so with GBP/USD.

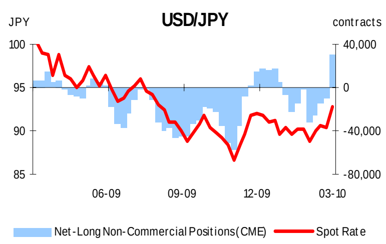
FX & Commodity Futures Positioning

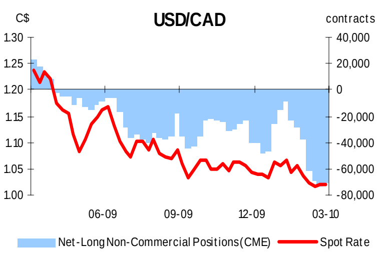
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

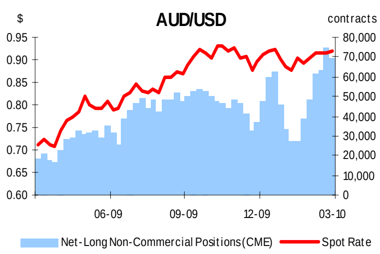


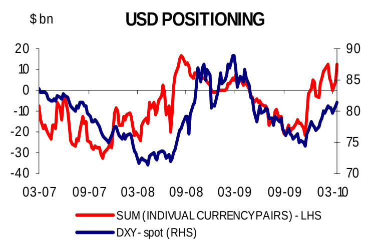


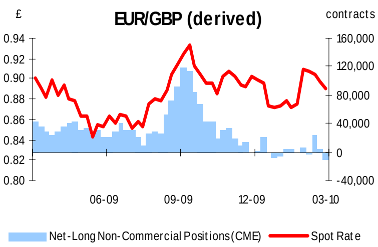


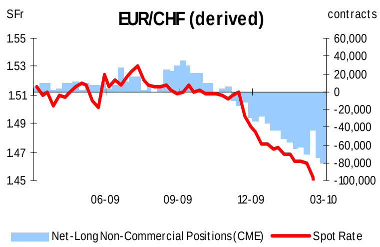


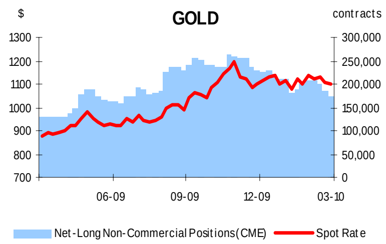


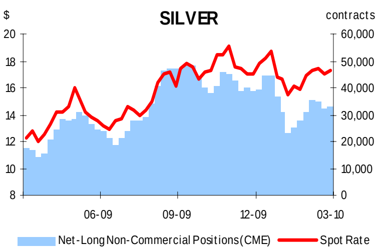


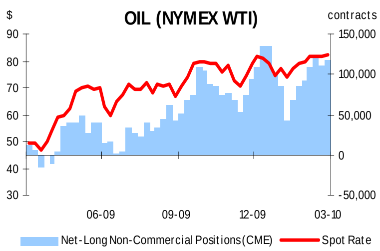


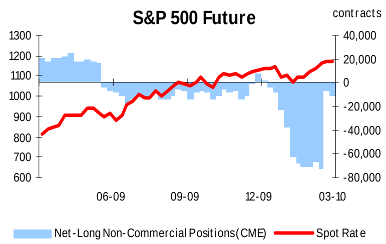


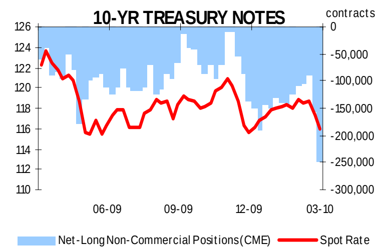


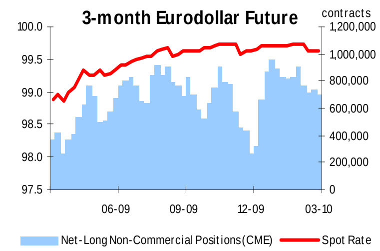






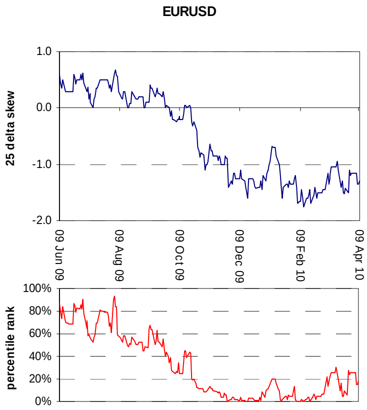


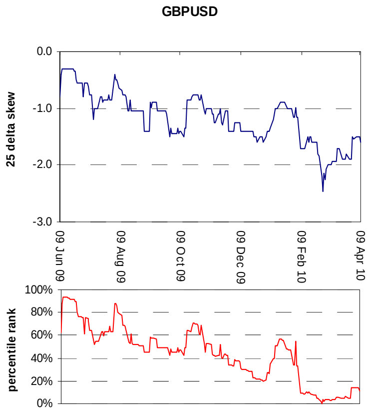


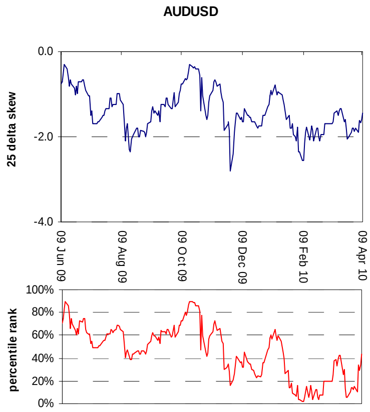


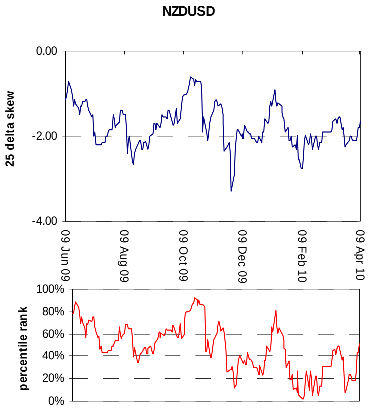
FX Options: Risk Reversal Skews

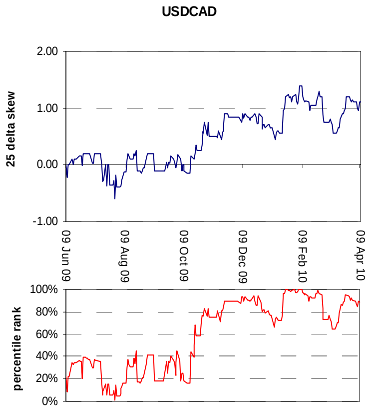
The risk reversal skew is the difference in volatility between similar out-of-the-money call and out-of-the-money put options. A positive risk reversal means that the implied volatility (used for pricing) of the call is greater than that of the put. In this section, the skew is based on 1-month 25 delta 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.

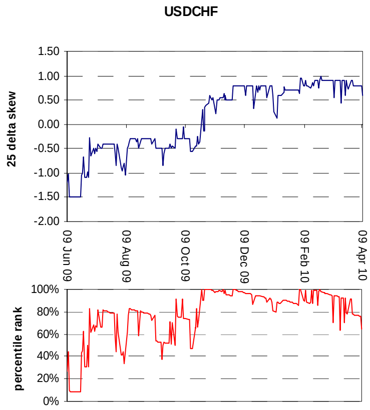


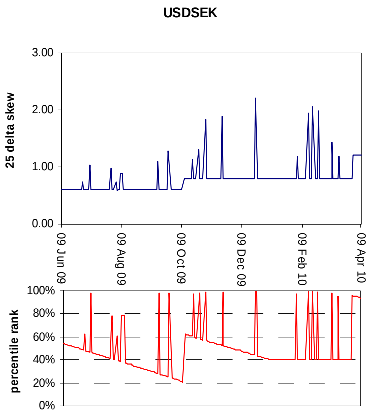


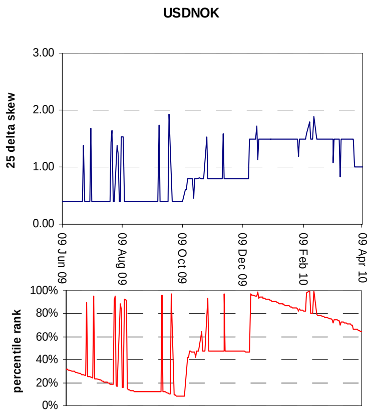


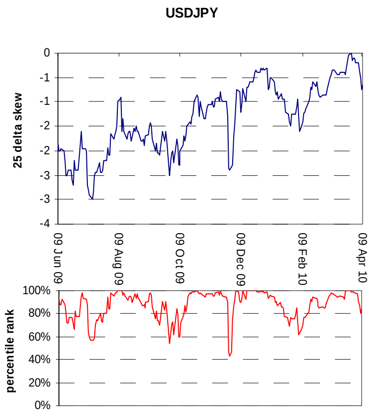






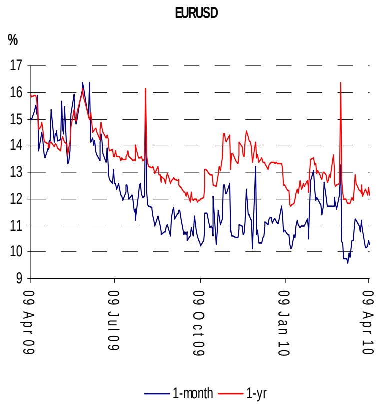


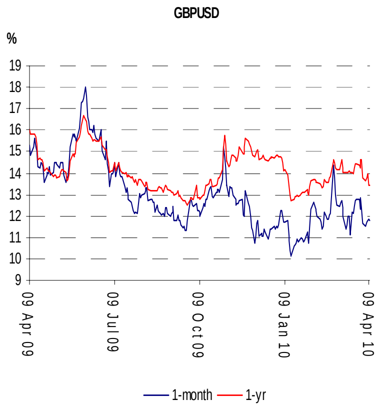


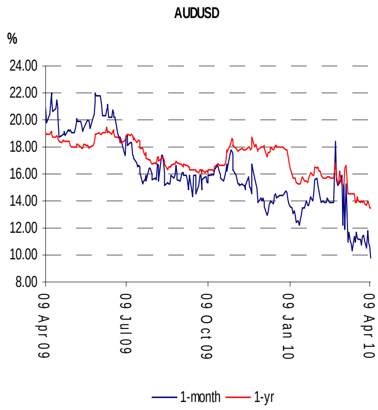


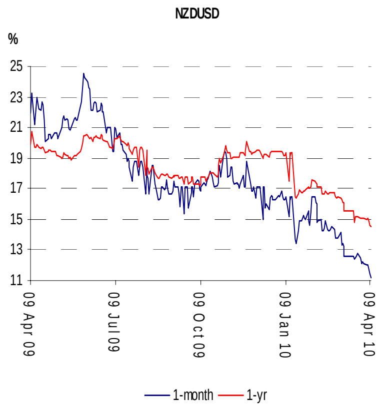
FX Options: Implied volatility

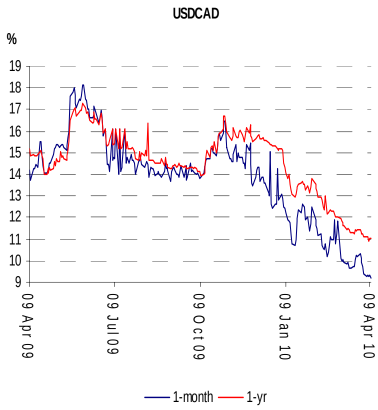
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

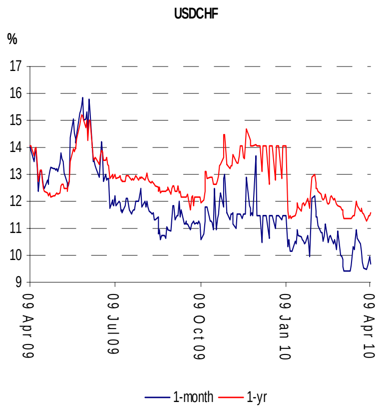


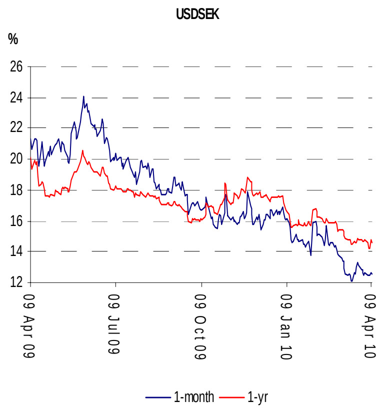


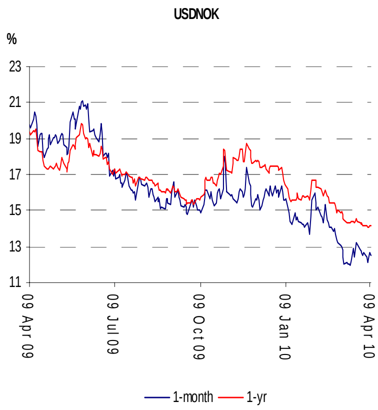


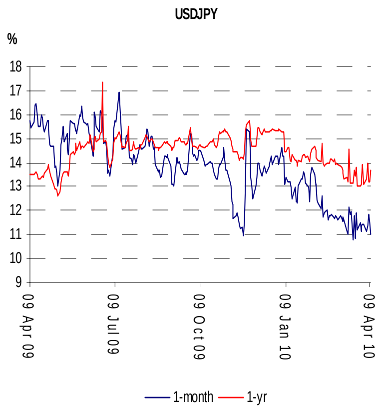






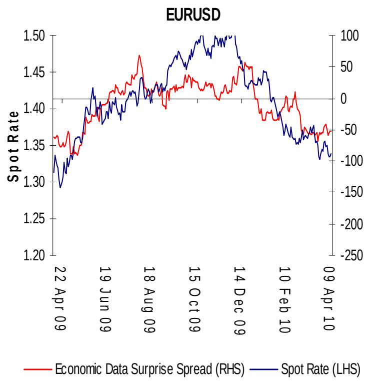


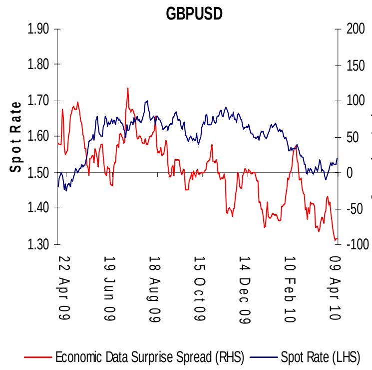


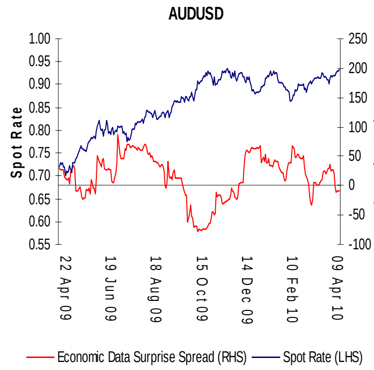


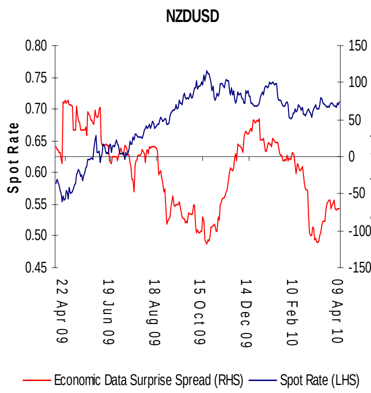
Economic Data Surprises

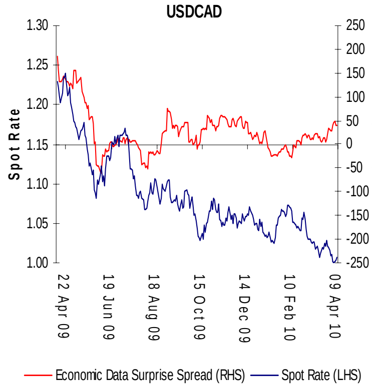
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

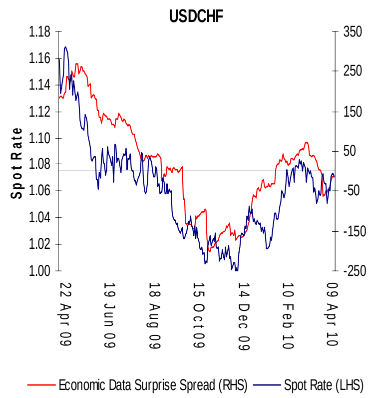


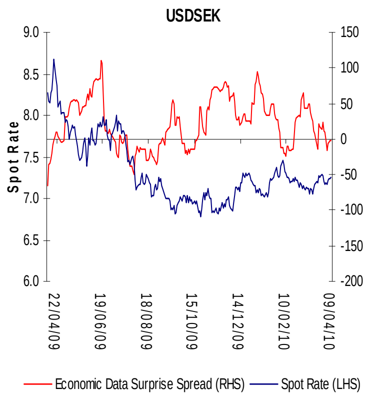


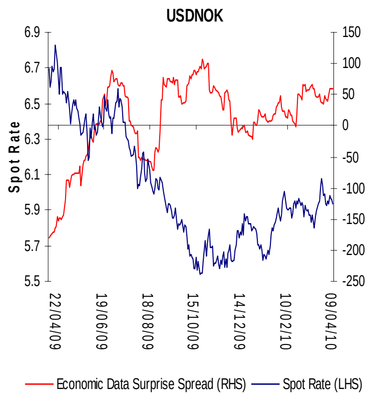


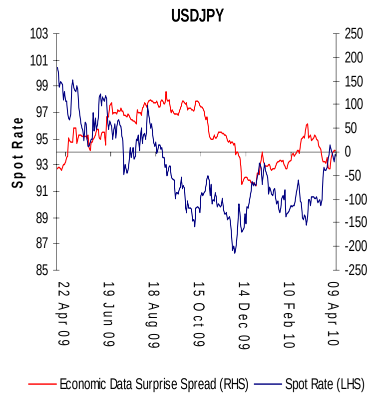






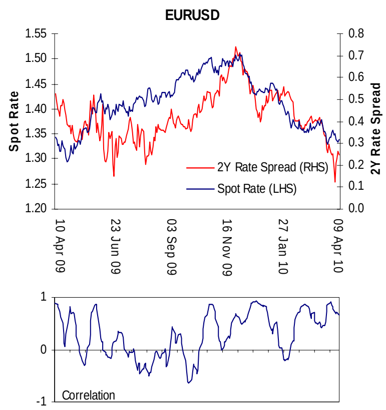


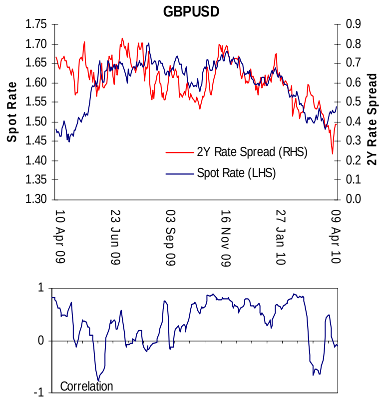


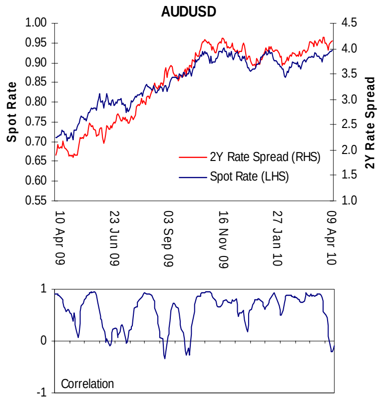


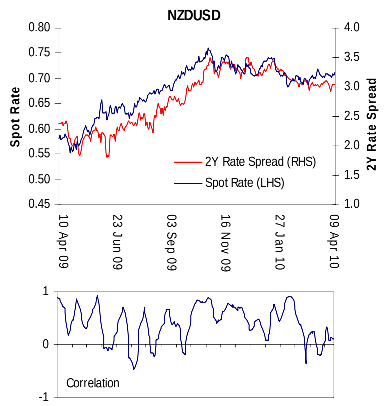
Interest Rate Spreads vs. FX

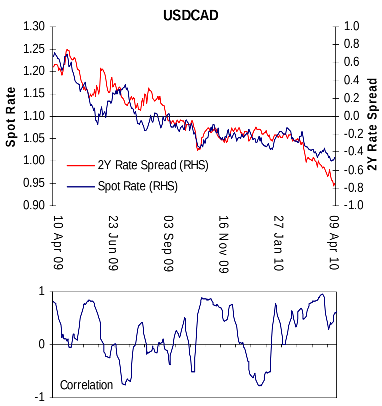
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

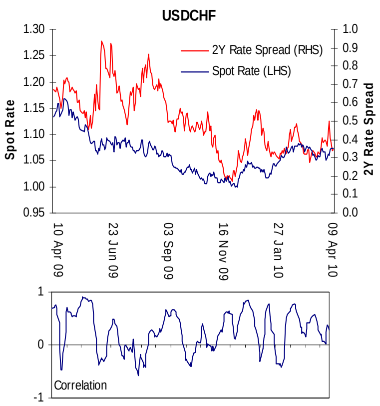


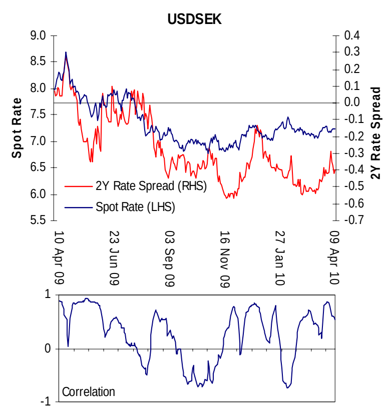


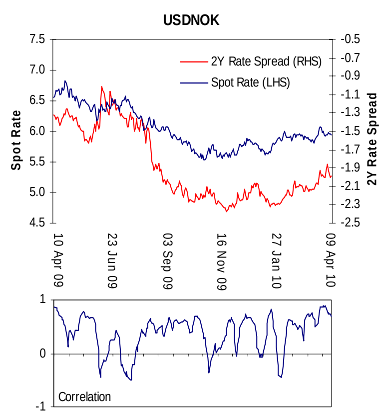


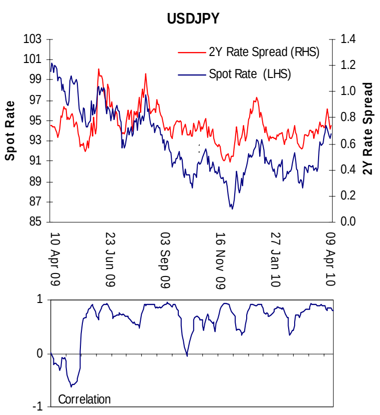






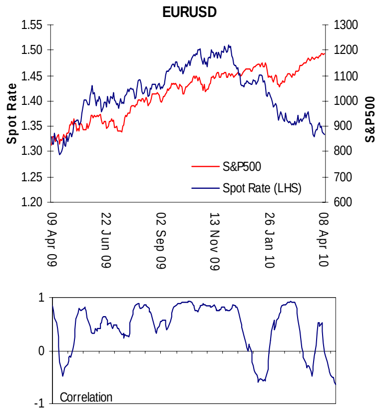


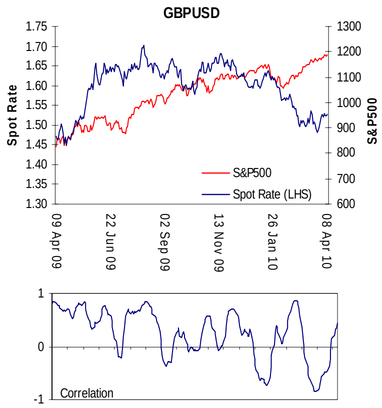


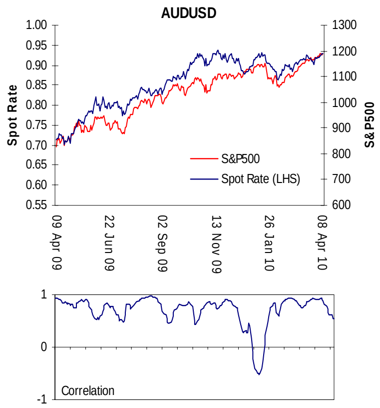


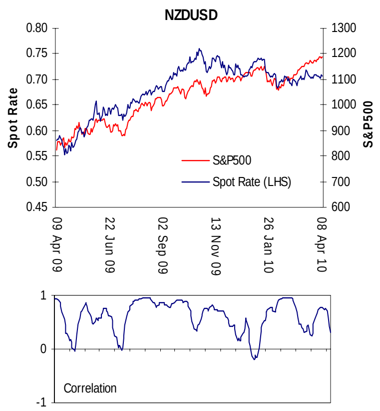
S&P500 vs. FX

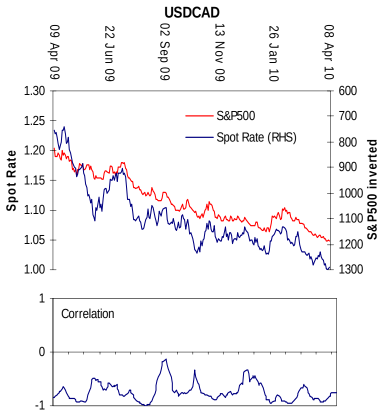
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

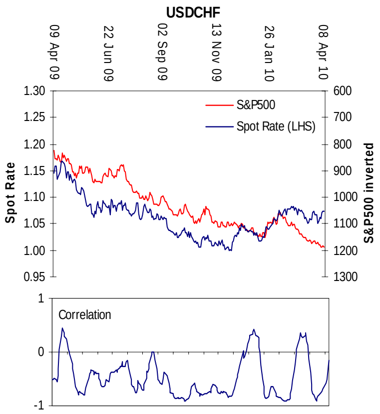


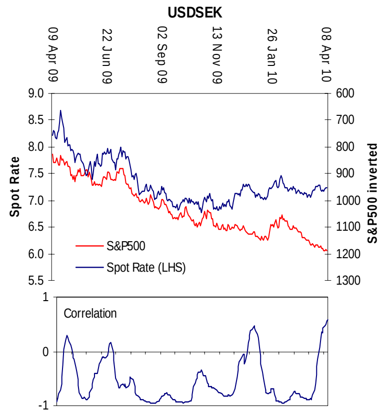


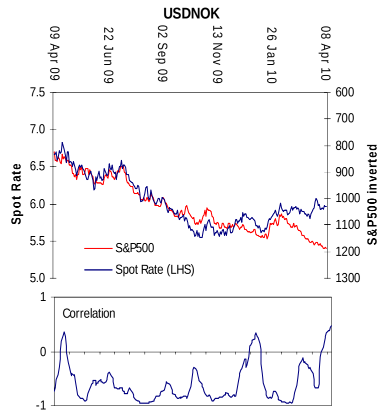


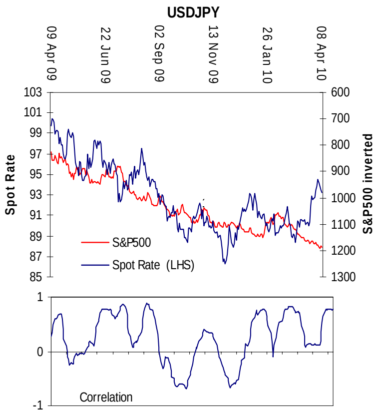






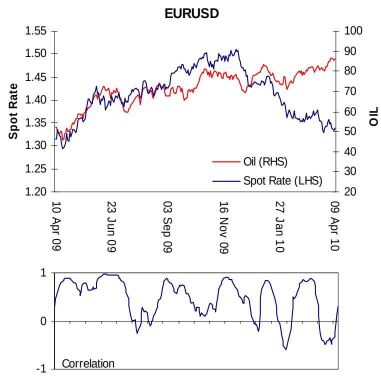


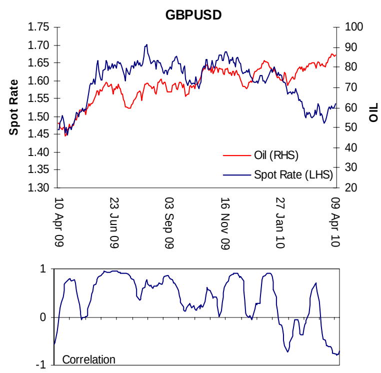


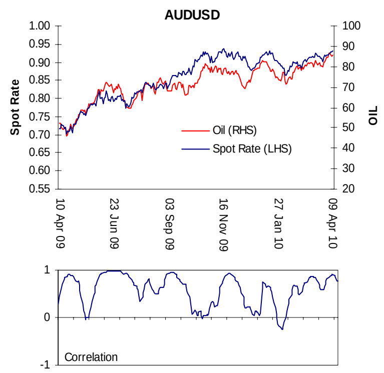


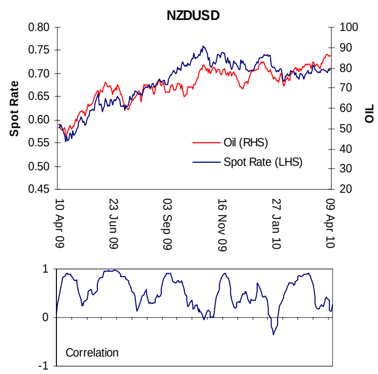
Commodities vs. FX

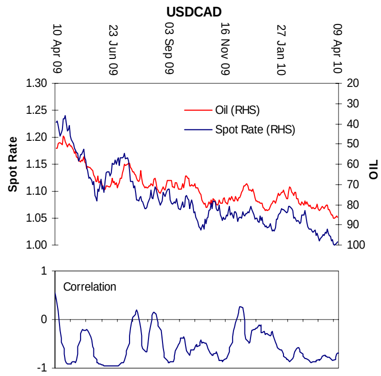
The charts below show the CRB commodity index plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

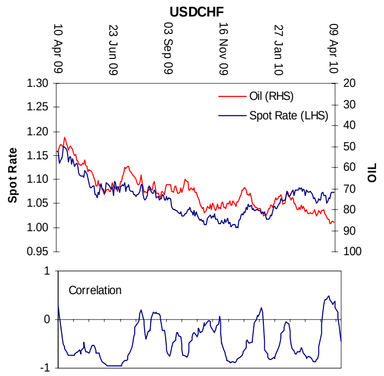


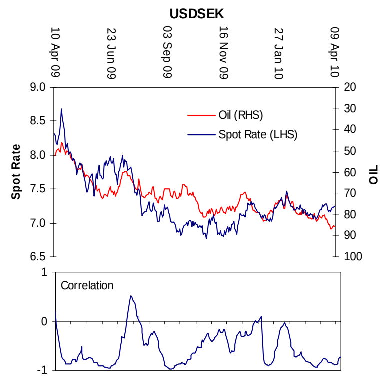


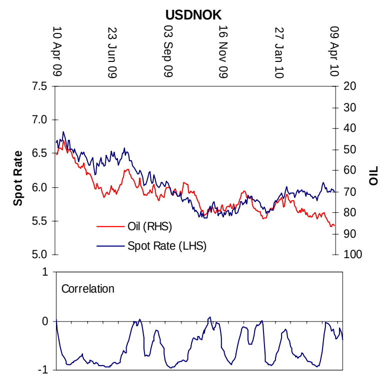


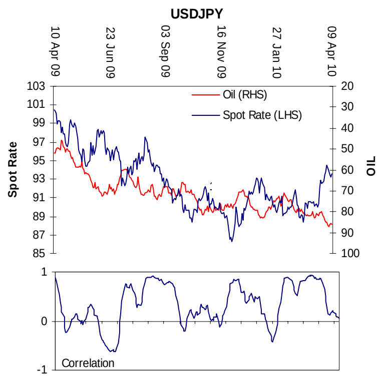








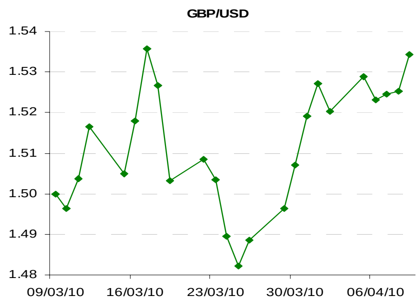


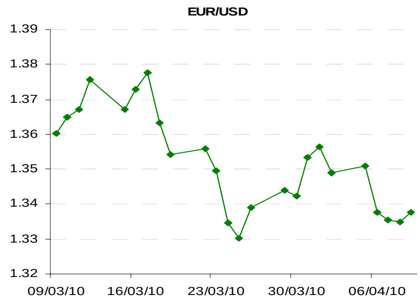


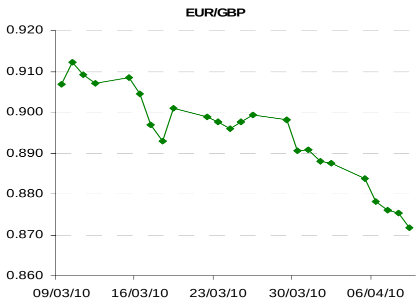
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

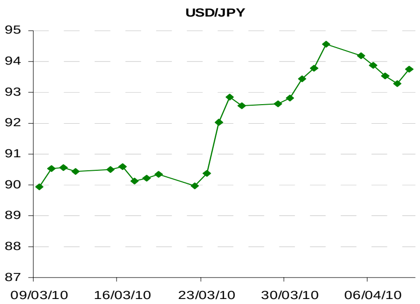
Market Review

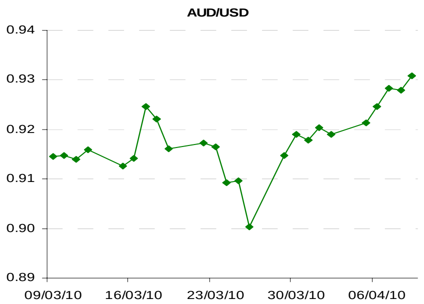
Short-term G-10 FX Charts

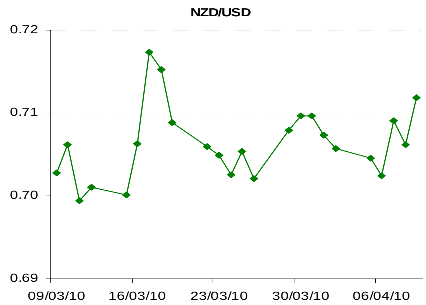


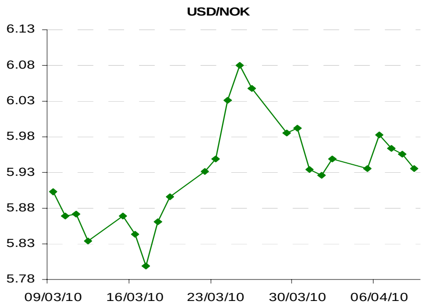


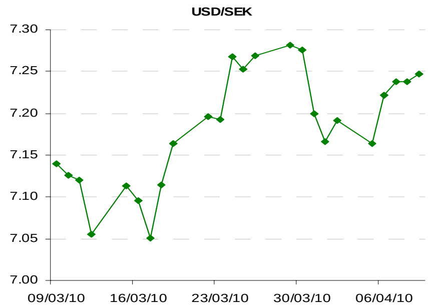


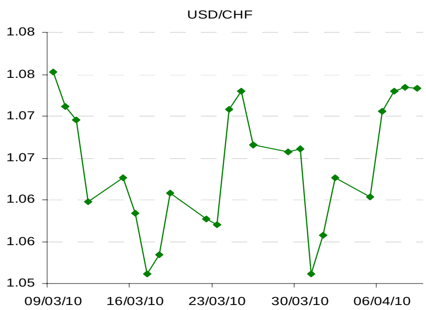


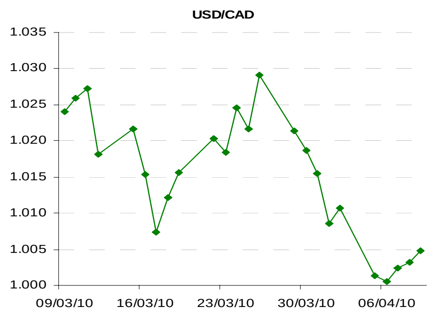




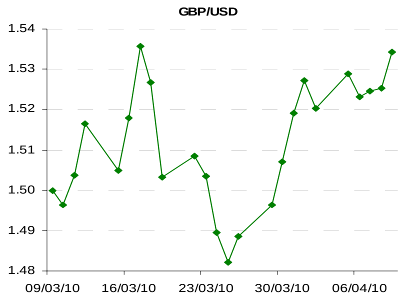


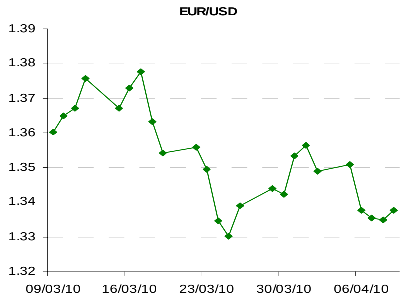


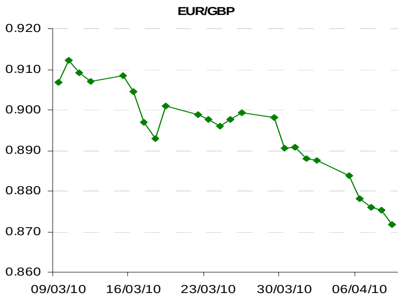


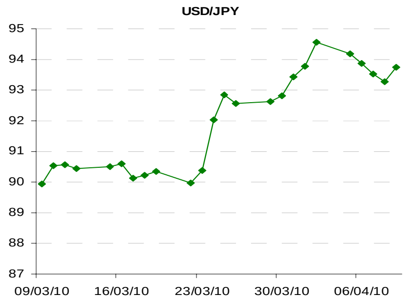


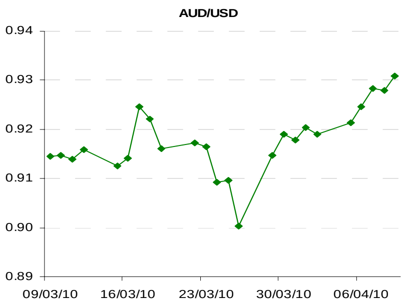
Medium-term G-10 FX Charts

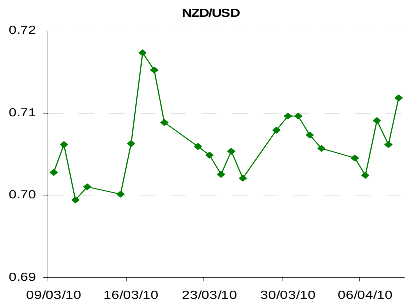


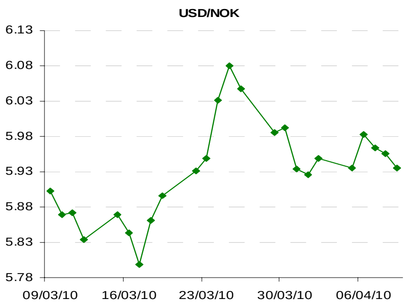


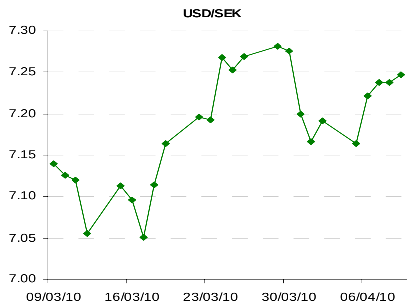


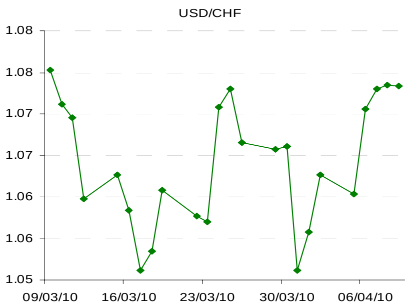


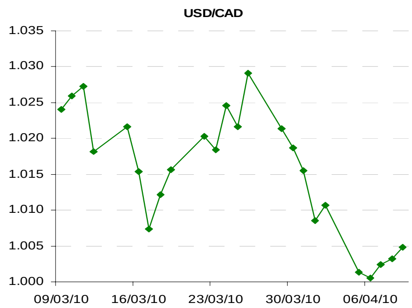






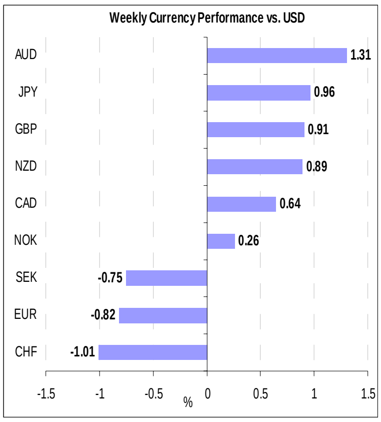


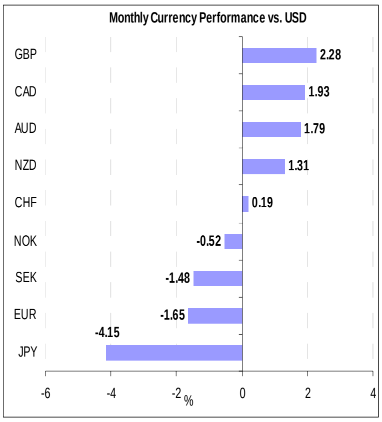


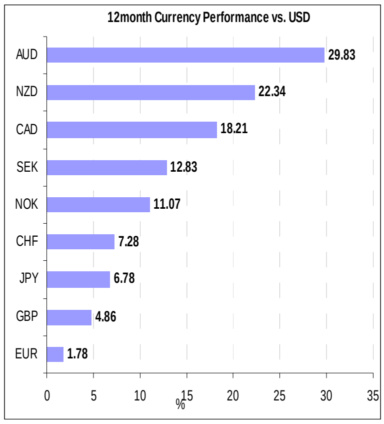


FX Snapshot

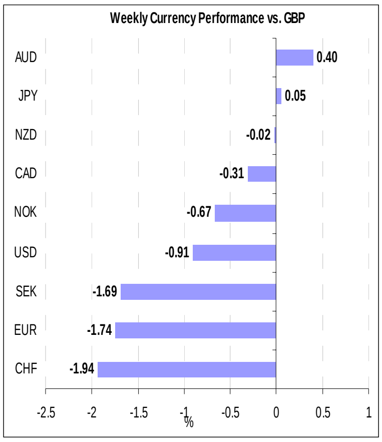
Currency performance vs. USD

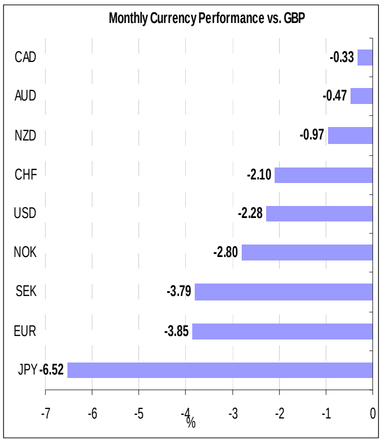


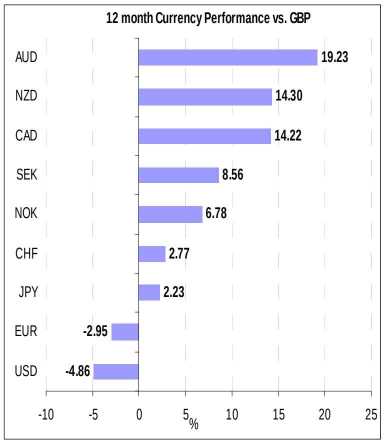




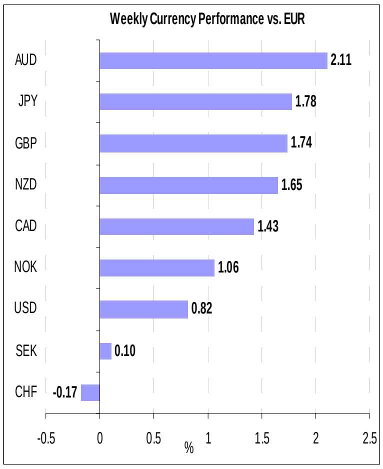
Currency performance vs. GBP

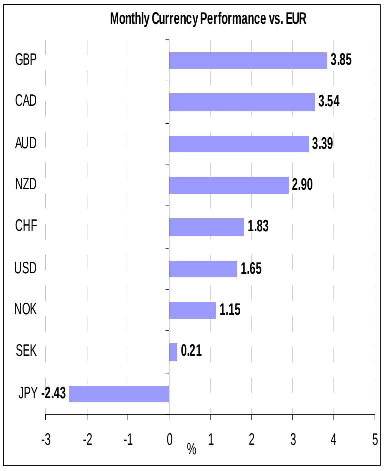


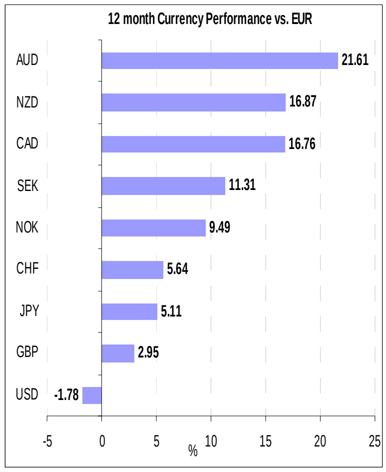




Currency performance vs. EUR







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