Lloyds TSB | Corporate Markets

Friday, 14th May 2010

FX Strategy Weekly

Market Strategy

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	Close	Weekly Change %
FX		
GBP/EUR	1.1754	1.23%
GBP/USD	1.4545	-1.75%
GBP/JPY	133.57	-1.46%
GBP/CHF	1.6465	0.37%
GBP/AUD	1.6394	-1.67%
GBP/NZD	2.0502	-1.06%
GBP/CAD	1.5055	-2.59%
GBP/NOK	9.0880	-1.36%
GBP/SEK	11.29	-0.25%
EUR/USD	1.2373	-2.99%
USD/JPY	91.83	0.26%
AUD/USD	0.8872	-0.09%
NZD/USD	0.7094	-0.70%
USD/CAD	1.0351	-0.84%
USD/SEK	7.7638	1.52%
USD/NOK	6.2484	0.40%
USD/CHF	1.1320	2.17%
Swaps %		**bp**
2yr	1.446	-20.2
5yr	2.611	-23.3
10yr	3.615	-10.0
Equities		**%**
FTSE100	5262.85	2.73%

Market Outlook

Tactical view:

= EUR crosses stay offered; counting on stocks for GBP relief

= USD, JPY outperform in risk averse world

The USD continues to attract solid buying interest as confidence in the EUR and GBP wanes. With risk reversals still heavily skewed towards USD calls, the outlook for the dollar index remains uniformly bullish even as the probability of a Fed rate hike this year fades. Economic data has been playing second fiddle in recent weeks and until the picture for risk assets clears up and EU debt fears subside, we think macro data are unlikely to be critical for price action near-term. The high correlation with equities continues to weigh on GBP but with the BoE now also reasserting its influence, we see no immediate escape for GBP from the clutches of the sterling bears. April retail sales and CPI data, and the MPC minutes will keep GBP on a knife-edge next week.

Recap

- The positive knee-jerk reaction to a Cons/LD government quickly petered out and saw the market re-establish short GBP positions vs the principal G10 currencies except vs the EUR. GBP/USD dropped below 1.45, and following a dovish BoE QIR, the cross is now slowly gravitating towards the 1.40-1.44 area. Buying of EU peripheral debt by the ECB briefly underpinned the EUR, but selling resumed as the Ascension Day holiday pushed peripheral spreads wider again over bunds. EUR/USD slipped below 1.2500 and now threatens 1.2330, the Oct-08 low. The JPY and USD were the best performers in the G10 as a probe into US sub-prime mortgages and lower commodity prices caused equities to resume their decline, spurring a flight-to-quality. The CAD held up remarkably well considering the fall in crude oil below $75 to a 3-month low, but looks well placed to draw support from the outlook for higher interest rates.

- Economic data continues to be a sideshow to the jitters in equity and sovereign debt space. The BoE kept Bank rate unchanged at 0.50% and the APF at £200bln, but in its quarterly Inflation Report it warned of downside risks to growth as public spending cuts in the EU and the UK threaten to hit demand. The BoE also sees CPI below 2% target in two years time based on the implied futures curve for interest rates. Manufacturing production rose a much stronger than forecast 2.3% m/m in March, fuelling speculation of an upward revision to Q1 GDP later this month. Jobless claims fell in March by 27,100, and the ILO unemployment rate held steady at 8%.

- UK 5y swaps slumped from a 2.94% high on Monday to 2.66% on Friday, causing the 3mth libor/5y swap spread to narrow below 200bp. A similar drop in gilt yields kept swap spreads within recent ranges. EU and US yield curves also flattened, with good demand at benchmark auctions and risk aversion driving the compression in long dated yields. Libor/OIS spreads widened in the US, the UK and the EU.

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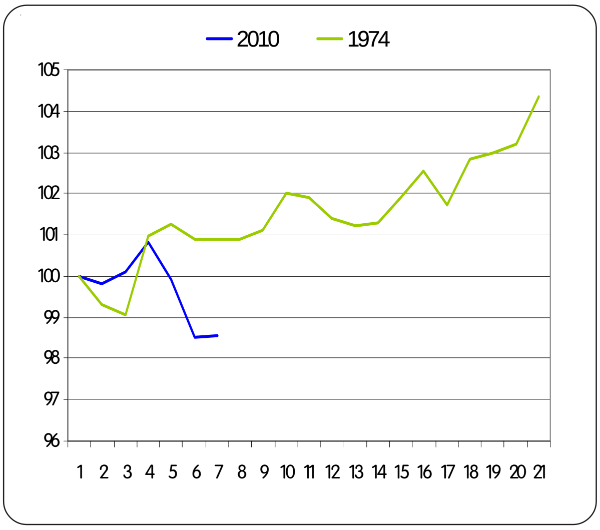
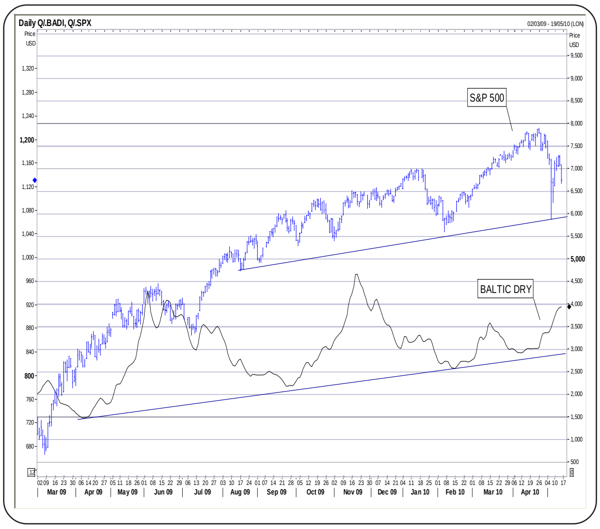
GBP/USD: early days, but post-election reaction lags vs 1974 performance



Baltic Dry: ground of optimism for S&P?



USD

• The USD continues to attract solid buying interest as confidence in the EUR and GBP wanes. Confidence in the EUR was only briefly restored after the EU's 750bln eur stabilisation mechanism and ECB buying of EU peripheral bonds. The rally in GBP after the announcement of a Cons/LD coalition equally proved short-lived. With risk reversals still heavily skewed towards USD calls, the outlook for the dollar index remains uniformly bullish even as the probability of a Fed rate hike this year fades.

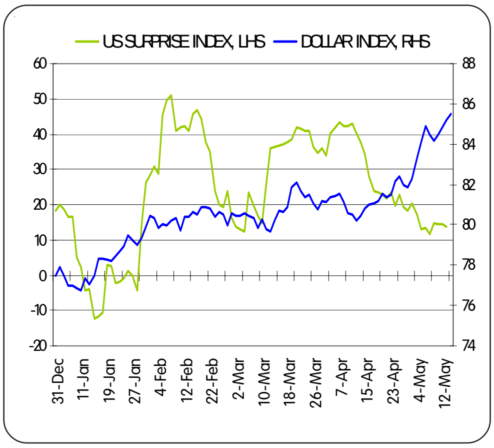
• The dollar index raced through 85.0 and 86.0 levels with remarkable ease on safe-haven flows, but strong overseas interest at the US quarterly refunding also added demand. This supports our medium-term view for a rally up to the Mar-09 high (89.60). Key resistance is situated at 86.76.

• It did not take long for sellers of EUR rallies to step in and pile pressure on EUR/USD for a test of 1.25. Record IMM short EUR positioning highlights the market's bias and after option levels were erased in the 1.2500-50 area, the pair slipped to a low of 1.24 33 low. Key support now runs at 1.2330, the Oct-08 low. A break clears the path for 1.20.

• The week ahead features PPI, CPI and the FOMC minutes. Economic data has been playing second fiddle in recent weeks and until the picture surrounding the probe into US sub-prime mortgages and EU debt clears up, macro data is unlikely to be critical near-term. US core CPI has continued to tick lower since the start of the year, hitting 1% in March. A strong dollar and lower oil prices should help to bear down on consumer prices in the near term, warranting the Fed's relaxed stance in interest rates.

• Fed commentary could be instructive with regard to the likelihood of asset disposals. How the committee views dollar strength from a monetary policy perspective is unclear. The decision by the Fed to re-activate USD swap lines with other central banks was only decided last week and will not feature in the minutes. TIC flows, housing starts and building permits are also due, and will give a first glimpse of residential construction at the start of Q2.

Dollar index powers ahead



EUR

• What was initially received as a silver bullet has failed to put doubts to rest over a possible debt restructuring and haircuts for financial institutions holding Greek, Portugese and Spanish debt. New fiscal austerity packages were agreed this week in Portugal and Spain, and provided a temporary fillip to equities and the single currency. However, as soon as the ECB disappeared as buyer of peripheral benchmark bonds, spreads immediately shot up vs bunds, lead by a 66bp surge in Greek 10 yields. This is indicative of the bearish sentiment that continues to stalk the single currency, with rumours of further sovereign downgrades to boot.

• Sentiment remains overwhelmingly bearish vis-a-vis the EUR. With speculative EUR positions at a record high, buying below 1.25 in EUR/USD is likely to be sporadic. We reiterate our preferred tactic of selling EUR/USD rallies. Failure to bounce off 1.2330 support argues for a retracement to 1.20. EUR/USD risk reversals bounced off -3.195 low to -2.54, pointing to a less bearish skew.

• For EUR/GBP, a post UK election bounce lifted the pair to 0.8620 high, before profit taking set in. The dovish BoE QIR has not done GBP any favours vs other currencies in the G10, but the line of least resistance from a EUR perspective is for a decline back to 0.85, with a test of 0.8422 impossible to rule out over the coming week. In contrast to the widening tendency for Spanish and Italian yield spreads over bunds, 10y gilts have managed to hold up around 90bp pivot, and 2y gilt/bunds finding support at 38bp.

• The focus next week is on targeted ECB bond purchases, the Ecofin meeting and the maturing ofGreek 10y debt. Leading indicators of activity have so far held up remarkably well in the face of pledges to cut public sector wages and abolish various tax credit schemes. The release of the May PMIs next Friday will attract close scrutiny for confirmation that confidence in services and manufacturing sectors is not dented by the sovereign debt jitters.

GBP

• The high correlation with equities weighs but with the BoE now also reasserting its influence, we see no immediate escape for GBP from the clutches of the sterling bears. In the end, knee jerk buying of GBP/G10 on PM Brown's resignation almost surpassed the reaction to PM Cameron's nomination. Though the initial noise surrounding budget deficit reduction plans by the Con/LD government is promising from a ratings perspective, GBP has not escaped the widespread selling vs the USD and JPY. As we await the emergency Budget in 50 days time, hopes for a near-term bounce in GBP/USD and GBP/JPY are pinned on a bounce in commodities and stocks. Failure of the FTSE to regain 5,500 does not bode well for the ST.

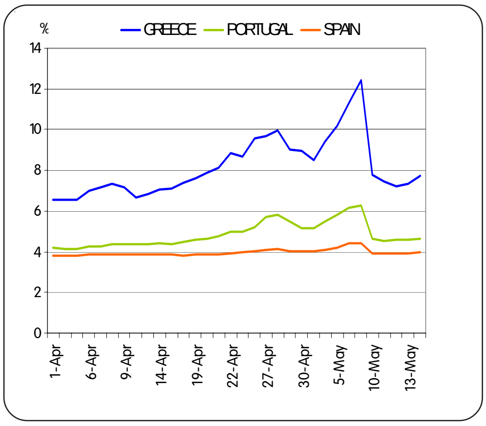
• April CPI data and the MPC minutes will keep GBP on a knife-edge next week. Even if CPI surprises to the upside (cons f/cast 3.5% vs 3.4% in March), selling of GBP/USD rallies is preferred. The BoE QIR made clear that downside growth risks have returned and that inflation remains on target to fall below 2% target in two years. The idea that the BoE may extend asset purchases later this year has been touted in some quarters. With the Fed moving in the opposite direction and voices on the FOMC mulling asset sales, the danger exists for a fall in GBP/USD to 1.40 in the weeks ahead, backed by a narrowing in US/UK 10y rate differentials.

• Along with GBP, the AUD is equally highly correlated with stocks and this explains the sideways price action in GBP/AUD between 1.62 and 1.65. The situation is different for GBP/CAD, where the unchanged prospect of a hike in Canadian interest rates this summer could magnify the selling pressure in GBP/CAD below 1.50 over the coming weeks, with the 1.4581 low of February 1985 an obvious target.

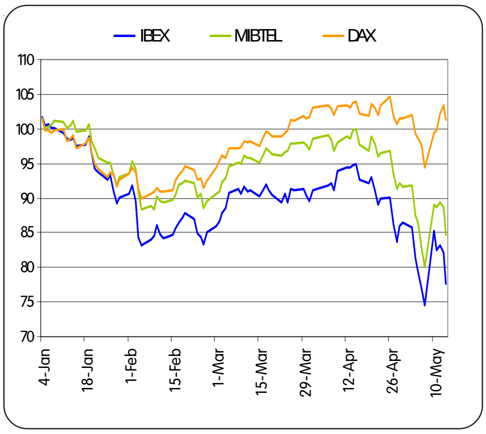
• GBP and JPY are situated at opposite sides of the scale vs risk assets. Bearing in mind the bearish set-up in stocks, GBP/JPY bulls are far and few between. After taking out 135.0 support, focus will shift to the May 6 low of 130.08, though interim support rests at 1.3203. The lower end of the trend channel dating back to June last year runs at 128.0. Resistance is situated at 140.0.

• Aside from CPI, next week also features the May MPC minutes, April retail sales (cons f/cast +0.2% m/m), Q1 business investment (f/cast -0.6%) and public finances for April (PSNB f/cast £7.0bln).

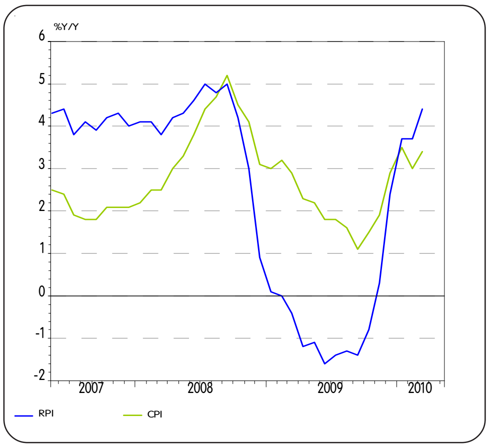
Bond yields drop on ECB buying



Spanish, Italian equity indices plunge



UK CPI: how long before pressures abate?



GBP/USD: 1.40-1.44 range ahead

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FX update - CNY outlook

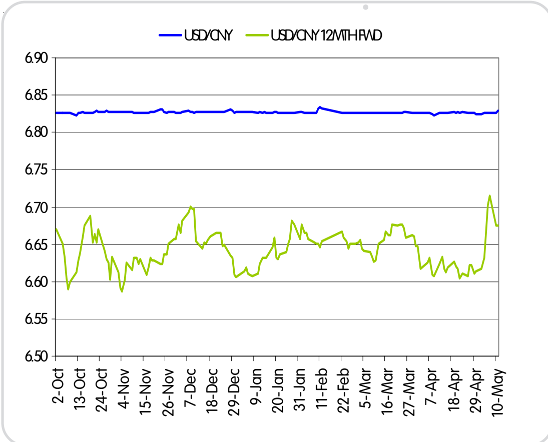
We haven't changed our central view since our March update that China will at some stage, possibly later this year, revalue the yuan. The current USD/CNY 12-month forward has displayed increased volatility (see chart) because of the jitters across different asset classes over the last few weeks and the attraction of the USD as a safe harbour. Fears of contagion from the peripheral euro zone debt markets and a sell-off in equities has prompted market participants to take their eyes of the still supportive global macro economic backdrop, but this has in our view not necessarily changed the outlook for the CNY over the next 12 months as inflation pressures in the Chinese economy continue to build, despite efforts to cool the economy through other channels.

The recent surge in volatility, perceived across different currency markets has also been observed in CNY 12-month forwards (see chart) and means the forward market is attaching a reduced probability of a yuan revaluation compared to a month ago when USD/CNY forward traded near the January low of 6.5930. The weakness in Chinese equities has also tempered speculation that a revaluation may near, but the sell-off in the Shanghai composite (the index officially entered bear territory this week) may be a partial cause rather than the symptom of the global recent malaise.

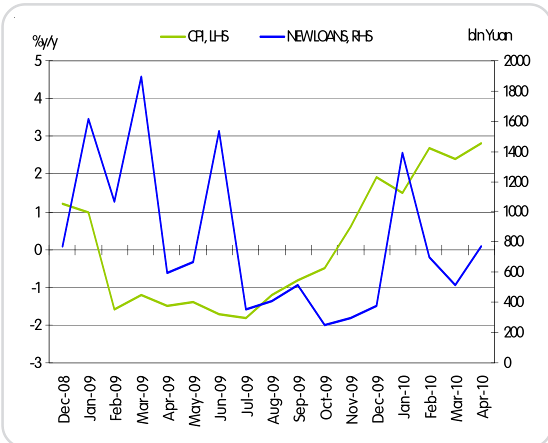
Chinese inflation data for April was released earlier this week and revealed an acceleration to 2.8% y/y in April from 2.4% in March. This marks the highest level since March 2008. Other data showed a still very dynamic backdrop for retail spending and industrial output. In addition, new bank lending rose last month by 774bln yuan, marking the 3rd highest monthly increase this year. This comes despite successive increases in the reserve lending ratio (see chart).

We are of the view that the yuan remains central to the PBoC as it considers taking additional steps and deploy other measures to dampen inflation, cool property prices and slow lending growth. The timing of a revaluation essentially depends on a normalisation of equity, bond and currency markets in the developed economies. Following the recent announcement of the EU stabilisation mechanism and IMF aid for Greece, the PBoC is likely to bide its time until markets have calmed down. Our central view is that USD/CNY will fall to 6.61 by end-2010 and 6.50 by mid-2011.

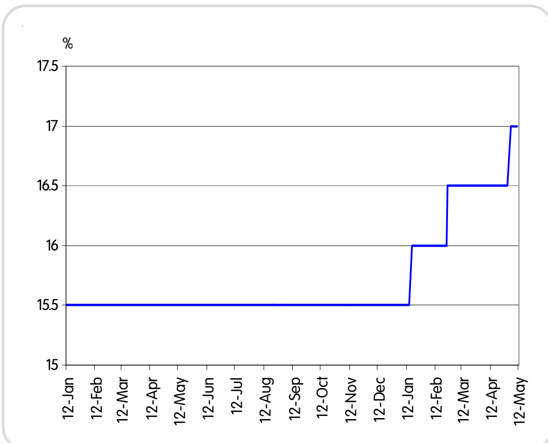
Increased volatility in USD/CNY 12-mth forwards



Chinese CPI: headed upwards



Reserve lending ratio: a popular policy tool



Quantitative Market Analysis

- **EUR short positioning scales new record**
- **USD correlation with CRB, oil takes off**

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.

Short GBP positioning rose for a 2nd successive week, causing short contracts to reach a 5-week high (-82,300). Reported short contracts jumped by 11,000 to 65,000, the highest since March 30. The price action of the last few days indicates that more short positions were probably accumulated following a brief post election bounce in GBP/USD over 1.50.

Elsewhere, the biggest moves continue to take place in the EUR, where short positions shot up to a record 112,000 contracts (+15,500). Reported short positions also topped 100,000 contracts. The selling in EUR/USD to a 1.2359 low on Friday testifies to the prevailing bearish flows and should result in short contracts snowballing in next week's IMM release. The gap between GBP and EUR shorts remained steady at -30,000 and may lead EUR/GBP to stall in the 0.85-0.86 area. Short CHF positions jumped to 22,000 contracts, adding fuel for the bounce in USD/CHF through the 1.10-1.12 area. Long AUD and CAD positions were pared back for a 2nd successive week. Long AUD positions were cut back by 12,000 contracts to 70,000, the lowest since March 12 (AUD/USD 0.9152). Long CAD positions dropped to 80,000, the lowest since March 2 (USD/CAD 1.0356).

The US DXY resumed its upward trend in decisive fashion, crushing through the 85-86 area with remarkable ease, capitalising on its safe haven status. Our medium-target is unchanged at 89.0 as global risk aversion remains the driving theme. The FOMC minutes could be key next week to understand how close or how far the Fed is removed from asset sales. Subdued inflation data on cheaper oil and a stronger USD justify the Fed's ultra-loose monetary policy. US 10y break-even rates have dropped 20bp in May.

Risk reversals turned less bearishly for all G10 currencies vs the USD up until Thursday. The data does not include Friday's prices so may be less instructive than usual in the light of the broad based support for USD calls observed on the final trading day of the week. Having said this, USD/CAD positions continue to look stretched for CAD and CHF puts and can be traced to the pullback in stocks. Short-dated volatility understandably plunged following the extreme swings of the prior week. The biggest declines in 1mth vol were registered in USD/CAD, USD/CHF and USD/JPY. The VIX briefly fell back below 25.0 but roared higher again on Friday, climbing over 31.0 as equities wilt.

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	0.37	0.06	**0.86**	-0.13	0.54	**0.89**	**0.93**
10 YR SPD	0.08	-0.70	-0.68	-0.69	0.42	**0.89**	**0.86**
S&P500	**0.92**	**-0.92**	**0.83**	**0.83**	0.50	**0.90**	**0.89**
Gold	**-0.86**	0.60	**-0.92**	**-0.90**	-0.21	-0.73	**-0.89**
Oil	**0.95**	-0.70	**0.90**	**0.93**	0.55	**0.94**	**0.97**
Relative Yield Curve	0.55	0.58	**0.90**	**0.79**	-0.09	-0.32	**0.78**
CRB	**0.97**	**-0.85**	**0.91**	**0.90**	0.47	**0.92**	**0.95**

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&P 500 and commodities (represented through the CRB index).

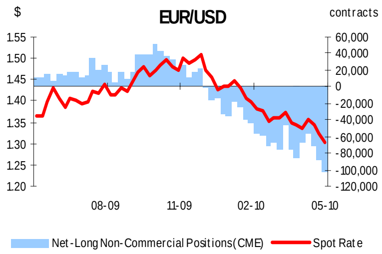
G10 correlations with 2y interest rate differentials remained pretty significant, with EUR/JPY and AUD/JPY but also EUR/USD registering statistically significant levels. For AUD/JPY and EUR/JPY, 10y rate differentials also continue to play a powerful influence.

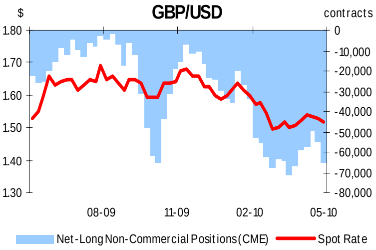
In terms of risk assets (S&P 500), the correlation in GBP/USD edged lower to 0.83 from 0.91, which could gradually bring some respite for the cross even as the FTSE retraces below 5,300. AUD/JPY and EUR/JPY remain highly correlated as illustrated in this week's price action. EUR/JPY stumbled below 115.0. In the absence of a relief bounce in equities, a test of 110.70 now looks probable. The correlation of most crosses with the CRB commodity index has also shot up with the exception of USD/JPY. The correlation of the USD/G10 and oil has reached extreme levels. As crude prices slump towards $70pb, the USD is netting impressive gains vs all G10 currencies except vs the JPY.

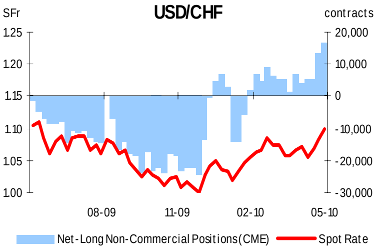
The gulf between EUR/USD and the EU/US economic surprise index remains exceptionally wide. A similar pattern is starting to occur in GBP/USD and USD/CHF, though the move we reported on last week in USD/SEK has stabilised.

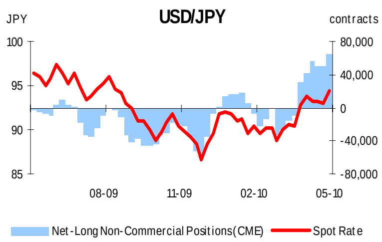
FX & Commodity Futures Positioning

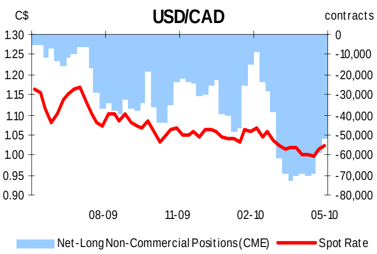
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

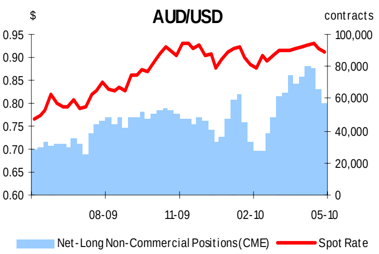


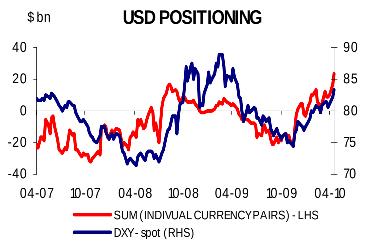


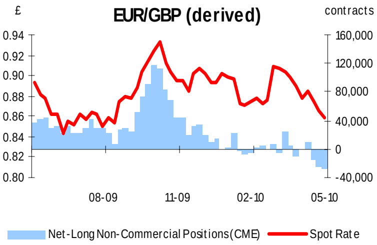


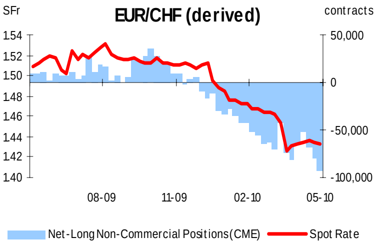


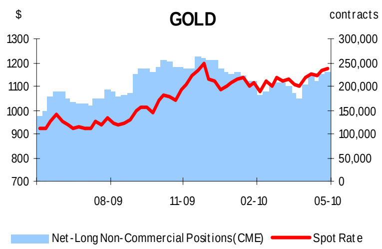


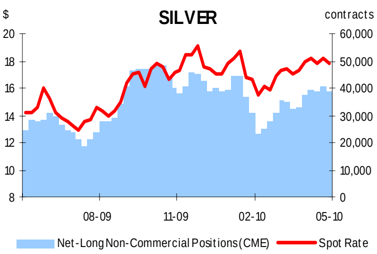


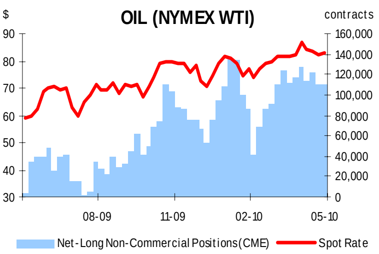


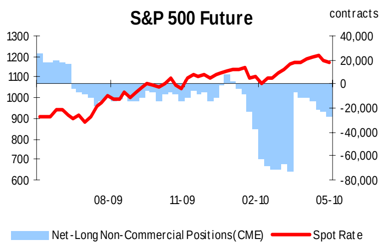


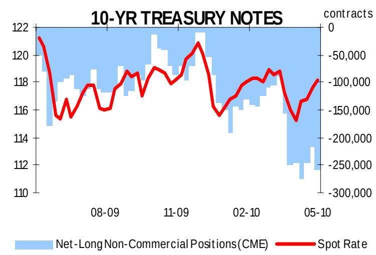


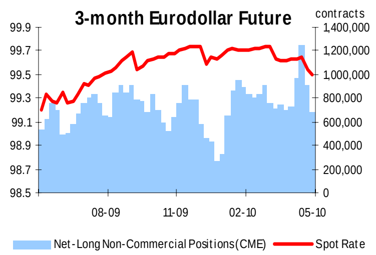






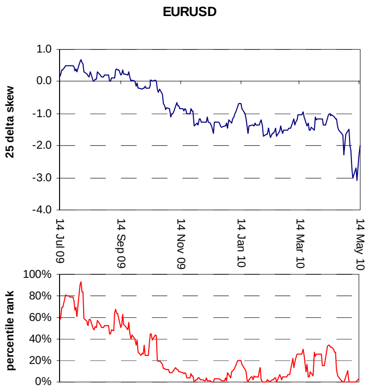


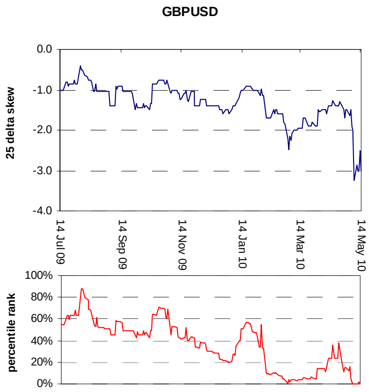


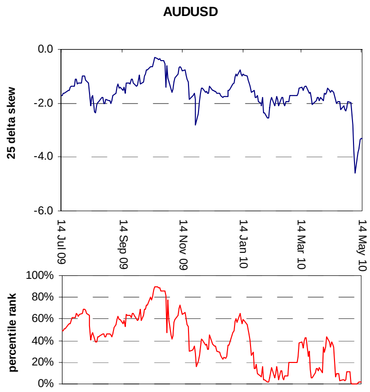


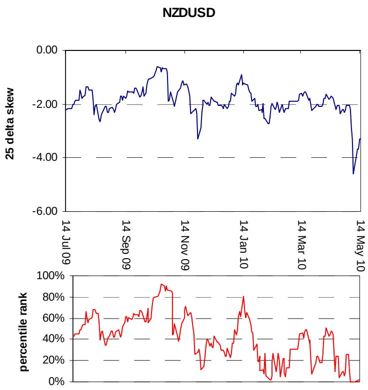
FX Options: Risk Reversal Skews

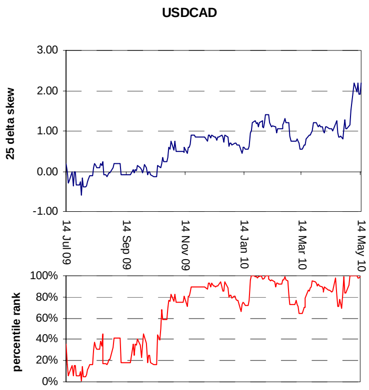
The risk reversal skew is the difference in volatility between similar out-of-the-money call and out-of-the-money put options. A positive risk reversal means that the implied volatility (used for pricing) of the call is greater than that of the put. In this section, the skew is based on 1-month 25 delta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

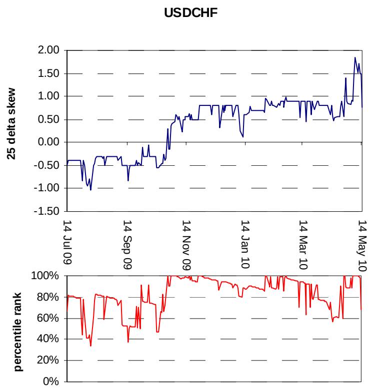


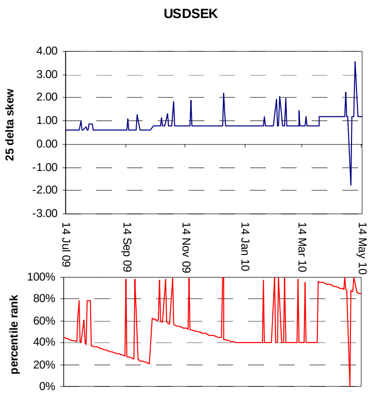


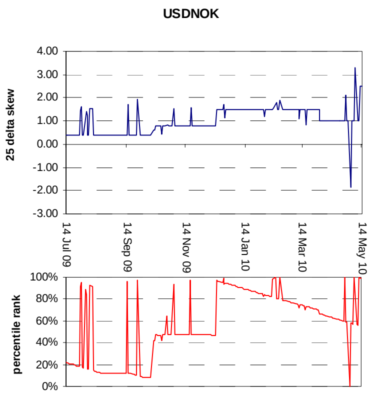


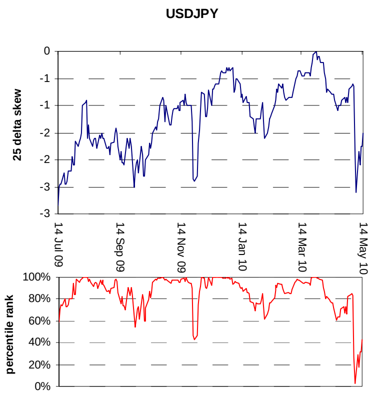






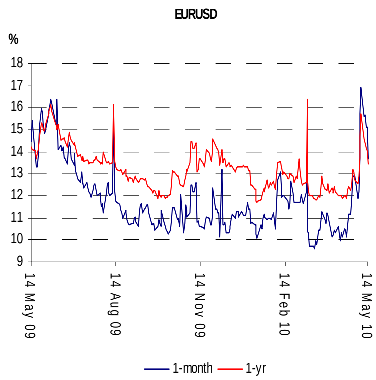


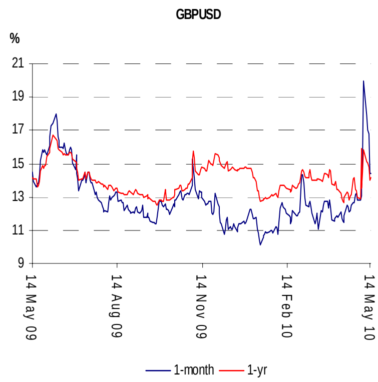


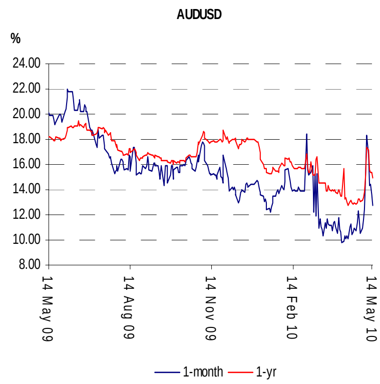


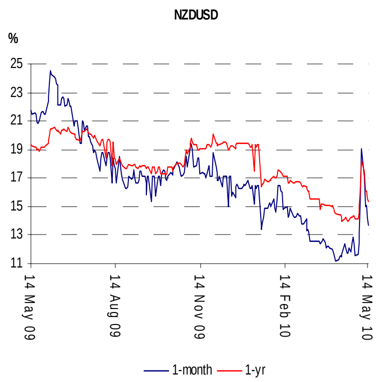
FX Options: Implied volatility

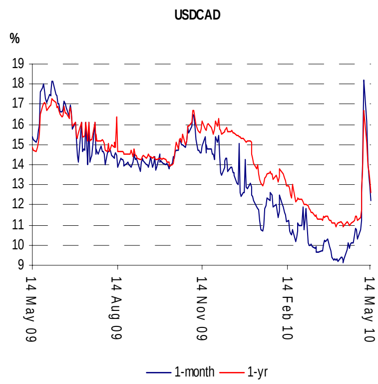
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

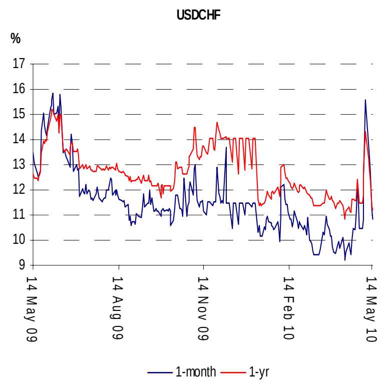


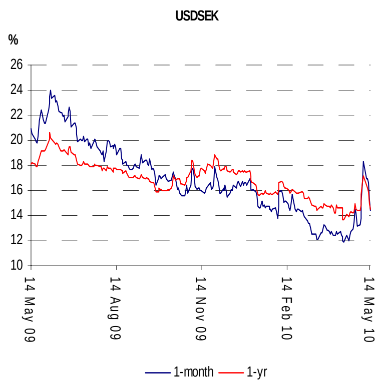


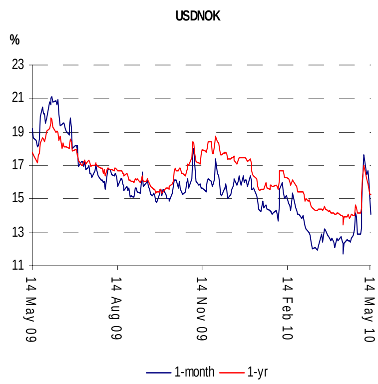


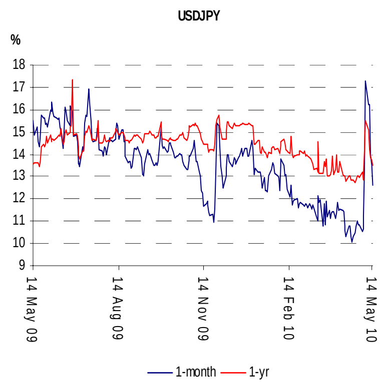






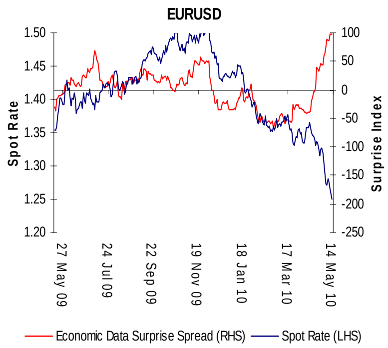


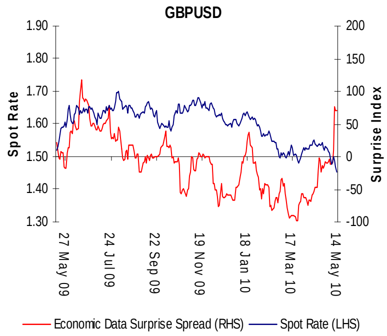


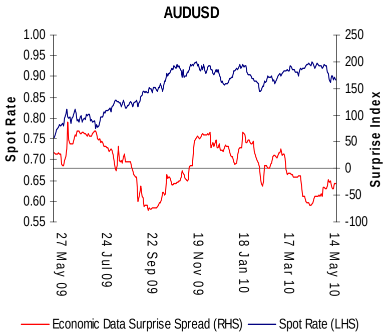


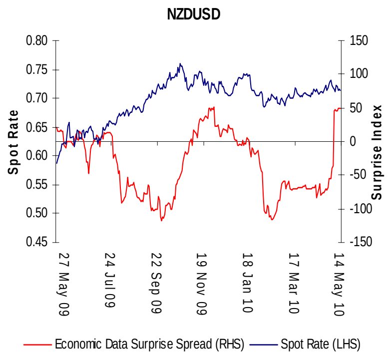
Economic Data Surprises

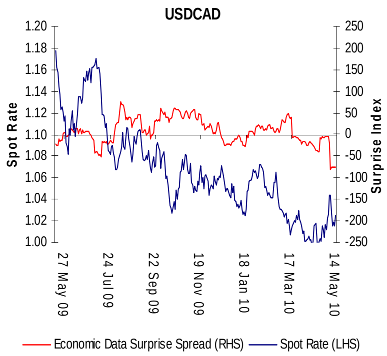
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

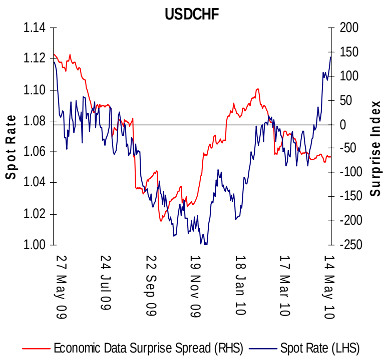


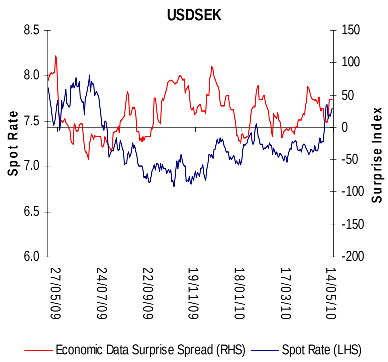


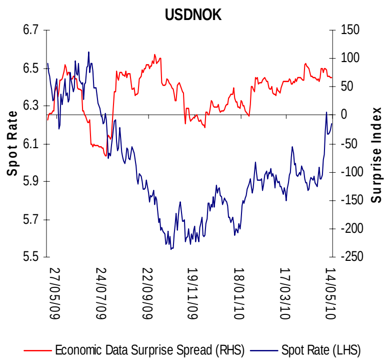


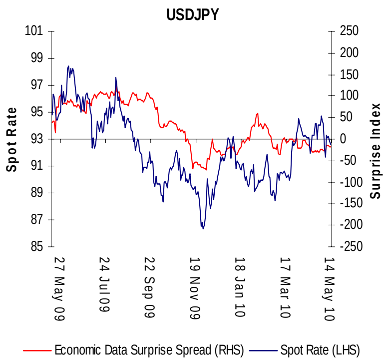






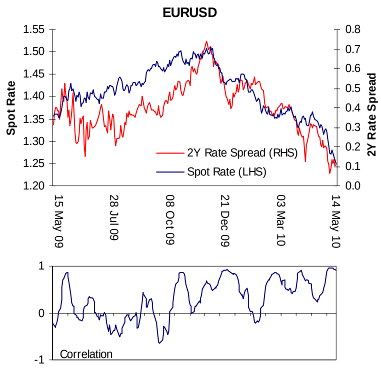


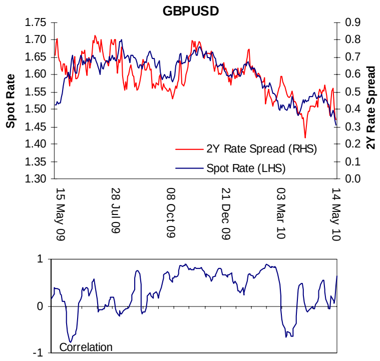


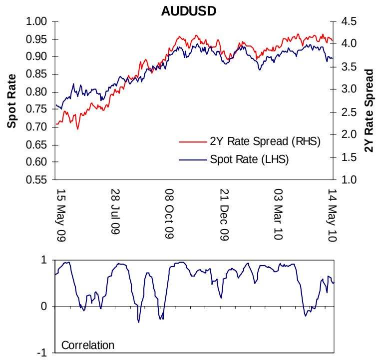


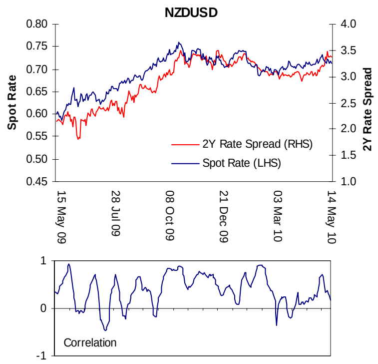
Interest Rate Spreads vs. FX

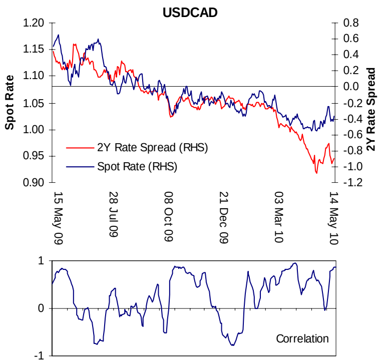
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

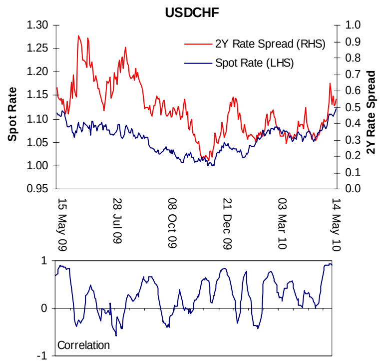


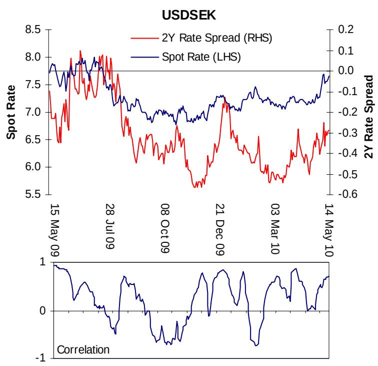


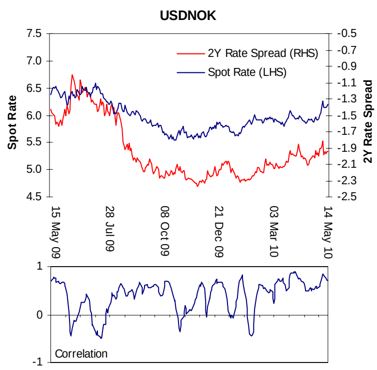


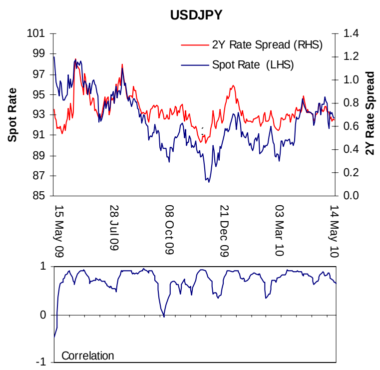






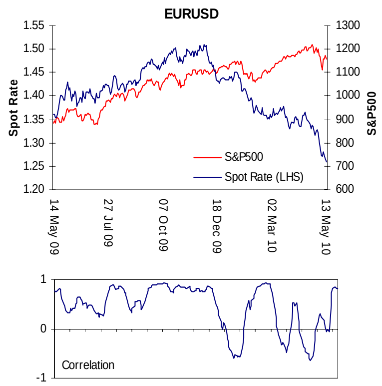


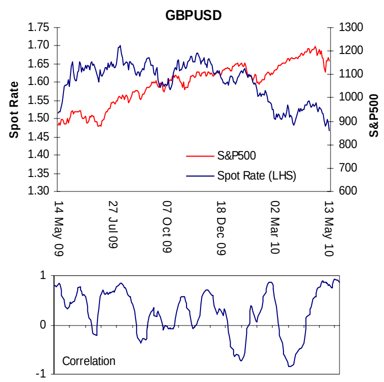


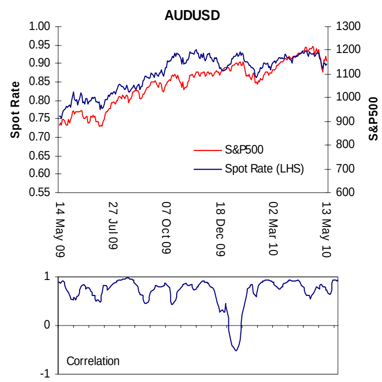


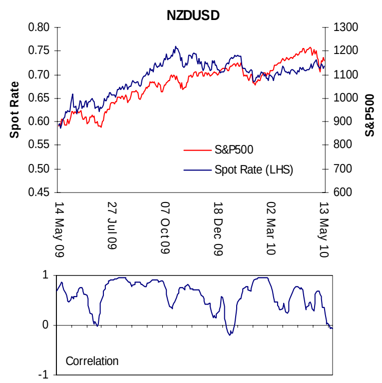
S&P500 vs. FX

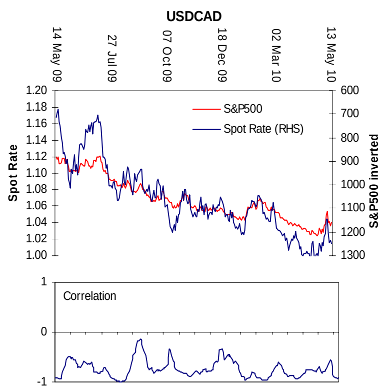
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

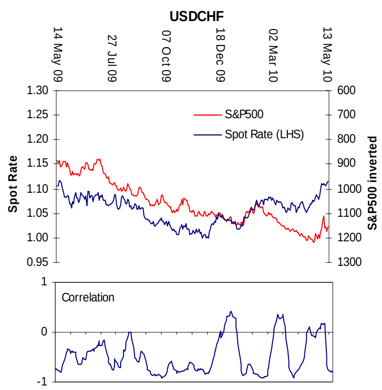


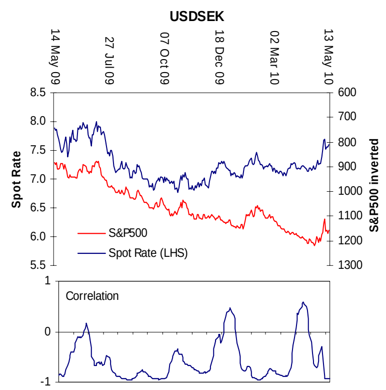


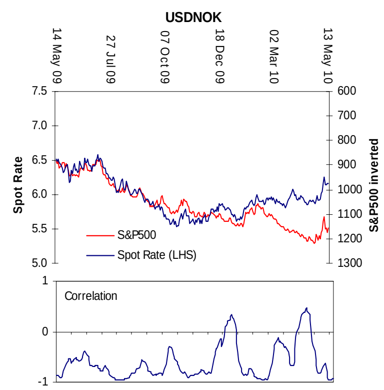


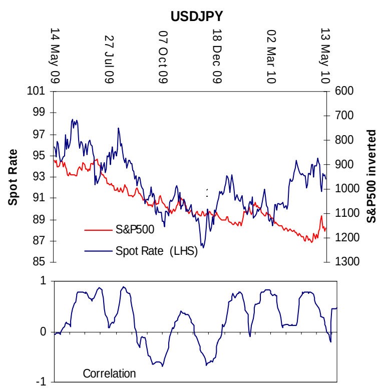






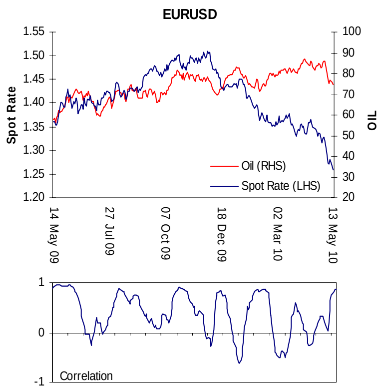


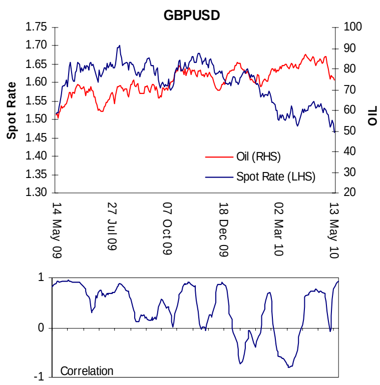


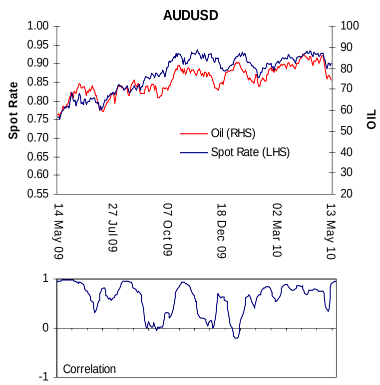


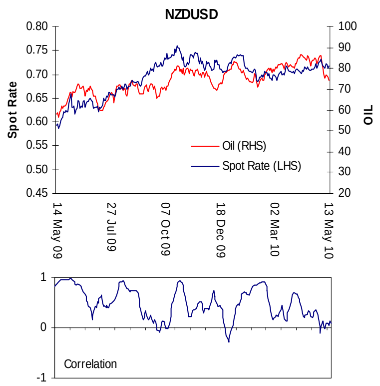
Commodities vs. FX

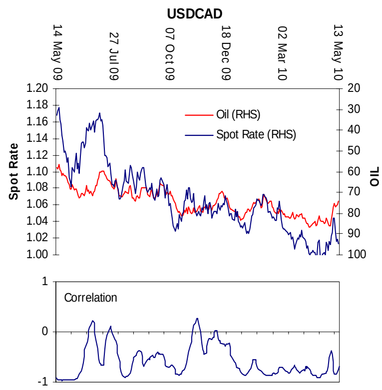
The charts below show oil prices plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

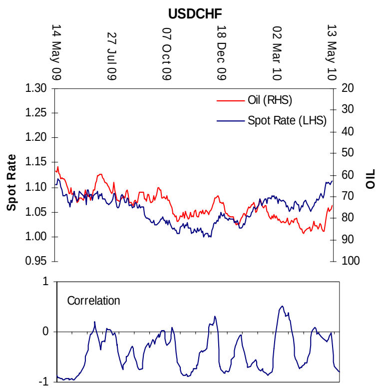


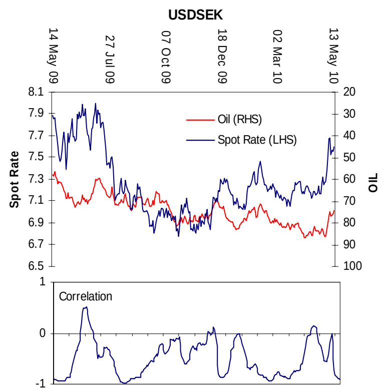


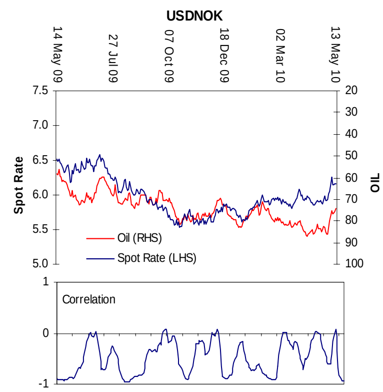


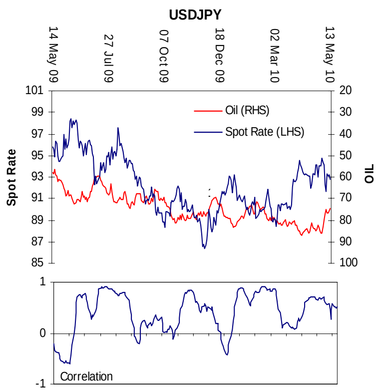








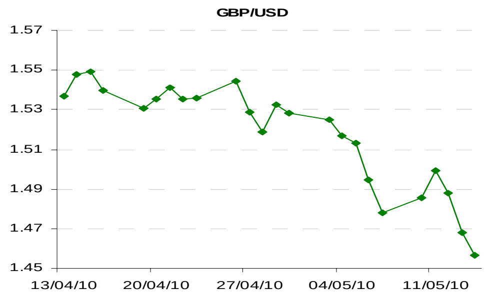


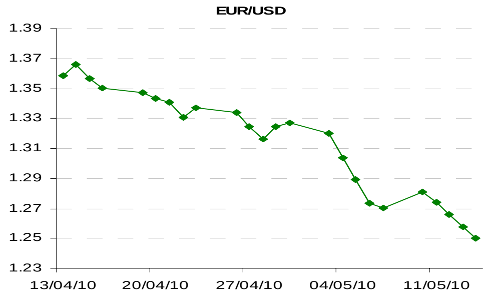


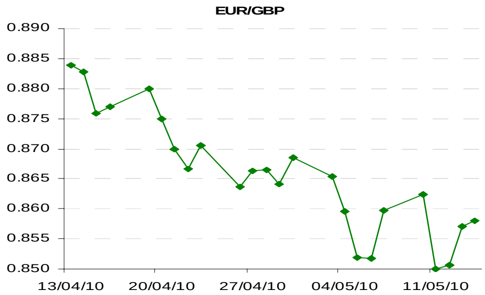
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

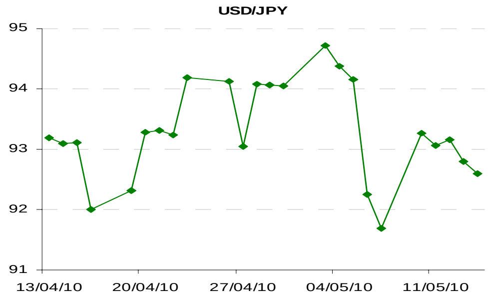
Market Review

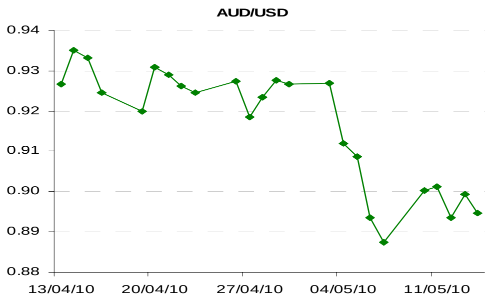
Short-term G-10 FX Charts

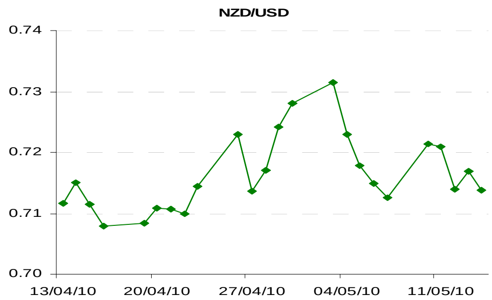


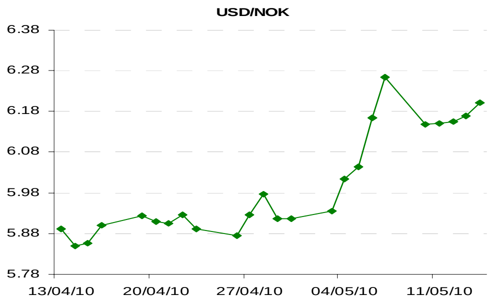


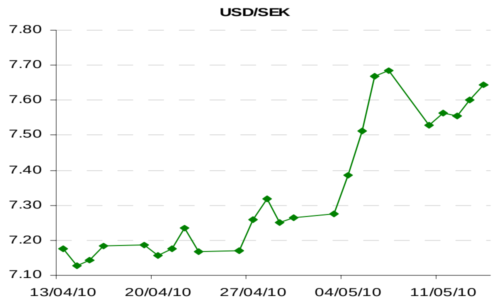


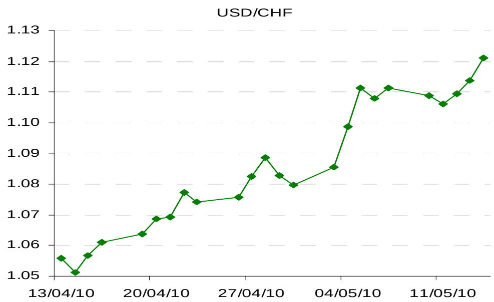


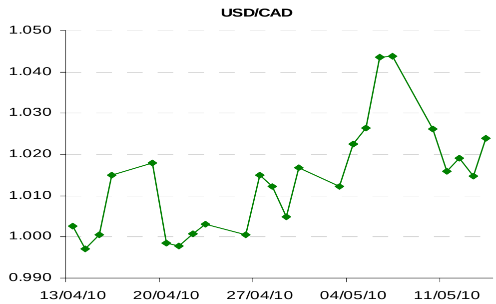




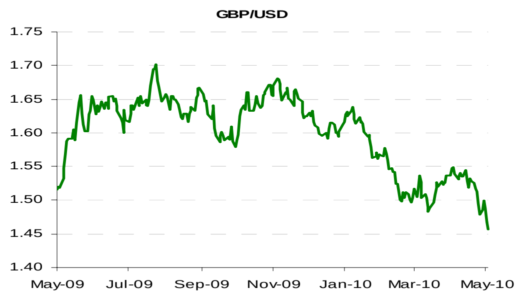


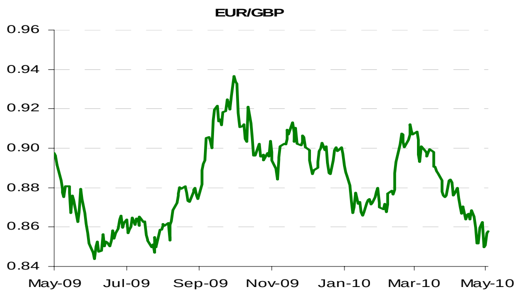


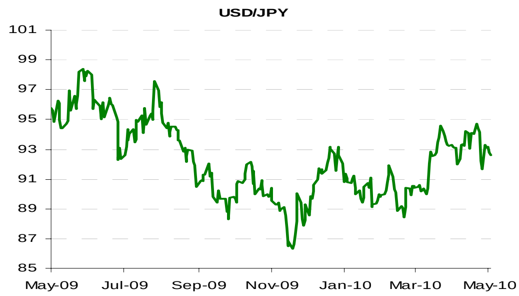


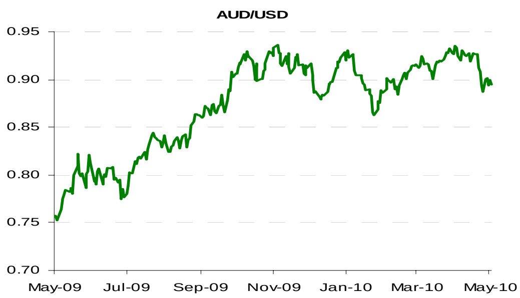


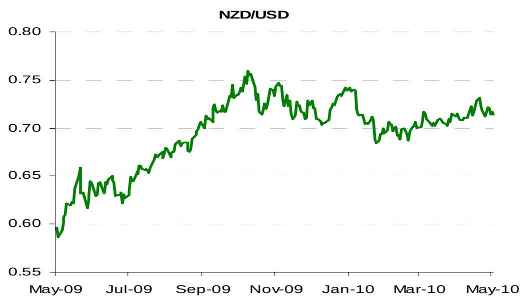
Medium-term G-10 FX Charts

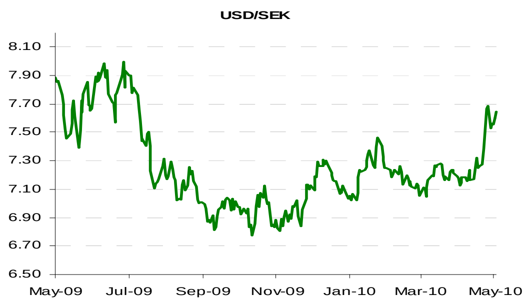


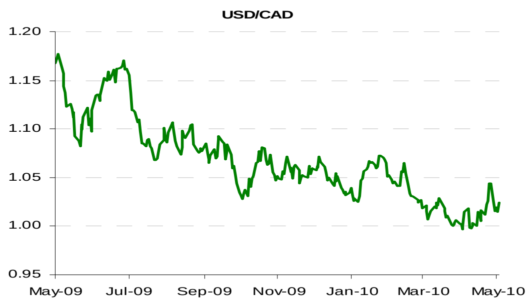






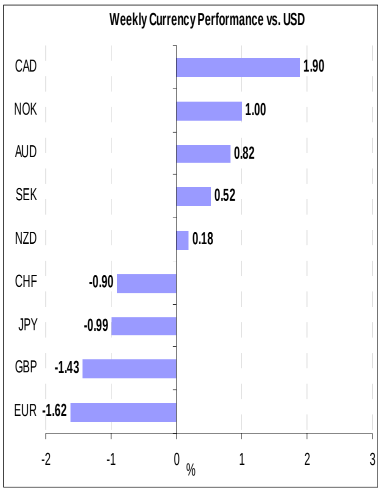


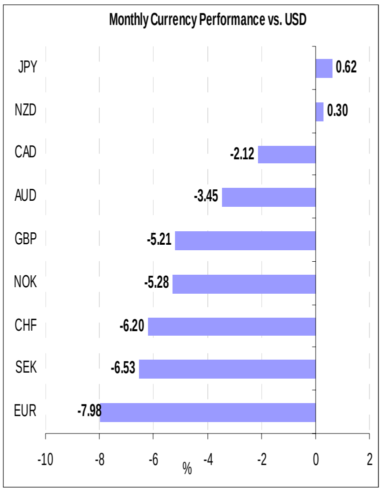


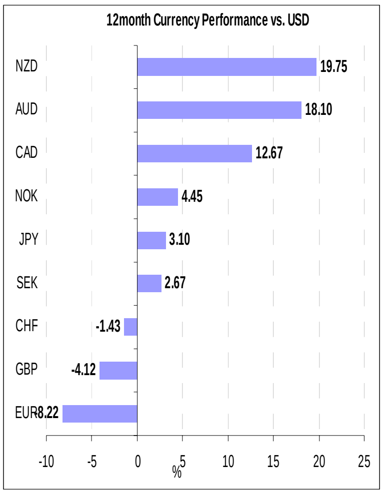


FX Snapshot

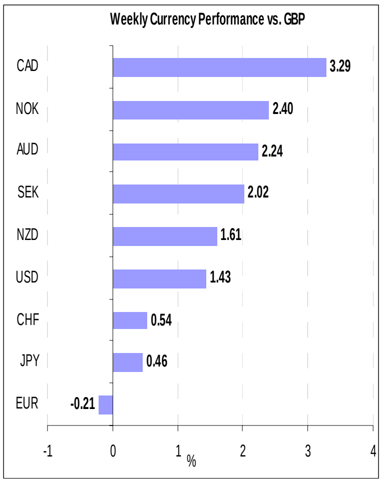
Currency performance vs. USD

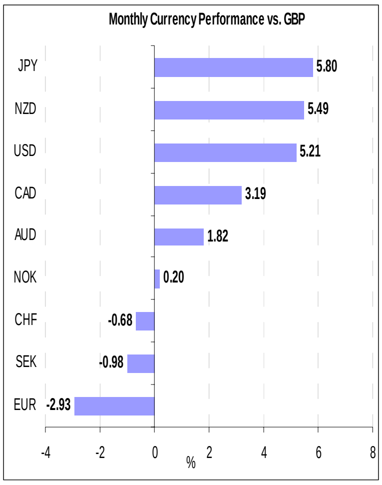


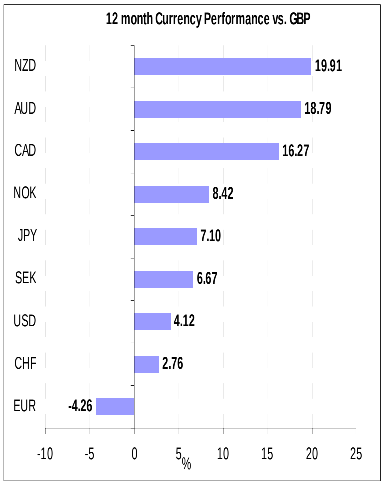




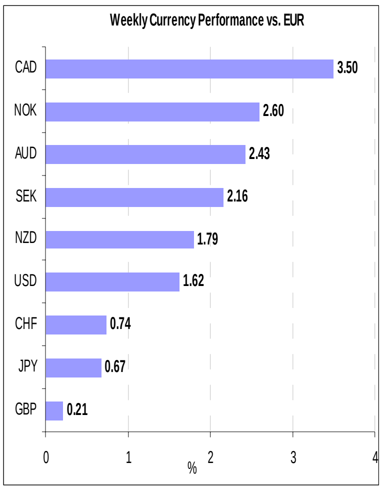
Currency performance vs. GBP

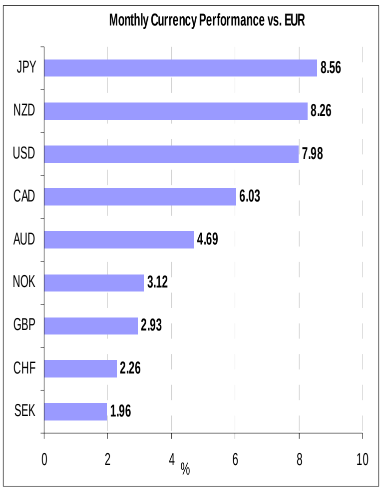


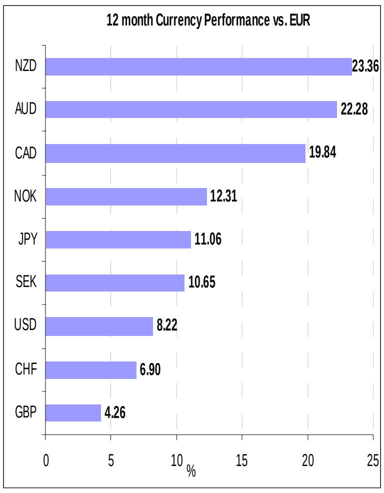




Currency performance vs. EUR







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