

Daily Market Strategy

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Market Strategy

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- GBP slump continues, JPY biggest gainer overnight
- Germany elects centre-right government; buy the DAX?

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/\$: 1.5828, €/\$: 1.4615, \$/Y: 89.35

UK 5y sw: 3.28%, US 5y sw: 2.66%, EU 5y sw: 2.71%

Overnight

- BoE in damage limitation exercise, says governor King's message was 'misinterpreted'
- UK faces greatest threat from inflation (FT)
- IMM data show surge in net GBP short positions

It is why you will never hear ECB or Fed officials directly refer to exchange rate policies. The BoE was involved in a damage limitation exercise over the weekend, arguing that governor King's comments on sterling were misunderstood by the market. The excuse was to no avail and as soon as Asian markets opened this morning, GBP/USD slid to a 1.5771 low, taking out 1.5803 key support in the process. EUR/GBP vaulted 0.9300. Considering the UK's relative small penetration in global exports vs 'the big three', the country's whopping (overseas) funding requirement, and the pressure on inflation through import prices, one has to wonder how far sterling can fall. To repeat what we said last week, beyond a relief bounce from oversold conditions and perhaps an upward revision to UK Q2 GDP tomorrow, it is very hard to argue against selling GBP rallies.

By contrast, Germany run a trade surplus, has a relatively strong productivity record, has no credit crunch, cut and has cut back on planned bond issuance for Q4. Moreover, the country has elected a centre-right government committed to cutting taxes. Turning its manifesto into reality will be a challenge for Germany's CDU/CSU and FDP but the pledge to cut taxes in a G3 world of future fiscal policy tightening (US/UK/euro zone) and deleveraging is what could set Germany apart and continue to give the DAX the edge vs other developed economy benchmarks (over the longer term). Since Merkel's election victory in 2005, the Dax has outperformed the S&P, CAC and FTSE.

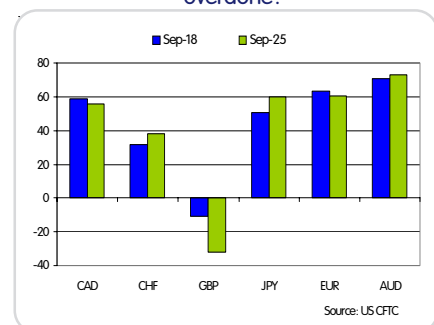
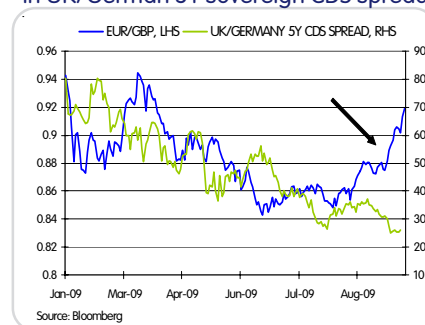
FX: We are mindful of a technical bounce but choose to go with the trend in GBP and see no obvious stop to the sterling rout, though conditions are looking heavily oversold in most crosses. Next line of support for GBP/USD runs at 1.5718. A break of 0.93 in EUR/GBP brings trendline resistance around 0.9343 in play. We've also lowered our GBP/JPY target to 135.0 following a break of 140.0.

Rates: UK 5y swaps opened at 3.28%, at the low end of the trading range. Support runs at 3.26%. The BoE will purchase £1.4bn of longer-term gilts this morning. UK 2y yields have dropped below 0.75% and could test 0.70%. UK 10y sits on a key level at 3.60% and could target a move back to 3.50% if risk appetite fades. Dec bund futures hit an early 121.91 high.

EUR/GBP has decoupled from narrowing in UK/German 5Y sovereign CDS spread

IMM update: is GBP bearishness overdone?

	Close	Daily Change %
FX		
EUR/GBP	0.9210	0.88%
GBP/USD	1.5951	-0.67%
EUR/USD	1.4689	0.16%
USD/JPY	89.636	-1.80%
AUD/USD	0.8680	0.35%
Bonds %		bp
US 10Yr	3.318	-6.3
EUR 10Yr	3.256	-4.9
UK10 Yr	3.610	-8.2
UK 5yr Swap	3.278	-4.3
Equities		%
S&P500	1044.38	-0.61%
FTSE100	5082.20	0.06%
Eurostoxx50	2831.95	-0.22%
Shanghai	2763.53	-2.65%
Composite		
Commodities		%
Crude Oil \$/bl	66.02	0.20%
Gold \$/oz	991.0	-0.31%
Copper	274.1	1.14%
Baltic Dry	2183	0.92%
Other		
VIX	25.61	2.65%
iTraxx XOVER	576.97	9.1



Today's Events

Event	Time	Consensus	Previous
UK HomeTrack House Prices, Sep	00:01	+0.2% A	+0.1%
German CPI, Sep prelim, y/y	TBC	-0.2%	-0.1%
Chicago Fed Activity Index, Aug	13:30	n/a	-0.74
Dallas Fed Manufacturing Index, Sep	15:30	-4.0%	-9.1%
ECB speakers: president Trichet at the EP (15:30)			
Bank of Canada speakers: governor Carney (20:40)			
BoE to purchase £1.4bn of gilts: UKT_5_070325, UKT_4.25_071227, UKT_6_071228, UKT_4.25_070632, UKT_4.5_070934			

Technical Analysis

Paul Rodriguez, Senior Technical Analyst

- The cautious bias on equities increases as the FTSE hits the key sell level at 5,075 with major stops above the recent high at 5,169. Key support at 5,005 is the next barrier for the bears with a breach opening up 4,906. It could be easy to get carried away with a bearish view here, but for now the topping signals are minor and come amid a back-drop of weakening commodities as copper fails to break 300 c/lb and reverses the outlook for a correction. The Shanghai composite could be in the throws of a major top- this will be monitored carefully over the coming sessions, but for now the bias is to sell equities until the market grips support.
- Once again sterling is under major pressure trading below 1.5800 against the dollar. This happens to be a major support point and a close below here would open the way for a deeper correction towards 1.5500. However, of interest is the potential for weakness in the commodity currencies and in line with the reversal in base metals, the US dollar could stage a rebound (and sterling could bounce against the currencies in sympathy- but this is not the primary trade). Despite the long stop not being hit in NZD/USD, the position has been reversed. EM currencies are holding up relatively well, but a bout of dollar strength could be in the pipeline, especially as Crude oil falls below key support at \$66.00.
- The reaction of bond yields will be interesting. Further compression given the weakening state of the asset markets is likely, but will UK yields hold steady and the core bonds reverse providing some support for the pound? Either way, long term yields look set to test the bottom end of their ranges in core bonds. US 10y yields support is at 3.25%- a break of this level would negate the bearish bond, bullish yield view, making the this week potentially pivotal for the markets.

Chart of the day: Shanghai composite- Possible major top.



Key Levels

	EUR	GBP	JPY	EUR/GBP	GBP/EUR
R2	1.4865	1.6300	95.15	0.9482	1.1135
R1	1.4728	1.5982	91.80	0.9300	1.1004
Current Spot	1.4601	1.5813	89.25	0.9233	1.0830
S1	1.4450	1.5802	87.14	0.9088	1.0753
S2	1.4407	1.5724	85.00	0.8981	1.0546

Spot prices as of: 07:10:35 Source: Bloomberg

The failure to break through 3,000 and the 50% drop in the Baltic Dry index, coupled with broader decline in commodities implies extreme caution on all equity markets. A break of 2,650 here would complete a major top.

	Spot	Bias	Entry	Target	Stop	Comment/Levels
EUR/USD	1.4601	Neutral	-	1.4950	-	
USD/JPY	89.25	Neutral	89.90	96.00	89.30	Stop hit.
USD/CHF	1.0338	Bullish	<u>1.0225</u>	1.0500	1.0160	
GBP/USD	1.5813	Neutral	-	1.6000	-	Stop hit.
EUR/GBP	0.9233	Neutral	-	0.9000	-	-
GBP/JPY	141.40	Neutral	-	156.00	-	
EUR/JPY	130.57	Bullish	-	128.00	-	
CAD/JPY	81.61	Bearish	82.70	78.55	83.10	
AUD/USD	0.8632	Bearish	<u>0.8650</u>	0.8450	0.8725	
USD/CAD	1.0953	Bullish	<u>1.0800</u>	1.1200	1.0715	
NZD/USD	0.7147	Bearish	<u>0.7200</u>	0.6700	0.7255	
USD/BRL	1.7902	Bearish	1.8338	1.7000	1.8455	
USD/PLN	2.8914	Bearish	<u>2.9000</u>	2.7000	2.9110	
USD/HUF	184.95	Bearish	<u>188.00</u>	180.00	190.20	

Spot prices source: Bloomberg

ENTRY - Targetted

ENTRY - Active

Market Summary

FX	Close	Daily Change %		Close	Daily Change %	
EUR/USD	1.4689	0.16%		Equities		
USD/JPY	89.636	-1.80%		S&P500	1044.38	-0.61%
AUD/USD	0.8680	0.35%		DJIA	9665.19	-0.44%
EUR/GBP	0.9210	0.88%		FTSE100	5082.20	0.06%
GBP/EUR	1.0859	-0.86%		Eurostoxx50	2831.95	-0.22%
GBP/USD	1.5951	-0.67%		Shanghai Composite*	2838.84	-2.65%
GBP/JPY	142.99	-2.46%		*latest price		
GBP/CHF	1.639	-0.88%		Commodities		%
GBP/AUD	1.838	-1.03%		Crude Oil \$/bl	66.02	0.20%
GBP/CAD	1.740	-0.51%		Gold \$/oz	991.0	-0.31%
GBP/NZD	2.218	-1.14%		Copper c/lb	274.1	1.14%
GBP/NOK	9.261	-1.03%		Silver \$/oz	16.05	-1.26%
GBP/ZAR	11.822	-1.52%		Baltic Dry	2183	0.92%
GBP/CNY	10.893	-0.64%				
				Swaps %		bp
Bonds %		bp		US 5yr	2.688	-0.4
US 10Yr	3.318	-6.3		EUR 5yr	2.705	-2.2
EUR 10Yr	3.256	-4.9		UK 5yr	3.278	-4.3
UK10 Yr	3.610	-8.2				
				Official Rates %		
Other			UK	0.50		
VIX	25.61	2.65%	US	0.25		
iTraxx XOVER	576.97	9.1	EU	1.00		
DJ Agriculture	57.56	0.00%	Japan	0.10		
Index						

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