Daily Market Strategy

Thursday, 8th October 2009

Market Strategy

Market Strategy Team

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- **Equities set to extend gains on US earnings**
- **BoE to stand pat; ECB may comment on FX, one-year tender**

Market Outlook

Kenneth Broux

Opening levels (7.15am)
£/$: 1.5987, €/$: 1.4754, $/Y: 88.32
UK 5y sw: 3.07%, US 5y sw: 2.55%, EU 5y sw: 2.67%

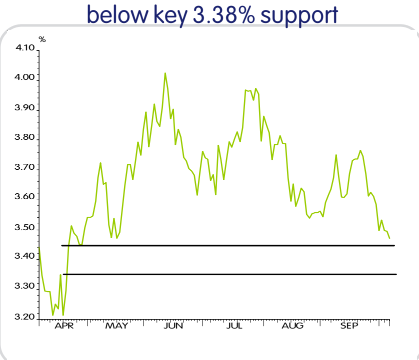
Overnight
- US 10y auction: bid/cover 3.01, indirect bidders take 47.4%
- Australian employment jumps 40.6K in Sep, jobless rate falls
- Japanese investment flows positive in latest week, net inflows in stocks/bonds

Australian government bonds were crushed overnight and AUD/USD soared above 0.90 (GBP/AUD below 1.78) following good US earnings and the report of the biggest jump in Australian employment in nearly two years (+40.6K in Sep). This vindicates the RBA's rate hike to 3.25% and makes a follow-up move before year-end extremely likely. The dollar traded heavy in Asia with the USD index fast approaching 76.0. Gold is bid above $1,050. Still ahead today, we are not buying into speculation that ECB president Trichet will try to talk down the EUR. The USD could find some reprieve if Trichet elaborates on G7 discussions of last weekend. On the other hand, USD supportive comments have not quite registered in currency markets where USD rallies are still viewed as opportunities to sell. Unless a coordinated response is put in place or a shift in fed funds policy becomes more realistic, the market will remain inclined to short the USD. Trichet's analysis of last week's one-year tender (€75.2bn) should prove insightful and may offer some indication about a possible change to the December procedure. Those looking for a policy change by the BoE risk being disappointed and we expect the MPC to put out exactly the same statement as last month, stating that it plans to complete the £175bn asset purchase programme whilst keeping the scale under review. German industrial output is expected to show a 1.6% rise in August. The US Treasury will complete this week's auction schedule with the sale of $12bn in 30y bonds.

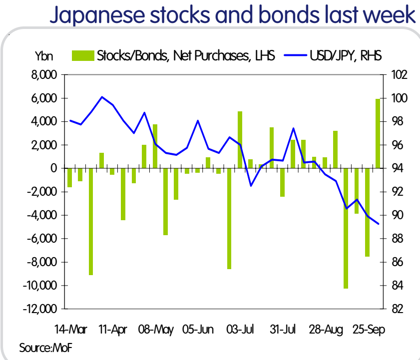
FX: The break of 0.90 in AUD/USD could spur fresh buying and favours a move up to 0.9250 - our next target. GBP/AUD fell overnight to 1.7700 - a new low. The ECB faces an uphill task in slowing the ascent of EUR/USD, where a rally up to the September 23 high of 1.4844 now looks inevitable as dealers trim USD holdings on higher risk appetite and rising gold/platinum prices. EUR/GBP is steady at 0.9220. Support runs at 0.9184.

Rates: Corporate GBP supply is quiet vs USD and EUR issuance despite the favourable rate environment and tight spreads. 10y gilt yields dropped to 3.37% and may target a breakout to 3.32%, followed by 3.20%. UK PPI data tomorrow (and CPI next week) are key to this bullish scenario. The US Treasury will tap the market for $12bn in 30y bonds. We look for 2y/10y spread to re-flatten into next week, support at 230bps.

UK 10y yields on the verge of beakout below key 3.38% support



Foreign investors were strong buyers of Japanese stocks and bonds last week



	Close	Daily Change
FX		**%**
EUR/GBP	0.9201	-0.50%
GBP/USD	1.5969	0.30%
EUR/USD	1.4692	-0.21%
USD/JPY	88.610	-0.24%
AUD/USD	0.8912	0.11%
Bonds %		**bp**
US 10Yr	3.182	-7.3
EUR 10Yr	3.118	-4.0
UK10 Yr	3.405	0.4
UK 5yr Swap	3.070	-3.1
Equities		**%**
S&P500	1057.58	0.27%
FTSE100	5108.90	-0.57%
Eurostoxx50	2852.17	-0.47%
Shanghai Composite	2779.43	0.00%
Commodities		**%**
Crude Oil $/bl	69.57	-1.85%
Gold $/oz	1044.2	0.20%
Copper	278.0	-0.18%
Baltic Dry	2546	4.30%
Other		
VIX	24.68	-3.97%
iTraxx XOVER	572.95	7.0

Today's Events	Time	Consensus	Previous
Japan Trade Balance, Aug	00:50	+Y303.7bnA	+Y437.3bn
France Business Sentiment, Sep	07:45	92A	89
German Industrial Output, Aug	11:00	+1.8%	-0.9%
BoE Rate Decision	12:00	0.50%	0.50%
ECB Rate Decision	12:45	1.0%	1.0%
Canada Housing Starts, Sep	13:15	148.0K	150.5K
US Initial Claims, Oct-3	13:30	540K	551K
US Treasury sells $12bn, 30y notes			
Bank of Canada speakers: Jenkins (14:50)			

Technical Analysis

Paul Rodriguez, Senior Technical Analyst

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- A positive showing from equities overnight should put Europe in a bullish mood this morning. Whilst the Nikkei continues to sit below the main 10,000 level (9,832 - underperformance due to yen strength), Dec. DAX index futures are trading within a whisker of the 5,764 prior high - a break targets a squeeze to 5,800. Dec. FTSE futures should take a run at 5,169 (also the contract high) which is the high water mark and my assumed top for the market. Given the positive sentiment in commodities, an equity squeeze may not be far behind, but this level still needs to be broken to change strategy. S&P cash also needs to take out 1,080 to imply another leg to the bull run. We should get a conclusion soon.
- In the FX space, the dollar remains under pressure against the commodity currencies with the AUD, CAD, NOK and NZD favoured buys. Emerging market currencies stay in demand with strength in the INR (completion of a major head and shoulders reversal) which targets 45.00. The ZAR is readying itself for a break through 7.29 - last month's low. The MYR is up sharply having breached a major H&S neckline at 3.44 and the pace of the move suggests 3.30 will be hit before year end. The broad pressure on the dollar has kept the DXY firmly below 77.20 - the main downward trendline - and risks puncturing prior support at 75.82 today. Dollar weakness should help cable to bounce given the lack of downside yesterday and failure to breach the technical trigger at 1.5820. A squeeze through 1.6050 today is the main buy signal for what could be a decent rebound for the beleaguered currency. EUR/USD resistance at 1.4844 is the main level to take out in the coming sessions and with gold screaming higher towards the $1,080 target, there seems to be little to prevent further softening of the US currency.
- Bond yields remain steady at current levels, but if anything the pressure on a rebound should become compelling in the next few sessions. US 5 and 10-y yields continue to hug the 200 day m.a. and today's price action in the equity and commodity markets should nudge yields higher - even if the long term viability of this is currently uncertain.

Chart of the day: US 10 year yields

Yields continue to hold short term support around the 200 day m.a. at 3.17%. So far, the market has not closed below this key average line. However, resistance at 3.25% is the key level to breach.

Key Levels

	EUR	GBP	JPY	EUR/GBP	GBP/EUR
R2	1.4865	**1.6300**	95.15	0.9482	**1.1135**
R1	1.4764	1.611	91.80	0.9300	1.1018
Current Spot	1.4714	1.5874	88.54	0.9269	1.0789
S1	1.4450	1.5724	87.14	0.9076	1.0753
S2	1.4407	1.5455	85.00	0.8981	1.0546

Spot prices as of: 07:11:10 Source: Bloomberg

	Spot	Bias	Entry	Target	Stop	Comment/Levels
EUR/USD	*1.4726*	*Bullish*	1.4650	1.4844	1.4595	
USD/JPY	*88.42*	*Bearish*	current	85.00	89.20	
USD/CHF	*1.0279*	*Bearish*	1.0360	1.0000	1.0426	
GBP/USD	*1.5879*	*Bearish*	1.5965	1.5500	1.6020	
EUR/GBP	*0.9257*	*Bullish*	0.9225	0.9400	0.9190	
GBP/JPY	*140.18*	*Bearish*	142.00	143.10	137.71	Stop hit.
EUR/JPY	*129.79*	*Neutral*	-	133.00	-	
CAD/JPY	*83.61*	*Neutral*	-	-	-	
AUD/USD	*0.8919*	*Bullish*	0.8888	0.9000	0.8845	
USD/CAD	*1.0577*	*Bearish*	1.0650	1.0000	1.0715	
NZD/USD	*0.7348*	*Bullish*	0.7290	0.7468	0.7225	
USD/BRL	*1.7596*	*Bearish*	1.8338	1.7000	1.8025	Cautious as USD starts to rebound.
USD/PLN	*2.8397*	*Bearish*	2.8721	2.6000	2.8840	
USD/HUF	*180.98*	*Bearish*	182.09	165.00	183.10	

Spot prices source: Bloomberg

ENTRY - Targetted
ENTRY - Active

Quantitative Market Analysis

Naeem Wahid, Quantitative Strategist

A solid labour market report from Australia (where the unemployment rate has fallen alongside a rise in the participation rate) has propelled the AUD/USD overnight. The implied yield from interest rate futures contracts has risen by around 14bp as the market moves to discount further interest rate increases from the central bank – the Reserve Bank of Australia became the first G-10 central bank to raise interest rates this week. GBP/AUD continues to lurch lower, trading at its lowest since 1985. Having broken below A$1.80, the most obvious target on the chart now appears to be A$1.60.

In addition to the risk positive sentiment provided by Australian data overnight, the Q3 earnings season has opened strongly in the US with a number of companies (including Alcoa) providing upside surprises. This should continue to support equity markets, weigh on the USD (the DXY index is close to recording a new low for the year) and provide support for commodity currencies.

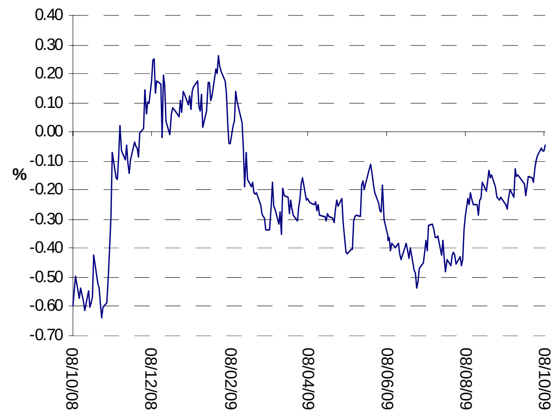
The latest portfolio flow data from the Japanese Ministry of Finance, for week ending 2nd October 2009, were released overnight - the data are charted on page 4. The data show that Japanese investors bought foreign equities (Y104.2bn) whilst foreigners sold Japanese equities worth Y69.7bn. This results in an equity related outflow of Y173.9bn from Japan. Over the same period, Japanese investors were net sellers of foreign bonds (Y1288.6bn) whilst foreigners were net buyers of Japanese bonds (Y663.3bn). This resulted in a bond related inflow of Y1951.9, dwarfing the net-equity outflows and accounting for some of the recent strength observed in the yen.

The trend following model continues to hold a short USD position. The model holds a portfolio that is fully short against EM currencies and 78% short USD against developed market currencies. The major exception in the model's positioning is GBP/USD where the model is short GBP and long USD, highlighting the weakness observed in the currency pair.

Table 1: 1-month correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	EURJPY
2 YR SPD	0.71	0.49	0.00	0.57	0.53	0.73
10 YR SPD	0.44	0.02	0.14	0.09	0.81	0.93
S&P500	0.41	-0.38	0.84	-0.06	-0.23	0.22
Gold	0.87	-0.90	0.54	-0.25	-0.60	-0.36
Oil	0.11	-0.61	0.19	0.44	0.15	0.28
CRB	0.57	-0.78	0.70	0.02	-0.30	0.07

Chart 1: Spread in EZ/UK 2-year interest rate swaps heading higher - positive for EUR/GBP

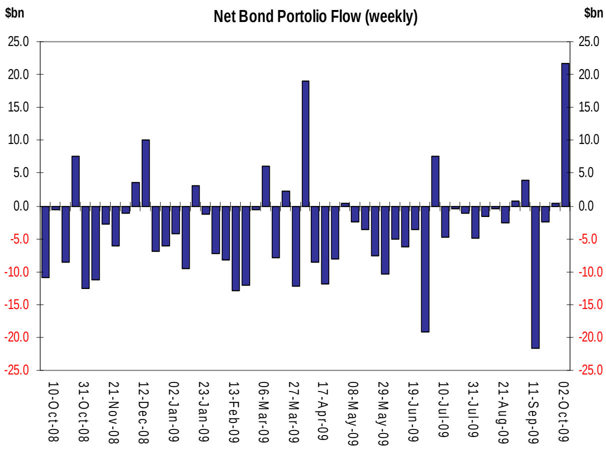


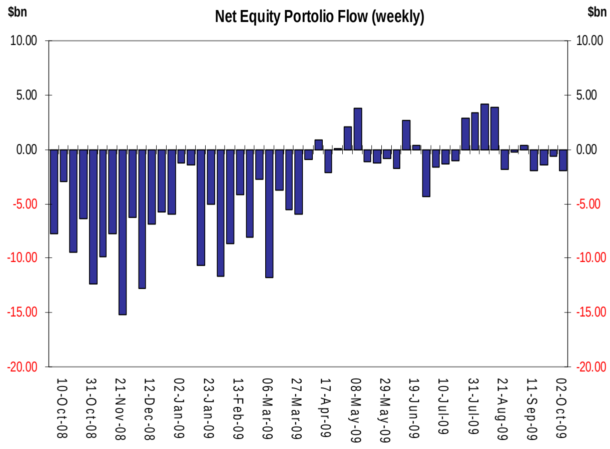
Trend following model signals

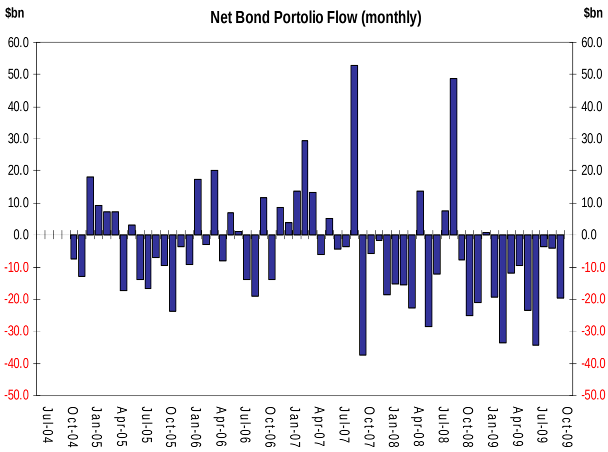
Trend Following Model Positions			
	Signal	Date	Entry Level
AUDUSD	long	15-Sep-09	0.8622
NZDUSD	long	10-Jul-09	0.6298
EURUSD	long	09-Sep-09	1.4480
GBPUSD	short	21-Sep-09	1.6270
USDCHF	short	17-Jul-09	1.0730
USDCAD	short	07-Oct-09	1.0593
USDSEK	short	09-Sep-09	7.0444
USDNOK	short	21-Jul-09	6.3025
USDJPY	short	28-Sep-09	89.64
Net-USD portfolio position			-78%

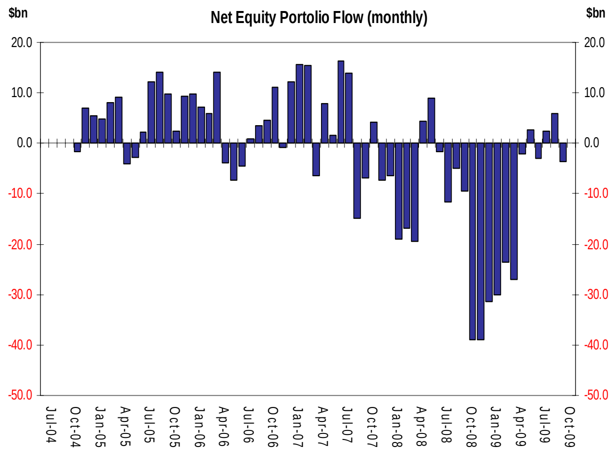
Trend Following Model Positions			
	Signal	Date	Entry Level
USDCZK	short	19-May-09	19.709
USDPLN	short	06-Oct-09	2.868
USDSGD	short	08-Sep-09	1.4337
USDTRY	short	15-Sep-09	1.4939
USDZAR	short	31-Aug-09	7.7525
Net-USD portfolio position			-100%

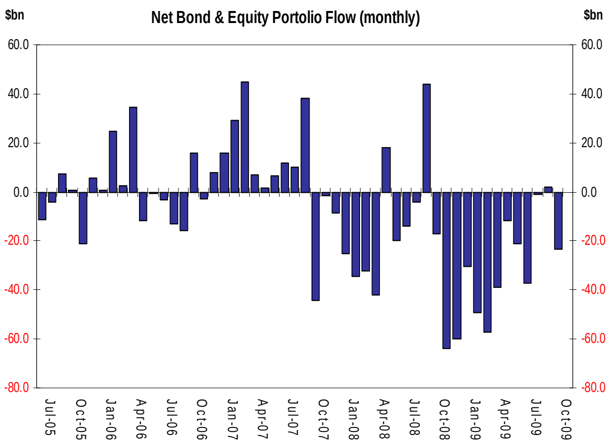
Japanese Yen FX Flows

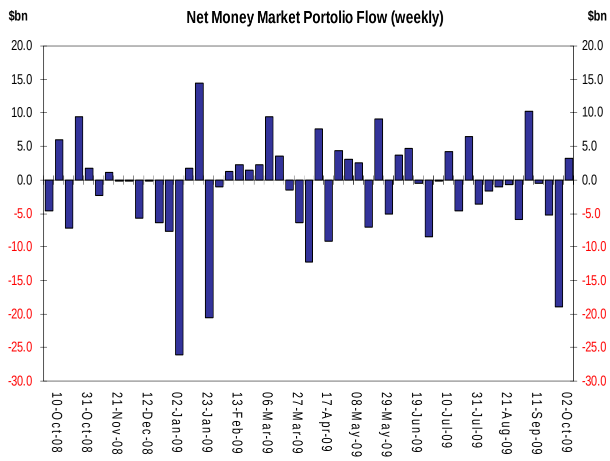












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Market Summary

FX	Close	Daily Change %
EUR/USD	1.4692	-0.21%
USD/JPY	88.610	-0.24%
AUD/USD	0.8912	0.11%
EUR/GBP	0.9201	-0.50%
GBP/EUR	1.0869	0.51%
GBP/USD	1.5969	0.30%
GBP/JPY	141.51	0.06%
GBP/CHF	1.649	0.88%
GBP/AUD	1.792	0.21%
GBP/CAD	1.695	0.49%
GBP/NZD	2.169	0.03%
GBP/NOK	9.083	0.25%
GBP/ZAR	11.869	0.33%
GBP/CNY	10.901	0.31%

Bonds %		bp
US 10Yr	3.182	-7.3
EUR 10Yr	3.118	-4.0
UK10 Yr	3.405	0.4

Other		
VIX	24.68	-3.97%
iTraxx XOVER	572.95	7.0
DJ Agriculture Index	58.52	-0.60%

Equities	Close	Daily Change %
S&P500	1057.58	0.27%
DJIA	9725.58	-0.06%
FTSE100	5108.90	-0.57%
Eurostoxx50	2852.17	-0.47%
Shanghai Composite*	2779.43	0.00%

*latest price

Commodities		%
Crude Oil $/bl	69.57	-1.85%
Gold $/oz	1044.2	0.20%
Copper c/lb	278.0	-0.18%
Silver $/oz	17.57	1.21%
Baltic Dry	2546	4.30%

Swaps %		bp
US 5yr	2.540	-7.9
EUR 5yr	2.642	-3.3
UK 5yr	3.070	-3.1

Official Rates %	
UK	0.50
US	0.25
EU	1.00
Japan	0.10