

Daily Market Strategy

Friday, 23rd October 2009

Market Strategy

Market Strategy Team

Paul Rodriguez
Senior Technical Analyst
0207 158 1744

Kenneth Broux
Market Economist
0207 158 1750

Naeem Wahid
Quantitative Strategist
0207 158 1741
naeemwahid@bostreasury.com

Altaz Dagha
Analyst
0207 158 1747
altazdagha@bostreasury.com

- GBP bid ahead of Q3 GDP, gilts in range
- EUR bulls await PMIs & IFO, ECB's Weber

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/\$: 1.6632, €/\$: 1.5013, \$/¥: 91.68

UK 5y sw: 3.34%, US 5y sw: 2.78%, EU 5y sw: 2.83%

Overnight

- UK Q3 housing starts rise 4% y/y, North shows biggest gains
- Strong French October PMI
- US Treasury plans \$123bn supply next week
- The diminishing dollar, why it's unlikely to turn into a dangerous collapse (The Economist)

The first q/q rise since Q1 '08 in UK GDP this morning is widely anticipated but we are careful not to rush to conclusions for what it may imply for QE or for rates per se. 'It's levels, stupid' is how governor King phrases the still challenging backdrop and with this in mind, the debate about the impact of fiscal and (un)conventional monetary policy will be lively in the run-up to the PBR and November MPC. Based on two months of flat retail sales and dreadful manufacturing data, the obvious skew is for downside risk (bullish for gilts and short sterling, but negative for GBP). Our economists look for a 0.1% gain vs 0.2% consensus. The whisper number of 0.4% - supported by re-stocking - would obviously encourage GBP bulls (GBP/USD bid above 1.66 overnight, GBP/JPY cleared 152) and could trigger a fresh leg of selling in gilts and short sterling. For what it's worth, the error margin for GDP between NIESR and ONS data averaged only 0.2% from Q2-08 to Q1-09, but spiked to 0.8% in Q2-09. The NIESR reported zero GDP growth in the three months to September.

Ahead today: the Oct EU-16 PMIs and German IFO are forecast to show small gains. US Sep existing home sales also feature along with speeches by ECB's Weber and Fed's Bernanke.

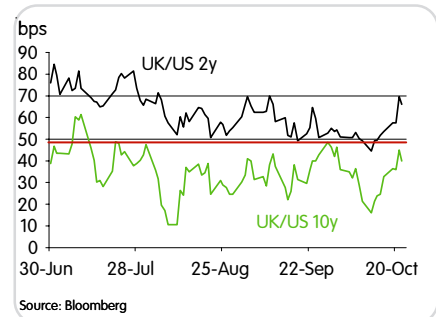
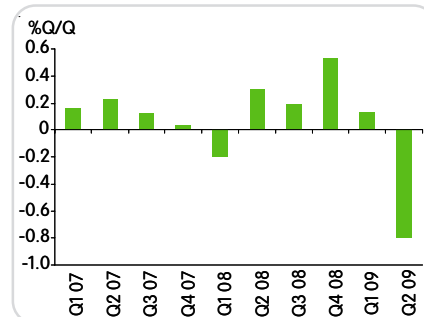
FX: EUR bulls will be tested by the PMIs and German IFO. EUR/USD hit a 1.5060 high overnight but profit taking is a threat if the data disappoints on EUR strength. Support comes in around 1.4937. For EUR/GBP, support is lined up at 0.8998 - Wednesday's low. A UK GDP number stronger than 0.2% could trigger a move to 0.8950.

Rates: UK rates threaten the upper end of the range and this argues for a disciplined approach and light positions going into the 09.30 GDP release. For 5y swaps, 3.43% is the first line of resistance. To the downside, support rests at 3.29%. Beyond GDP, the heavy US supply schedule next week does not bode well for longer duration paper with some concession likely to be priced in (higher yields). Stronger EU and IFO data also pose upside risk for the front end, with 2y bunds threatening major resistance at 1.45%. NRW Bank was the second corporate name to issue in sterling this week. The £300mn 3y issue was priced at 95bps over gilts.

GDP 'error margin' between ONS/NIESR was 0.8% in Q2; average is 0.1% over 2 years

UK/US swap spreads widened considerably this week, but still within ranges

	Close	Daily Change %
FX		
EUR/GBP	0.9044	0.03%
GBP/USD	1.6624	0.09%
EUR/USD	1.5033	0.11%
USD/JPY	91.298	0.36%
AUD/USD	0.9269	-0.25%
Bonds %		bp
US 10Yr	3.413	2.8
EUR 10Yr	3.305	-1.2
UK10 Yr	3.707	16.8
UK 5yr Swap	3.335	-4.5
Equities		%
S&P500	1092.91	1.06%
FTSE100	5207.36	-0.96%
Eurostoxx50	2902.19	-1.18%
Shanghai Composite	3096.81	1.49%
Commodities		%
Crude Oil \$/bl	81.19	-0.22%
Gold \$/oz	1060.1	0.10%
Copper	299.8	-1.25%
Baltic Dry	3001	2.88%
Other		
VIX	20.69	-6.89%
iTraxx XOVER	505.32	8.2



Today's Data

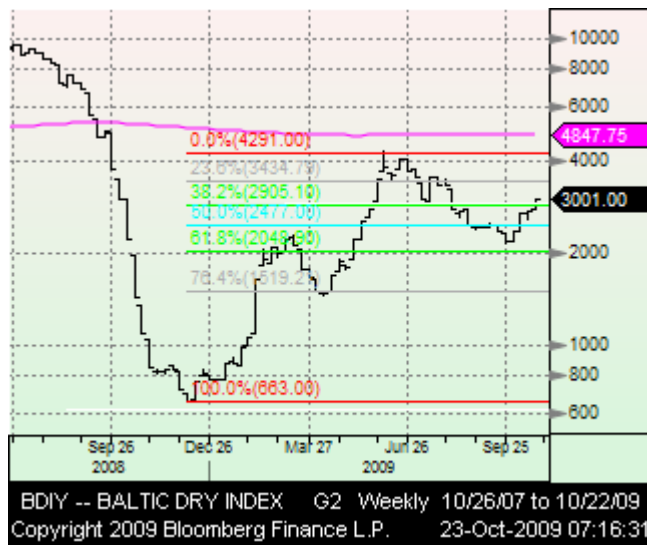
	Time	Consensus	Previous	Events
UK GDP, Q3, prelim	09:30	0.2%	-0.6%	ECB speakers: Weber (10:15)
UK BBA Mortgage Lending, Sep	09:30	39,300	38,095	Fed speakers: Bernanke (13:30), Kohn (16:30)
French Consumer Spending, Sep	07:45	0.6%	-10%	Bank of Canada releases Quarterly Monetary Policy Report (15:30)
EU-16 Manufacturing PMI, Oct	09:00	50.0	49.3	Earnings: Microsoft
EU-16 Services PMI, Oct	09:00	51.3	50.9	
German IFO Survey, Oct	09:00	92.0	91.3	
EU-16 Industry Orders, Aug	10:00	1.2%	2.6%	
US Existing Homes Sales, Sep	15:00	5.40mn	5.10mn	

Technical Analysis

Paul Rodriguez, Senior Technical Analyst

- After spending most of the European session in the doldrums, equities caught a second wind late in the New York session to brighten up the last trading session of the week. Coupled with copper pushing further above 300 c/lb and oil back through \$81.00 (\$81.50), the equity markets did not wait for a written invitation to rally. However, despite the positives, European stocks remain caught in the ranges of the past few weeks and, until a new high is attained, caution will prevail. It is difficult to resist getting drawn into these bullish factors here, but for the moment the bearish technical view will dictate. Short stops in the DAX index futures have been hit over 5,819 and FTSE futures over 5,200 but a potential head and shoulders reversal is developing and this volatility is consistent with a market looking to reverse. We should get further confirmation early next week.
- Sterling continues to hold the limelight with cable approaching the 1.6743 resistance (1.6634), EUR/GBP looking to break 0.8981 support (0.9025) and GBP/JPY continuing to push towards the 153.27 objective. I stay bullish on the pound, but look for a short term top today as profit-taking on this current trend is likely. Again, I had mixed success in the commodity currencies as they took the lead from stocks and rebounded off the lows. Despite this, I remain cautiously bearish on the commodity currencies and bullish on the US dollar (also noted in the FX Strategy Weekly is that 76.00 is where we get a true reversal signal in the DXY). My interest remains in USD/JPY (advocated yesterday) which has now hit key short-term resistance at 91.74. As also noted in the FX Strategy Weekly, the yen has further scope to weaken, with the dollar a prime candidate to play catch-up.
- Yields remain on an upward path in line with the core preferred short term view - UK 10y swaps are using 4.00% as support rather than resistance and US 2y yields have breached 1.00%. UK 10y yields target resistance at 3.80% with 4.00% the year-end

Chart of the day: UK 2y yields - Big barrier at 1.00%



Key Levels

	EUR	GBP	JPY	EUR/GBP	GBP/EUR
R2	1.5287	1.7050	95.15	0.9520	1.1364
R1	1.5063	1.6743	91.74	0.9482	1.1135
Current Spot	1.5006	1.6650	91.85	0.9013	1.1095
S1	1.4845	1.6125	87.14	0.8981	1.0546
S2	1.4407	1.5709	85.00	0.8800	1.0504

Spot prices as of: 07:47:02 Source: Bloomberg

Baltic Dry Index breaks 3,000 and copper pushes further above 300 c/lb. This has given risk appetiite a second wind.

	Spot	Bias	Entry	Target	Stop	Comment/Levels
EUR/USD	1.5018	Bullish	1.4650	1.5287	1.4920	Stop raised.
USD/JPY	91.68	Bullish	90.50	94.00	90.70	
USD/CHF	1.0064	Bearish	1.0360	1.0000	1.0185	
GBP/USD	1.6641	Bullish	1.6125	1.6750	1.6535	Stop hit- main objective close. Rebuy into 1.6580. Same stop.
EUR/GBP	0.9025	Bearish	0.9112	0.8800	0.9075	Stop revised downwards.
GBP/JPY	152.60	Bullish	143.71	153.27	150.85	Stop hit on pullback, but bias still bullish. Main target is close.
EUR/JPY	137.68	Bullish	<u>136.90</u>	138.74	135.80	Entry raised (again).
CAD/JPY	87.24	Bullish	87.20	92.00	86.30	Yen to weaken more than CAD to strengthen.
AUD/USD	0.9275	Bearish	0.9300	0.9000	0.9376	0.9180 stubborn support.
USD/CAD	1.0511	Bullish	1.0450	1.0800	1.0340	Reversing commodity currency trades.
NZD/USD	0.7564	Bearish	0.7585	0.7200	0.7610	
USD/BRL	1.7185	Neutral	-	-	-	Stop hit- Sideline for now.
USD/PLN	2.7773	Neutral	-	-	-	Not sure where this is going- stand aside- tempted by possible USD long - but being whip-sawed.
USD/HUF	176.23	Bullish	176.98	182.00	174.30	Reversing position.

Spot prices source: Bloomberg

ENTRY - Targeted

ENTRY - Active

Quantitative Market Analysis

Naeem Wahid, Quantitative Strategist

The trend following model has not initiated any new positions this morning. The model holds a portfolio that is 56% short USD against developed market currencies and 20% short USD versus emerging market currencies.

US leading indicators were released yesterday, showing a further rise (1%) in the month of September. The annual change in leading indicators is a strong indicator of US equities. I have plotted this in the chart across (with reference to the S&P500) and the relationship between the two is easy to visualise.

Importantly, it should be noted that at the end of September, the chart suggests that the S&P500 was not overbought relative to economic data. This is important given the consensus amongst market analysts that equities have run ahead of the positive sentiment in economic data. This suggests that further upside in equities is possible.

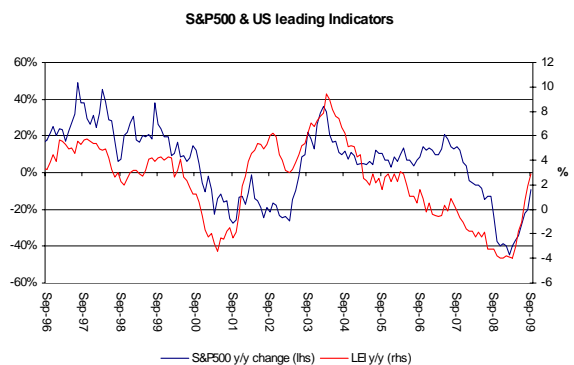
In this context, today's EZ flash estimate PMIs are the data of the day, marking the start of this month's leading indicators. Another increase in the October data would help to sustain the upward moves in both equity and commodity markets. The negative correlation between equities/commodities and the USD would leave the USD vulnerable to another leg lower.

The short-term (one-month) correlation between interest rate spreads and G-10 FX is becoming very strong. In a number of currency pairs it is close to one – see charts on the next page. Interest rate spreads are generally suggesting further downside risk for the USD. Importantly, the RSI suggests that the USD has yet to become convincingly over-sold – suggesting there is still room for the USD negative trend to continue.

Table 1: 1-month correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	EURJPY	AUDJPY
2YRSPD	0.95	0.92	0.80	0.76	0.43	0.85	0.97
10YRSPD	0.72	0.64	-0.43	0.30	0.48	0.60	0.93
S&P500	0.87	-0.79	0.90	0.62	0.45	0.78	0.90
Gold	0.93	-0.94	0.83	0.40	0.06	0.52	0.83
OIL	0.92	-0.77	0.91	0.76	0.46	0.80	0.95
CRB	0.96	-0.80	0.94	0.75	0.46	0.81	0.98

Chart 1: Equities not running ahead of sentiment in economic data

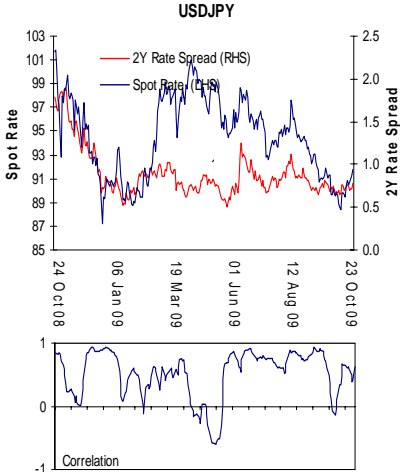
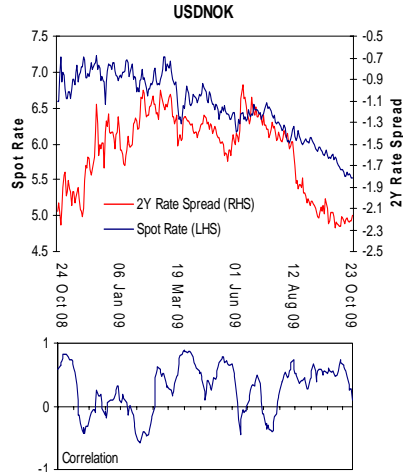
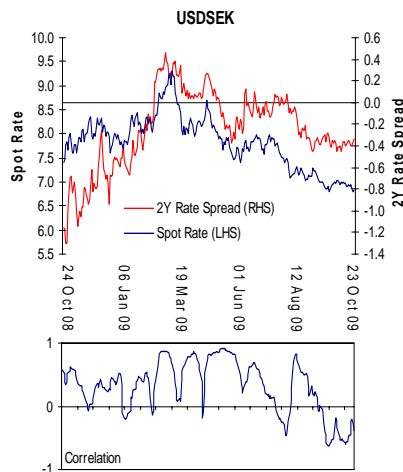
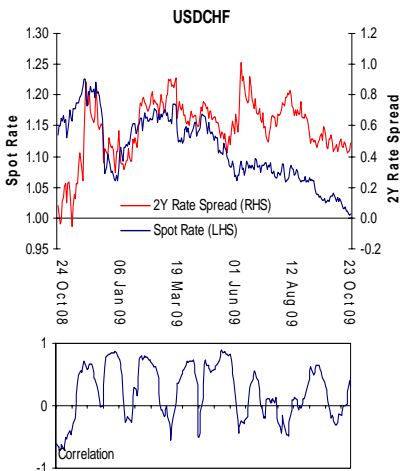
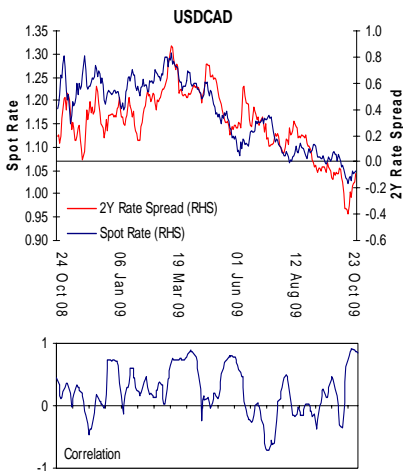
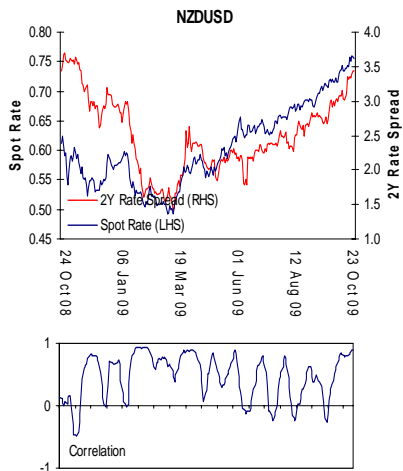
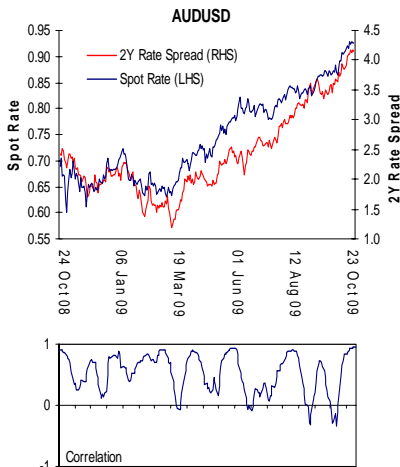
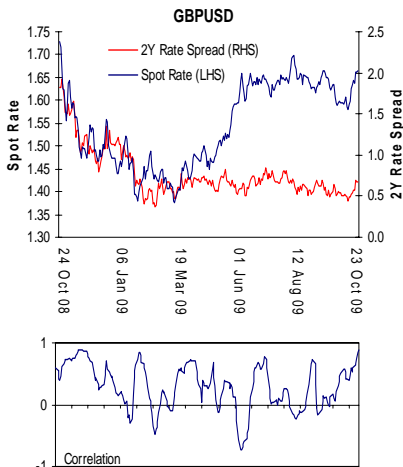
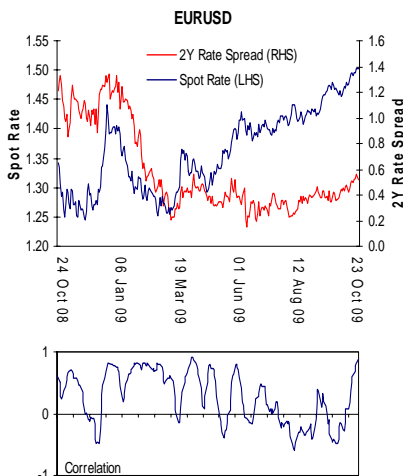


Trend following model signals

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	12-Oct-09	1.5842
USDCHF	short	17-Jul-09	1.0730
USDCAD	long	22-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			-56%

Trend Following Model Positions			
	Signal	Date	Entry Level
USDCZK	long	21-Oct-09	17.260
USDPLN	short	15-Oct-09	2.8237
USD SGD	short	08-Sep-09	1.4337
USDTRY	short	15-Sep-09	1.4939
USDZAR	long	22-Oct-09	7.3665
Net-USD portfolio position			-20%

2yr Interest Rate Spreads vs Spot Rate - 1-m correlations



Market Summary

FX	Close	Daily Change %	Equities	Close	Daily Change %
EUR/USD	1.5033	0.11%	S&P500	1092.91	1.06%
USD/JPY	91.30	0.36%	DJIA	10081.31	1.33%
AUD/USD	0.9269	-0.25%	FTSE100	5207.36	-0.96%
EUR/GBP	0.9044	0.03%	Eurostoxx50	2902.19	-1.18%
GBP/EUR	1.1057	-0.03%	Shanghai Composite*	3096.62	1.48%
GBP/USD	1.6624	0.09%	*latest price		
GBP/JPY	151.77	0.45%	Commodities		%
GBP/CHF	1.6699	-0.06%	Crude Oil \$/bl	81.19	-0.22%
GBP/AUD	1.7937	0.35%	Gold \$/oz	1060.1	0.10%
GBP/CAD	1.7413	0.53%	Copper c/lb	299.8	-1.25%
GBP/NZD	2.1939	0.46%	Silver \$/oz	17.66	-0.18%
GBP/NOK	9.1927	-0.42%	Baltic Dry	3001	2.88%
GBP/ZAR	12.2953	-0.13%			
GBP/CNY	11.3506	0.10%			
Bonds %		bp	Swaps %		bp
US 10Yr	3.413	2.8	US 5yr	2.726	2.0
EUR 10Yr	3.305	-1.2	EUR 5yr	2.805	0.4
UK10 Yr	3.707	16.8	UK 5yr	3.335	-4.5
Other			Official Rates %		
VIX	20.69	-6.89%	UK	0.50	
iTraxx XOVER	505.32	8.2	US	0.25	
DJ Agriculture Index	64.01	-0.44%	EU	1.00	
			Japan	0.10	

This document has been prepared for information purposes only and is based on information believed to be reliable. This information is provided as a courtesy to you and does not create an obligation for Bank of Scotland Treasury ("BoS Treasury") or another Group company within Lloyds Banking Group to notify you of any changes to this data or to do so in the future. Changes in rates of exchange or rates of interest may have an adverse effect on the value or price of these investments. Spot and forward foreign exchange transactions generally are not "designated investments" as defined in the UK Financial Services & Markets Act 2000 ("the Act") and therefore do not benefit from any of the protections contained either in the Act or in the rules of the FSA. Past performance is not necessarily a guide to future performance. This document has been written with market professionals in mind and recipients should seek guidance and advice from a suitably qualified professional if they find anything contained herein confusing or unclear. The distribution of this document in other jurisdictions may be restricted by local laws and recipients into whose possession this document comes should inform themselves about, and observe any such restrictions. This information has been provided for the use of the recipient only and must be treated as proprietary and confidential information. It may not be passed on or reproduced in whole or part under any circumstances without express written consent from BoS Treasury. Although the information contained herein is believed to be correct, Lloyds Banking Group does not guarantee its reliability or its accuracy. Opinions expressed are subject to change without notice, as are prices and availability, which are indicative only. In preparing this publication we have not considered your objectives, financial situation or needs. Appropriate independent advice should be obtained before making any such decision. Lloyds Banking Group specifically disclaims liability for any loss, claim or damage suffered by you or any third party resulting directly or indirectly from any use you may make from this data without limitation. Provision of this information does not constitute either a bid or offer to undertake any transaction or commitment by any Lloyds Banking Group company to make such an offer. Lloyds Banking Group or its employees may own or build positions or trade in such securities and derivatives and may also sell them whenever considered appropriate. Lloyds Banking Group may also provide banking or other advisory services to any company mentioned herein.

Bank of Scotland Treasury is a division of Bank of Scotland plc which is part of Lloyds Banking Group. Registered Office: The Mound Edinburgh EH1 1YZ. Registered in Scotland. Registered No SC 327000. Authorised and regulated by The Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. Australian residents please note: In Australia, Bank of Scotland plc is registered as a foreign company, Australian Registered Body Number 126 955 557. The liability of its members is limited.