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FX Strategy Weekly

Market Strategy

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Market Outlook

The dollar index recovered all of its early April losses this week, clawing its way back up over 82.0. We look for the index to stay supported near term, possibly aided by the FOMC next week. Though the words 'extended period' should stay in the FOMC statement next Wednesday, a more upbeat read on the economy and possible commentary on the timing of asset sales could bolster dollar sentiment. GBP crosses continue to trade quite well this month, shrugging off concerns of a hung Parliament and outperforming vs virtually all G10 currencies except the CAD. Above forecast UK March CPI data, arguably tempered by a below forecast 0.2% q/q increase in Q1 GDP, supports our view that the BoE may change tack in May as it revises up its inflation projections vs February. A departure from the ultra-dovish policy stance appears increasingly likely and could offset some of the prevailing bearish influence associated with the outcome of the general election. Though profit taking ahead of May 6 is probable, a bear flattening of the short sterling curve argues for buying GBP dips. We remain medium-term EUR bears and favour selling a relief bounce vs the G10 until details of a Greece bailout including a possible debt restructuring are published. The exposure of several EU states to Greek debt and fears of contagion through the periphery cloud the near-term outlook and should keep the single currency on the back foot.

Recap

- The JPY overtook the EUR as the worst performer of the week in the G10, with higher stocks promoting short JPY exposure vs high yielders and commodities. CAD/JPY finished the week up 3.2%, followed by NZ$/JPY (+2.9%). The EUR shed further ground as Greek bonds slumped and the cost of insurance against Greek default surged to a new record high. An EU/IMF bailout now only appears a matter of time and should help Greece past the 8bln eur debt refunding in May. GBP experienced a mixed performance, losing 1.1% vs the CAD and 0.9% vs the NZD, but ended the week 2% higher vs the JPY and 1% vs the EUR.

- UK inflation data surprised to the upside in March. CPI accelerated to 3.4% y/y vs 3.0% and RPI rose to 4.4% y/y from 3.7%. Q1 GDP came in below forecast at 0.2% q/q, whilst the March claimant count rate fell to 4.8% from 4.9%. March retail sales rose a smaller than forecast 0.4% m/m. Public finances figures showed a smaller than expected rise in FY 2009/10 public borrowing to £152.8bln, £13.2bln below the Treasury forecast.

- UK 5y swaps broke out of their narrow trading range, climbing above 3.0% to a two-month high (3.06%). The 2y/10y swaps curve bear flattened below 220bp to 215bp, with 2y/10y cash narrowing through 280bp. Short sterling sold off across the strip, with Dec-10 dropping below key 98.84 level, setting course for 98.78 trendline.

FX	Close	Weekly Change %
GBP/EUR	1.1490	0.98%
GBP/USD	1.5358	-0.03%
GBP/JPY	144.66	2.15%
GBP/CHF	1.6499	1.19%
GBP/AUD	1.6609	-0.09%
GBP/NZD	2.1502	-0.89%
GBP/CAD	1.5409	-0.96%
GBP/NOK	9.0482	-0.19%
GBP/SEK	11.01	-0.17%
EUR/USD	1.3366	-1.01%
USD/JPY	94.19	2.19%
AUD/USD	0.9248	0.05%
NZD/USD	0.7143	0.82%
USD/CAD	1.0033	-0.94%
USD/SEK	7.1681	-0.10%
USD/NOK	5.8914	-0.11%
USD/CHF	1.0742	1.21%
Swaps %		**bp**
2yr	1.762	23.0
5yr	3.063	20.0
10yr	3.912	9.0
Equities		**%**
FTSE100	5723.65	-0.35%

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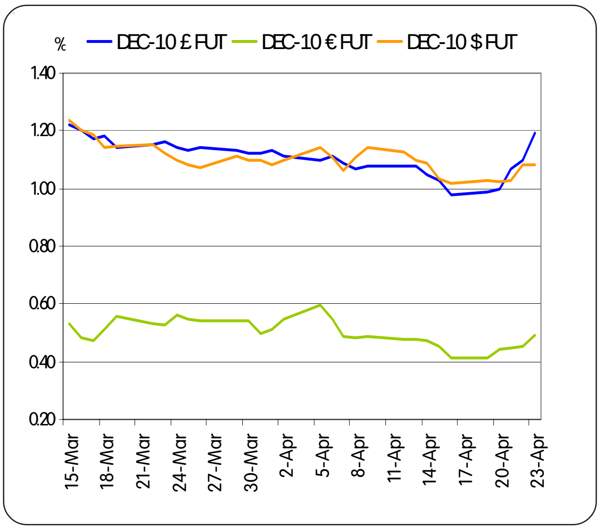
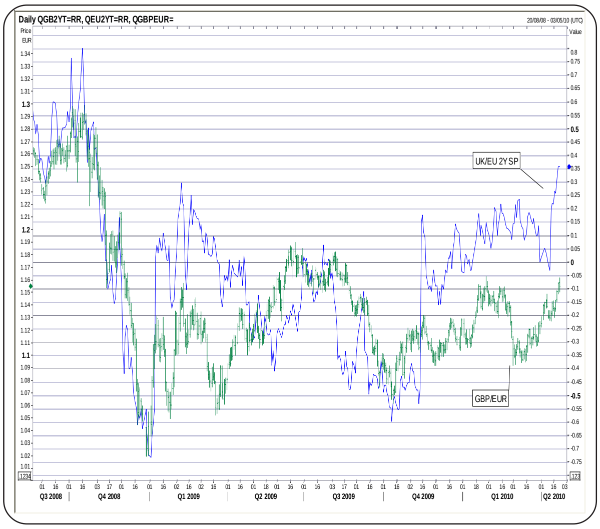
Implied GBP futures are adjusting BoE policy expectations



Good traction for GBP/EUR from 2y spreads



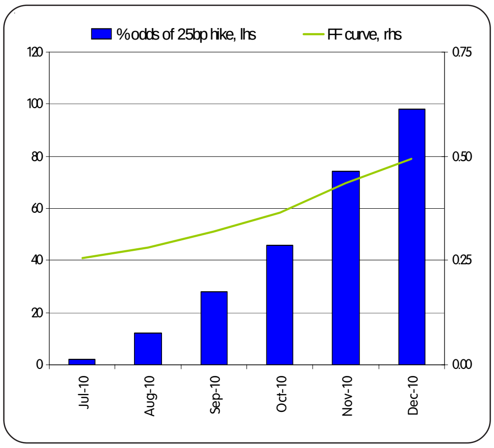
USD

• The dollar index has slowly recovered from the stumble to an 80.03 low in early April, clawing its way back up over 82.0. We look for the index to stay supported and extend gains, possibly aided by the FOMC next week, with the highs of 25 Mar (82.24) and 18 May-09 (83.22) the obvious targets. EUR weakness and follow through buying in USD/JPY back our bullish near-term view, with the latter rallying on a re-widening of the US/JAP 10y rate spread above 250bp and the resumption of JPY investment outflows.

• Based on Fed chairman Bernanke's salvo of comments to Congress earlier this month, the FOMC meeting should not change the language of the statement on Wednesday April 28 and instead leave intact the view that interest rates can stay low for an 'extended period'. Having said this, we look for the dollar to possibly draw some strength from a more upbeat read on the economy, with the FOMC statement echoing the Beige Book (11/12 Districts reported improved activity). We look for Hoenig to have dissented for a 3rd successive meeting. Asset sales have previously been discussed in the FOMC minutes, but speculation that a decision may be near was reported by CNBC newswires on Friday and could bolster dollar sentiment if confirmed.

• Consumer confidence on Tuesday and the advance estimate of Q1 GDP on Friday dominate the data calendar. A surprise drop in the Michigan confidence survey exposes downside risk for the Conference Board survey and could add some flight-to-quality support for the USD. The economy is forecast to have expanded 3.5% y/y annualised in Q1. The Treasury will sell \$11bln 5y TIPS (Monday), \$44bln 2y (Tuesday), \$11bln 5y (Wednesday) and \$32bln 7y (Thursday).

Will they or won't they: 'extended period' to stay?



EUR

• Sovereign funding pressures within the euro zone continue to hijack the debate about the broader state of the economy and are responsible for the latest round of weekly EUR losses vs all G10 currencies. It remains unclear at this juncture what will stabilise bearish sentiment. Considering the market's fixation with wider ramifications for credit and bond spreads, we see very little merit in reversing our bearish tactical view and recommend selling EUR/G10 rallies. A more cautious approach is advised vs GBP as we move into the final straight to the May 6 UK election.

• Though politically and financially the details of an EU/IMF loan programme have been agreed, the finer details of the execution and conditionality of the loans (reduced cost of borrowing at what price of fiscal reform?) are currently worked on in Athens by an EU/ECB and IMF delegation. A unanimous agreement by the 15 EU member states is then required to activate a formal request by Greek authorities. It is unclear whether a formal request for aid can trigger a relief bounce in the EUR, or instead leads currency/credit markets to switch attention to other high deficit EU countries. A rescheduling of Greek debt payments could be considered.

• Greece's access to capital markets for longer-term funding remains of crucial importance to the near-term EUR outlook. An estimated 8.5bln eur of 10y Greek bonds mature in the second half of May. A victory of German Chancellor Merkel at the May 9 NRW Westphalia regional election could give EUR/G10 a temporary lift.

• EUR/USD 1mth risk reversals slumped from -1.30 to -1.65 (favouring EUR puts) reflecting the bearish price action in spot. EUR/GBP 1mth risk reversals have dropped to 0.26 from over 1.40 about a month ago. Our medium target for EUR/USD is 1.30. We look for a relief rally to fizzle out in the 1.3545 area. Trendline resistance for EUR/JPY is situated at 127.0.

GBP

• GBP crosses continue to trade higher vs the start of the month, outperforming vs virtually all G10 currencies except vs the CAD. GBP/CHF is up 3.4% so far vs the CHF and 2.7% vs the EUR. Above forecast March CPI data, arguably tempered by a below forecast 0.2% q/q increase in Q1 GDP, supports our view that the BoE may change tack in May as it reviews its earlier projection for inflation to fall back to target by year-end. A departure from the ultra-dovish policy stance in May appears increasingly likely and could offset some of the prevailing fears of a hung Parliament.

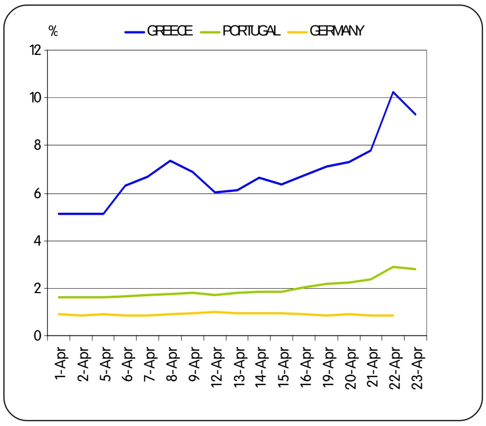
• GBP crosses held up in the wake of the weaker Q1 GDP release, demonstrating a sense of caution among participants of not being short. Though election polls have narrowed after the 2nd Party leader debate, a less pessimistic assessment by Moody's of a coalition government on Britain's public finances may have helped bearish sentiment to dissipate, though commitment to retest 1.5525 in GBP/USD has so far failed to materialise. As outlined on these pages last week, a GBP relief rally cannot be rued out after May 6.

• Positive developments in UK/G10 rate differentials led through UK/EU 2y spreads (see chart) are supported by positive UK data surprises (see chart). A further increase in the correlation of GBP/USD with risk assets also partially explains the resilience of GBP vs the broader G10. Though profit taking ahead of May 6 is probable, we still favour buying GBP dips with a greater emphasis on GBP/AUD after a technical break of 1.6669 following the latest RBA comments (interest rates 'close to average').

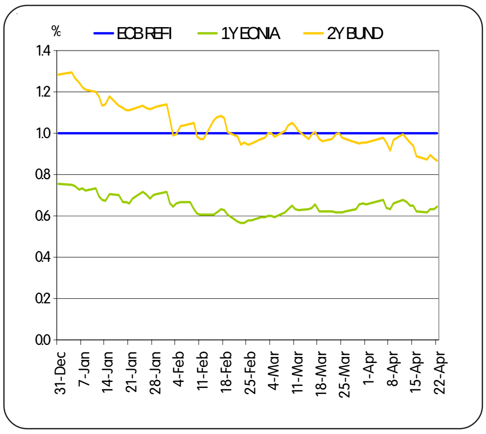
• For EUR/GBP a slide below key trendline support at 0.8670 has set our sights on 0.8578, the 38.2% Fibo retracement of 0.7809-0.9809. Profit taking in the wake of an EU/IMF relief for Greece and pre-election covering threaten to squeeze the cross back up to 0.88 before May 6 where new buyers should emerge.

• A quiet week for UK data and central bank events will be entirely eclipsed by the 3rd and final Party leader debate. BBA mortgage lending for March, Nationwide house prices and CBI distributive trades survey all feature but are second-tier.

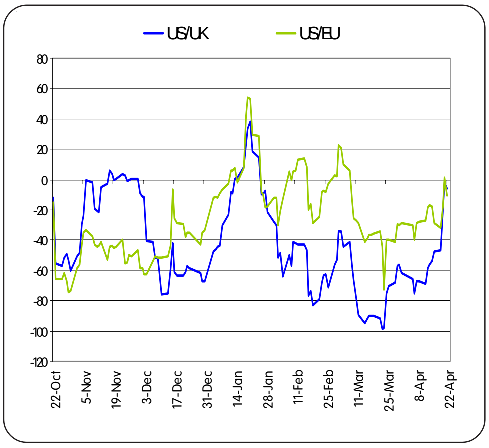
EU peripheral bond yields: from bad to worse



Euro interest rates: going nowhere



UK economic surprise idx: leading US and EU



UK/EU 2y spread: targeting 40bp

Quantitative Market Analysis

- **Long AUD, CAD vs short JPY contracts hit 180,000**
- **GBP/USD correlation with equities highest since Oct-08**

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.

Confirmation of the recent trend was observed in terms of IMM positioning with regard to GBP. A 3rd successive drop in overall shorts pulled the number of short contracts below 70,000 for the first time since February. Reported short positions fell to 57,000. Non-reported positions dropped to -11,000. Short EUR positions fell for a 2nd straight week, with the overall level of short contracts now 32,000 below the level of two weeks ago. We suspect some of that may have been unwound following the latest episode in the Greece rescue saga and the pullback in EUR/USD below 1.33. Positioning against the JPY rose for a 6th successive week, with the total amount of short contracts snowballing to a whopping -80,000. Taking a cue from this week's price action in USD/JPY (rally through 94.0), there are reasons to believe that JPY shorts now stretch even further.

There was no change in the balance of appetite for the AUD and CAD, with both currencies attract strong demand and long contracts vs the USD now both topping 100,000. As a result, the spread between AUD and CAD longs vs JPY shorts surged to 180,000, underpinning AUD/JPY above 86.0 and CAD/JPY above 93.0. The US DXY index nudged back over 82.0 this week on EUR and JPY selling, the two biggest constituents of the DXY. With all of April's losses erased, the DXY looks set to revisit the March high of 82.24. The level above that is situated at 83.22. The FOMC meeting next Wednesday will obviously be key to near-term direction. If there is any change in the statement, we think it may relate to the timing of asset sales rather than 'extended period' to phrase the outlook for a low Fed funds rate.

EUR/USD risk reversals reached extreme levels (below 25% percentile, favouring EUR puts) but also manifested itself in NZD/USD and AUD/USD, suggesting that both AUD and NZD long positions may be stretched. With the EUR still subject to the ebb and flow of Greek bond yields, drawing conclusions over stretched EUR short positions may be premature. We reiterate our bearish EUR/USD view (1.30 MT target) and preferred tactic of selling rallies ahead of the German regional election in NRW on May 9. Though a relief rally in EUR crosses emerged late on Friday, we think gains will be short-lived until the terms and conditions of a bailout and/or debt restructuring are clear. For GBP/USD, uncertainty surrounding the UK election took a breather this week but will return to the forefront of investor minds next week. UK macro data is second-tier and means the final election Party leaders debate and subsequent poll swings will take centre stage.

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	0.35	0.60	0.28	0.17	0.68	0.35	0.18
10 YR SPD	0.47	0.51	0.04	0.27	0.63	0.50	-0.17
S&P500	**0.81**	**-0.82**	0.23	**0.88**	0.23	0.64	0.31
Gold	**0.89**	**-0.83**	0.35	**0.91**	0.37	**0.78**	0.50
Oil	0.75	**-0.82**	0.34	0.70	0.66	**0.87**	0.71
Relative Yield Curve	-0.50	0.71	0.24	-0.30	0.05	-0.23	0.27
CRB	**0.86**	**-0.88**	0.42	**0.88**	0.54	**0.86**	0.67

Short-dated implied volatility rose in EUR/USD, GBP/USD, USD/CHF and USD/CAD, leading to flatter 1mth/1vol curves, Short-dated vol fell for USD/JPY, pushing the vol spread back above 2.50.

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).

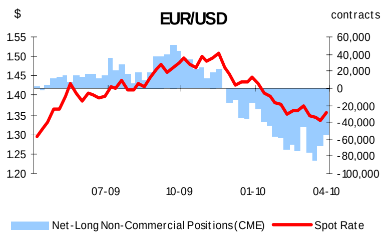
1-month correlations between 2y interest rate differentials show no major change vs last week and as a result offer no statistical significance with regard to short-term trends. The correlation of AUD/USD and USD/JPY with 10y differentials broke down vs last week, offering no guidance either for near-term performance for respective currency crosses.

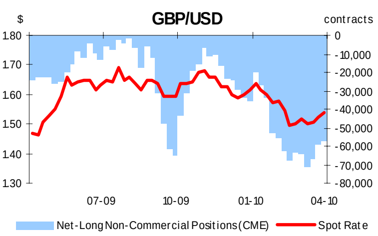
In terms of correlation with risk assets (S&P 500), the correlation in GBP/USD edged up to 0.88 vs 0.76, making equities an increasingly powerful gauge for direction in GBP/USD. Correlations in USD/NOK and USD/SEK remain flat, but above historical norms for AUD/USD and USD/CAD.

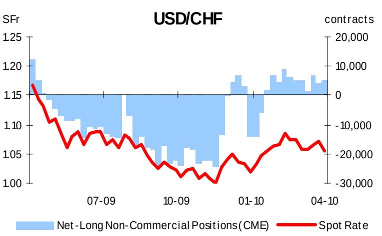
The major disconnect of EUR/USD with the EU/US economic surprise index is striking (see chart) and demonstrates how problems in Greece are currently overshadowing the improved state of the EU economy and the scale of recent surprises (IFO, etc) relative to the US.

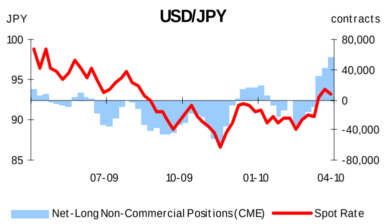
FX & Commodity Futures Positioning

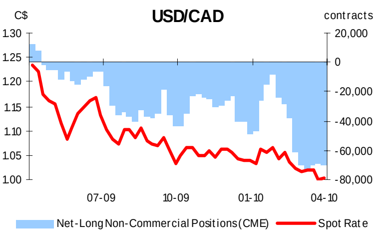
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

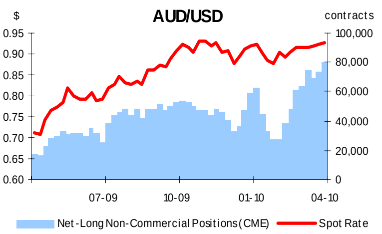


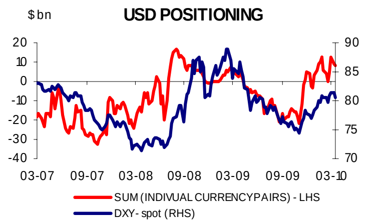


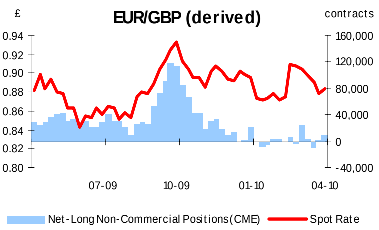


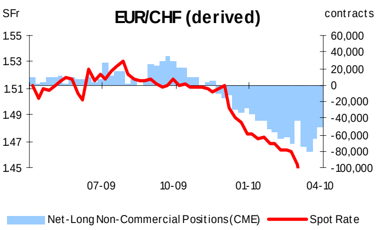


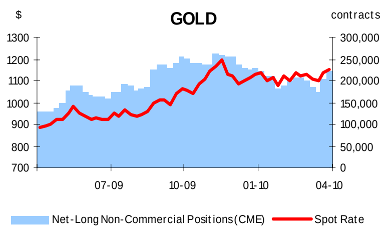


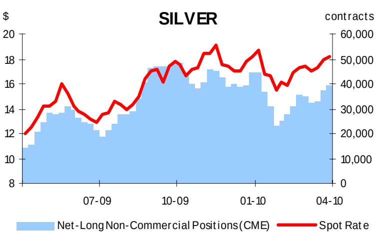


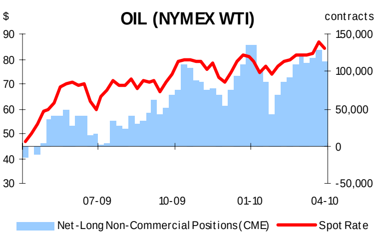


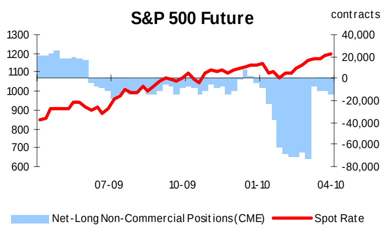


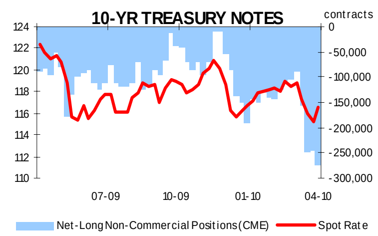


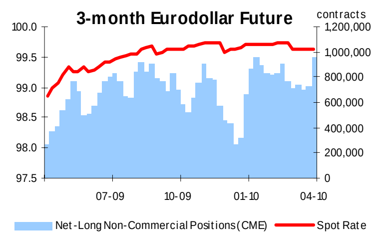






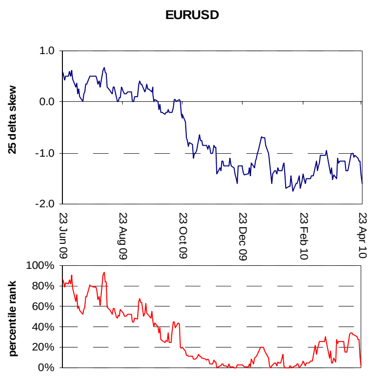


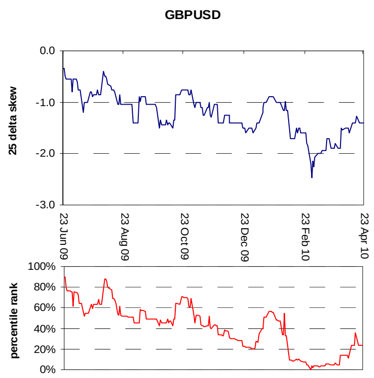


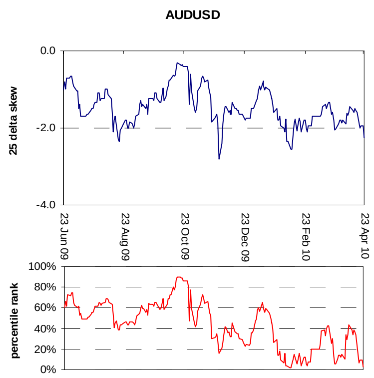


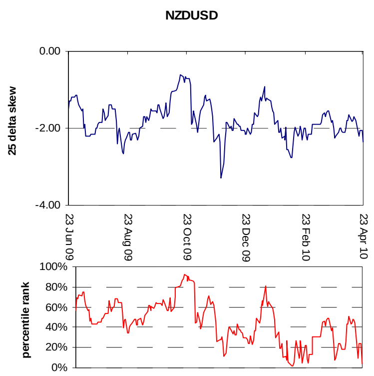
FX Options: Risk Reversal Skews

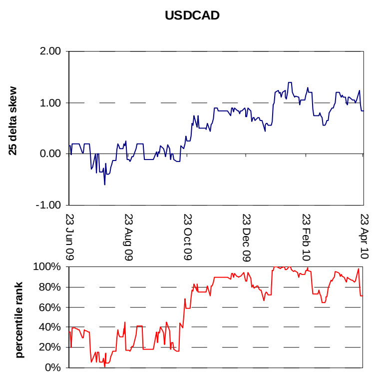
The risk reversal skew is the difference in volatility between similar out-of-the-money call and out-of-the-money put options. A positive risk reversal means that the implied volatility (used for pricing) of the call is greater than that of the put. In this section, the skew is based on 1-month 25 delta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

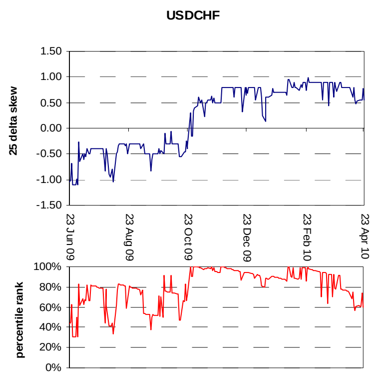


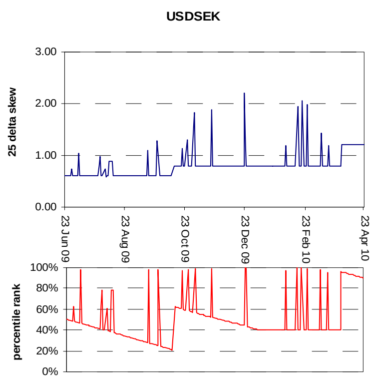


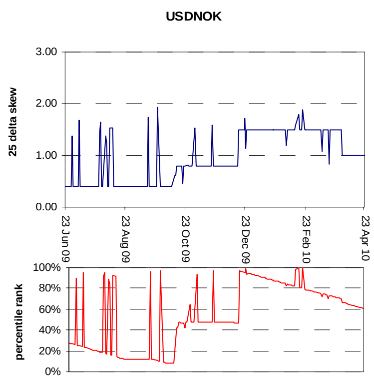


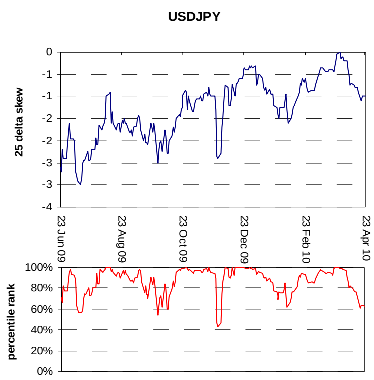






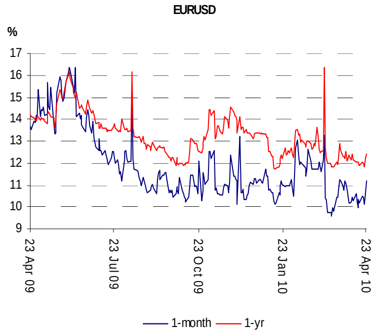


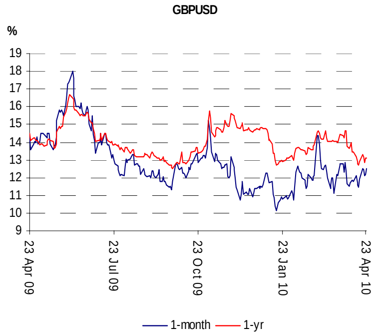


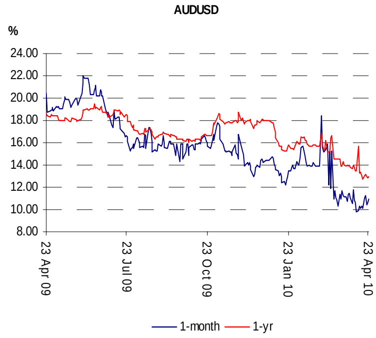


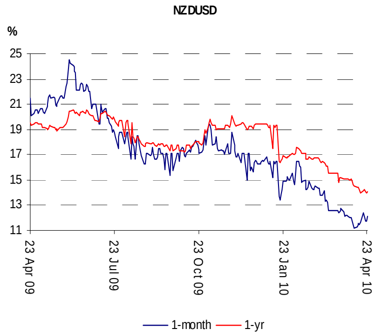
FX Options: Implied volatility

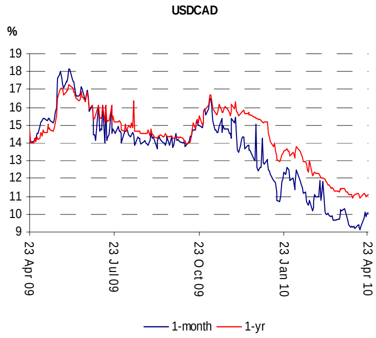
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

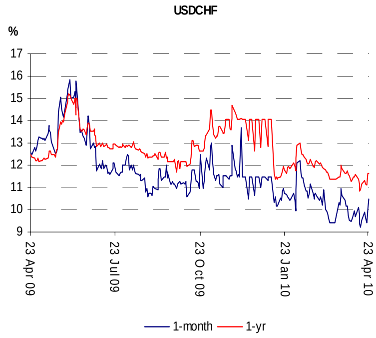


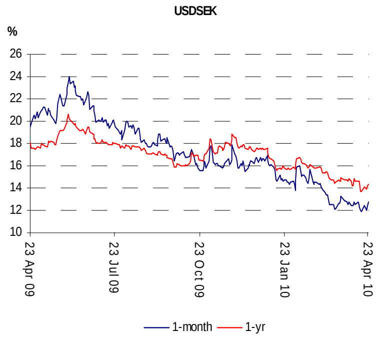


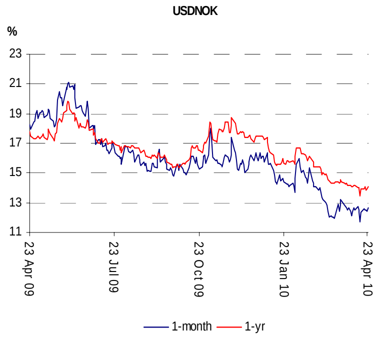


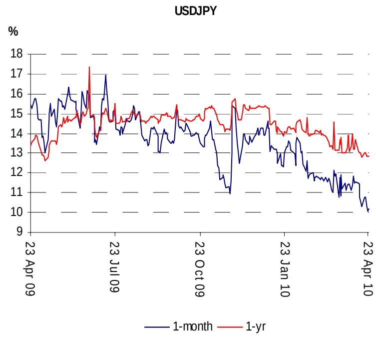






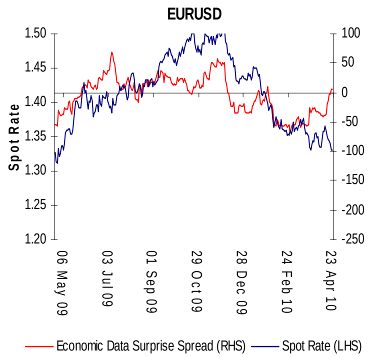


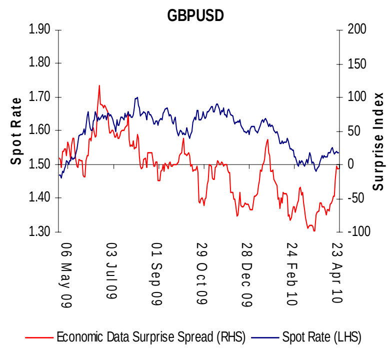


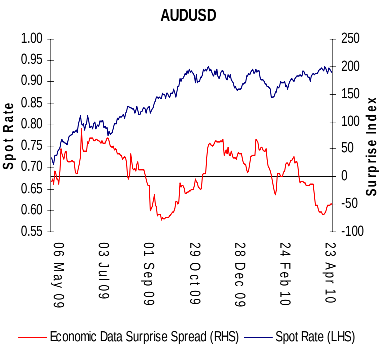


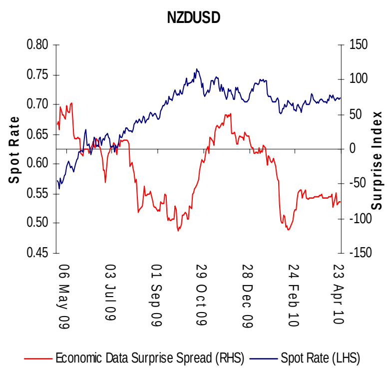
Economic Data Surprises

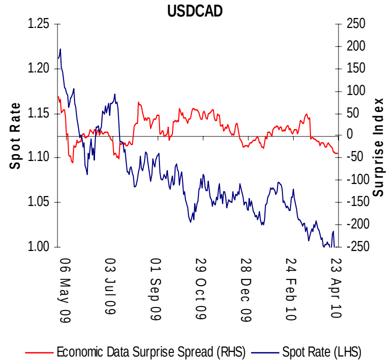
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

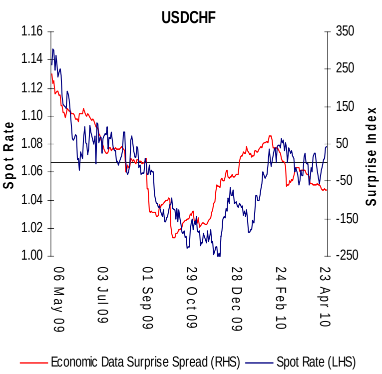


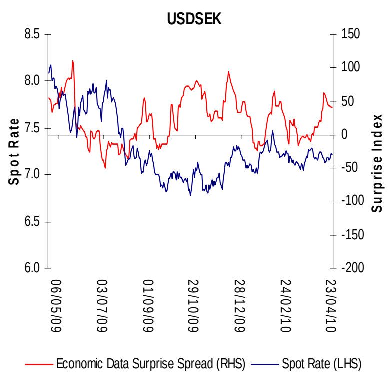


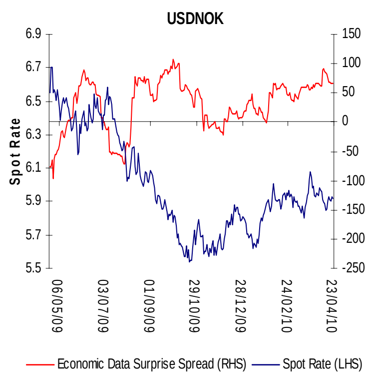


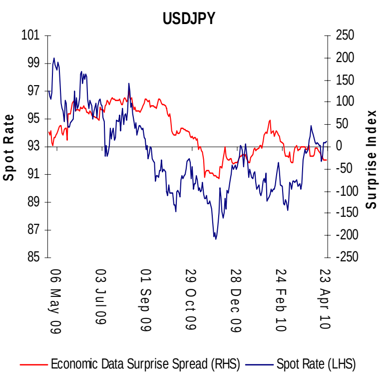






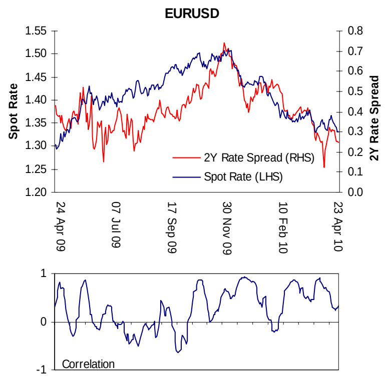


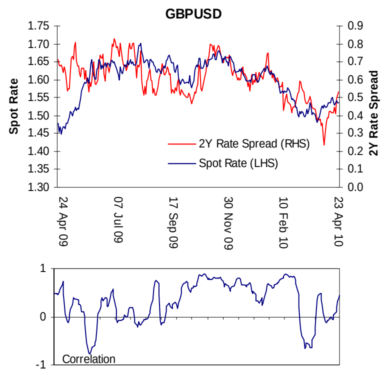


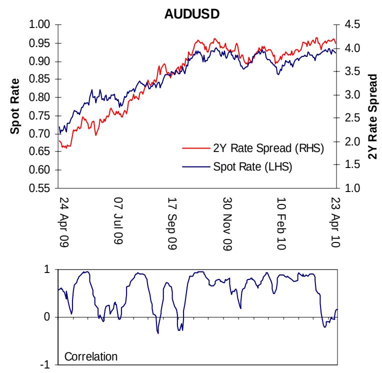


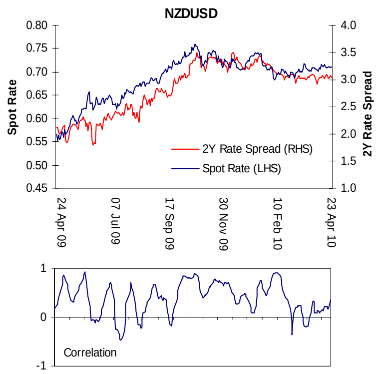
Interest Rate Spreads vs. FX

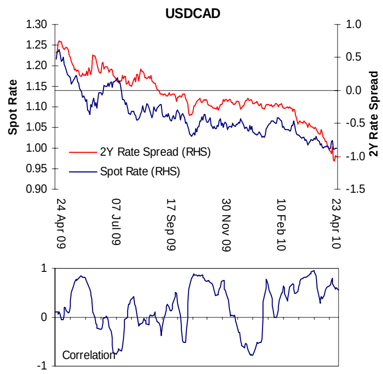
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

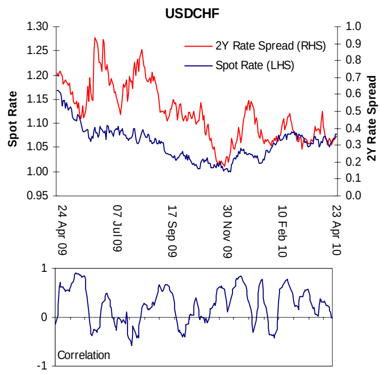


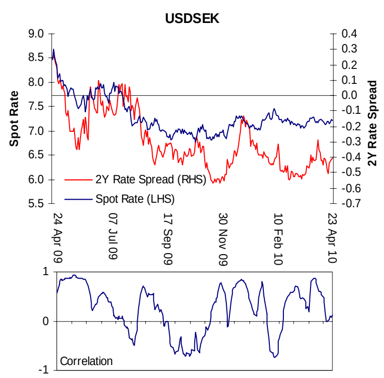


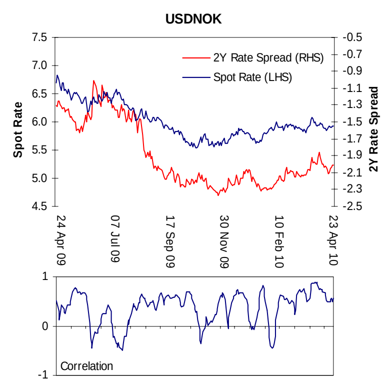


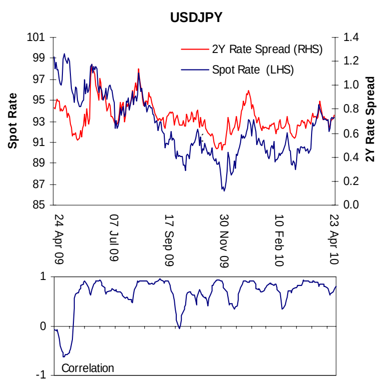






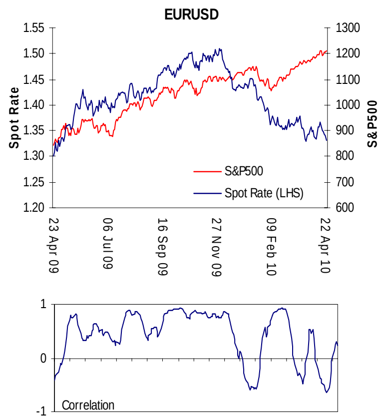


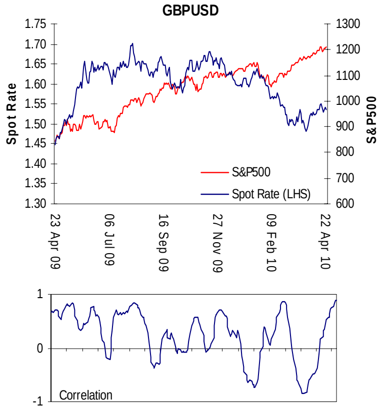


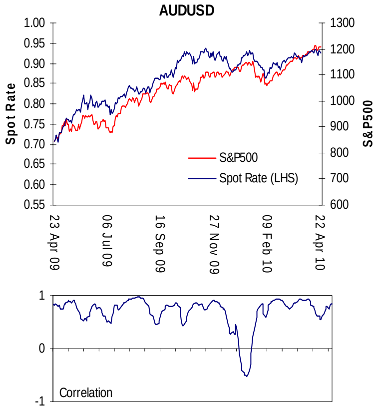


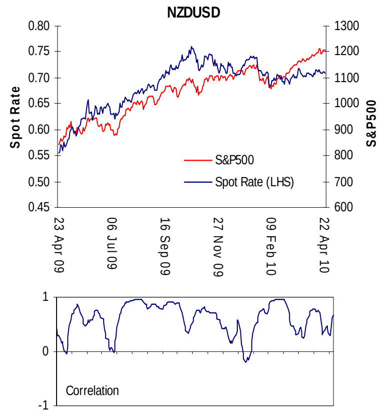
S&P500 vs. FX

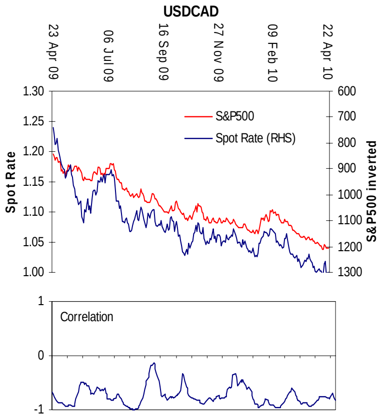
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

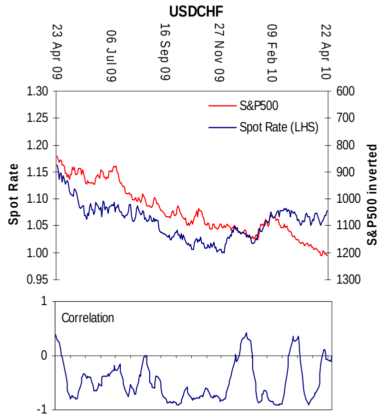


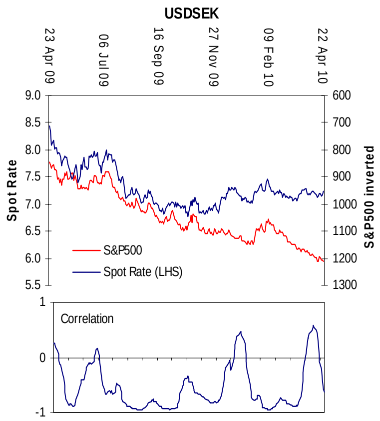


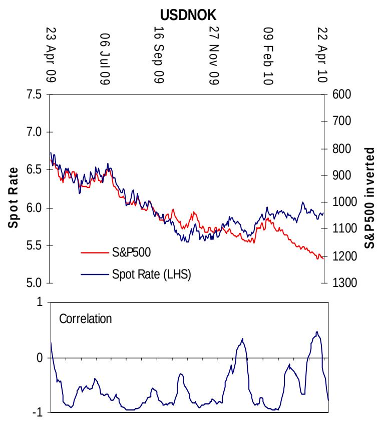


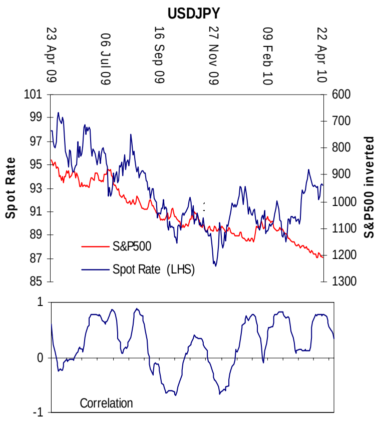






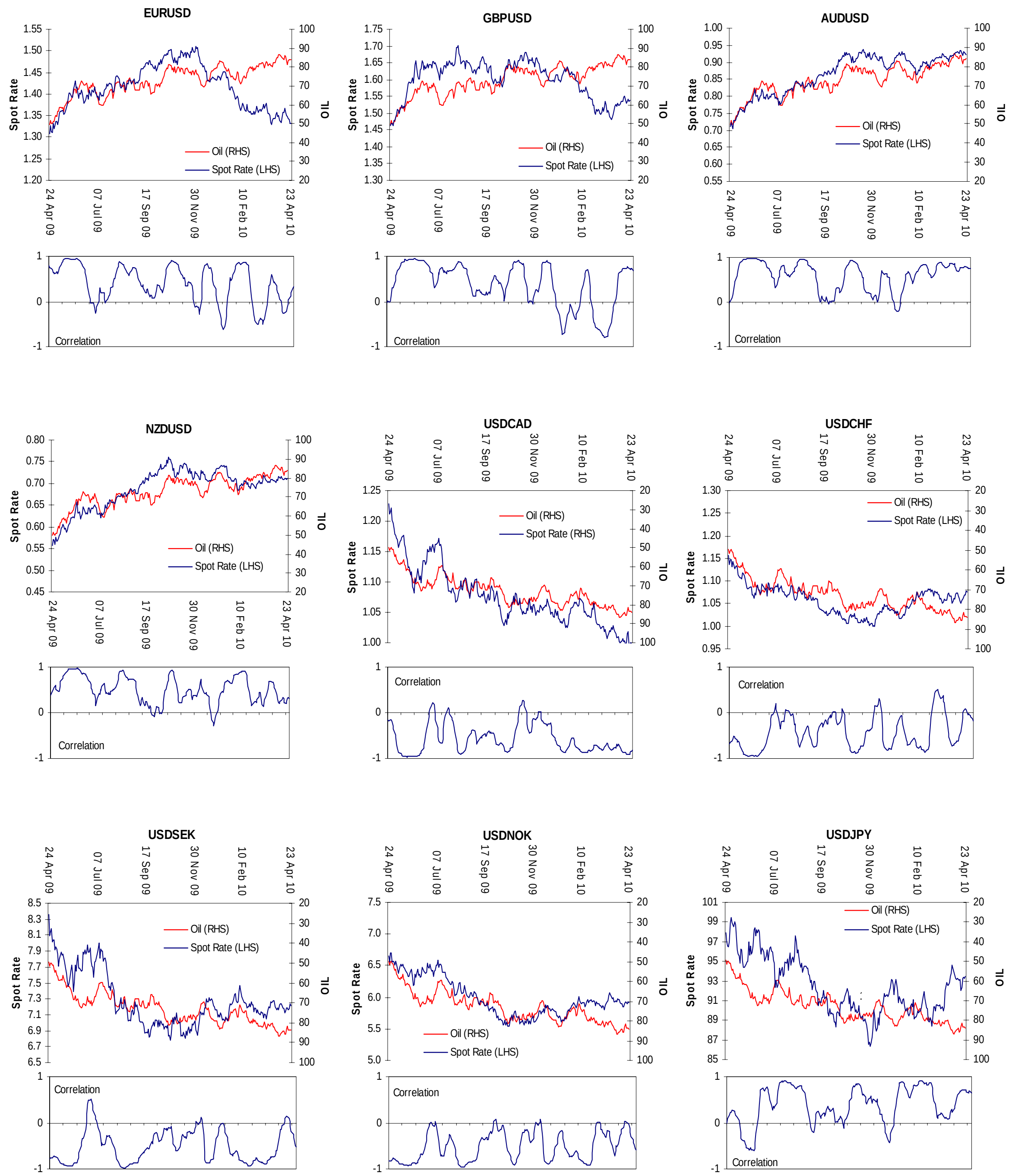






Commodities vs. FX

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.

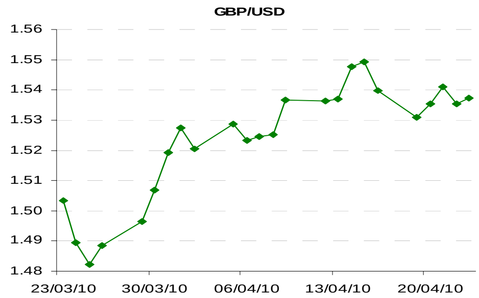


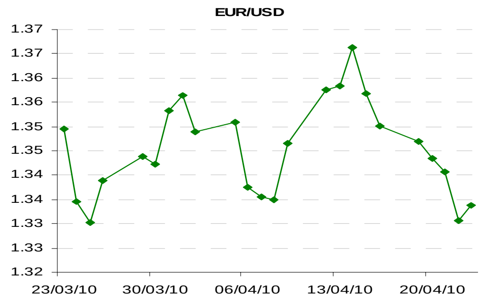
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

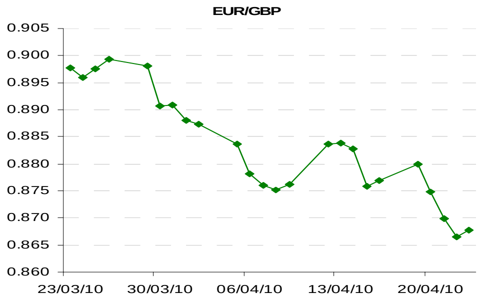
Lloyds TSB | Corporate Markets

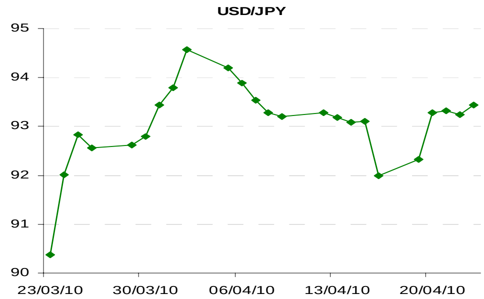
Market Review

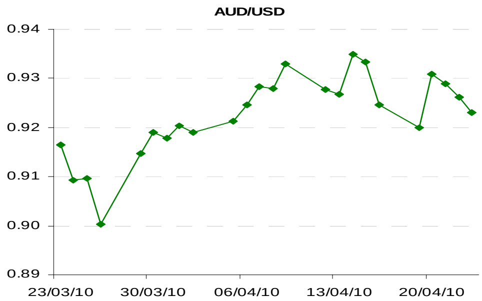
Short-term G-10 FX Charts

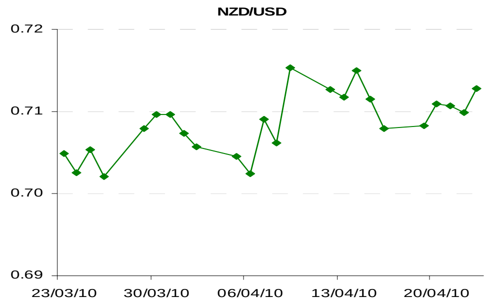


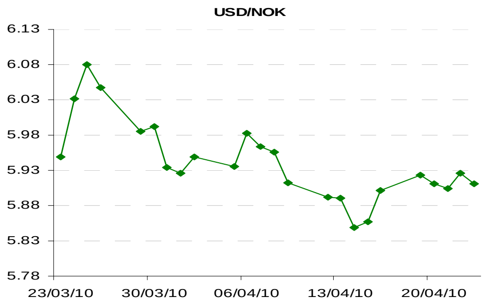


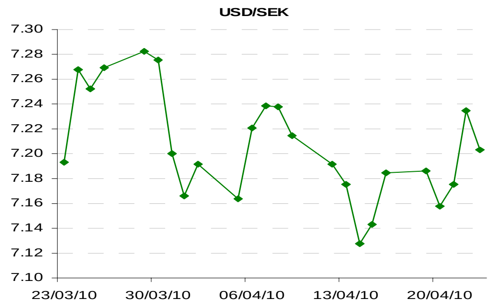


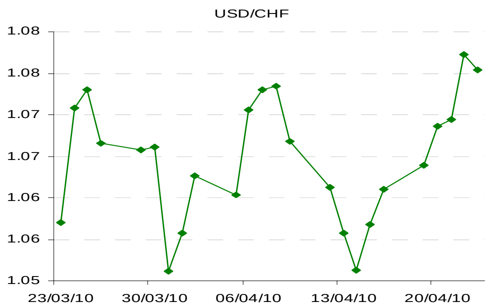


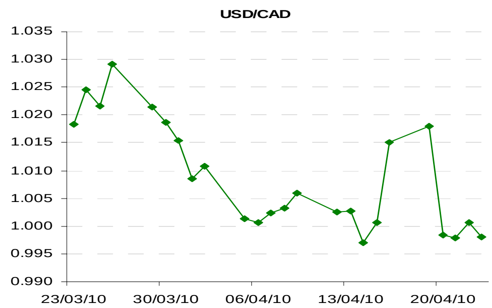




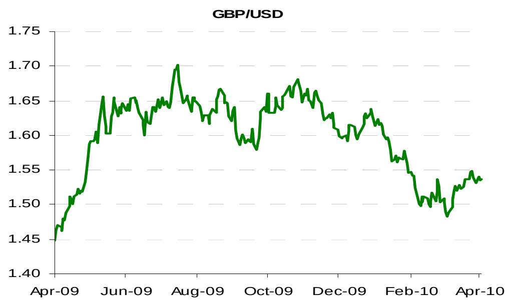


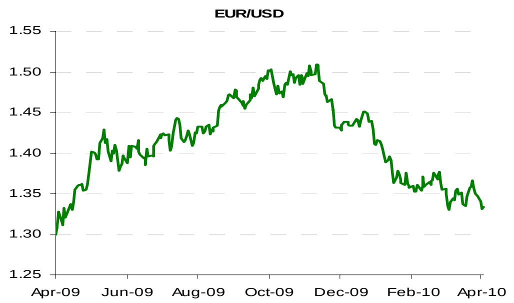


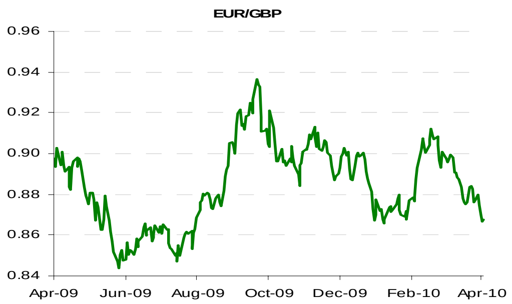


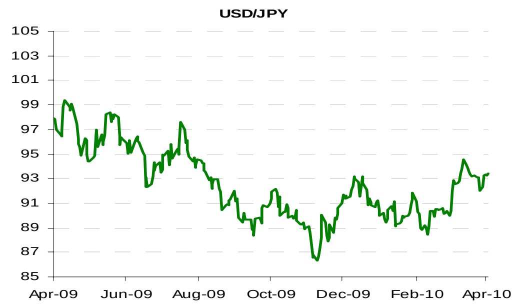


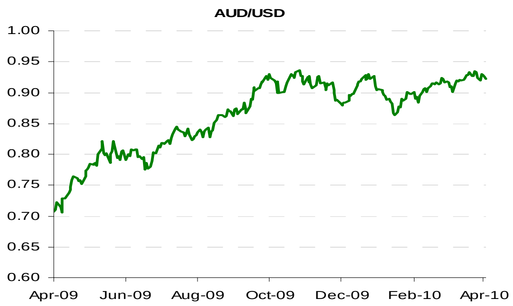
Medium-term G-10 FX Charts

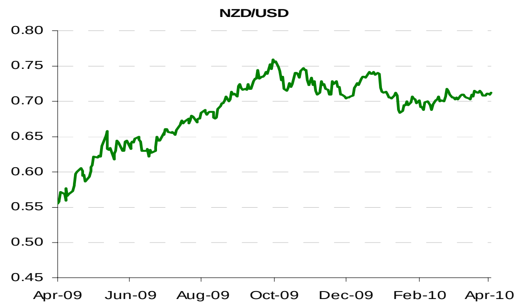


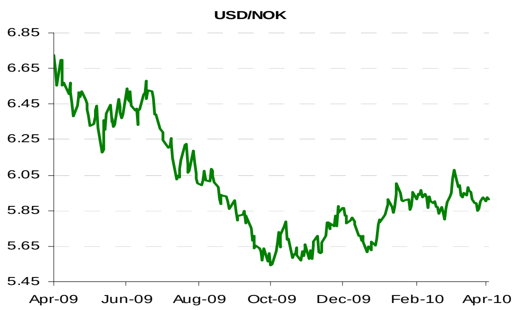


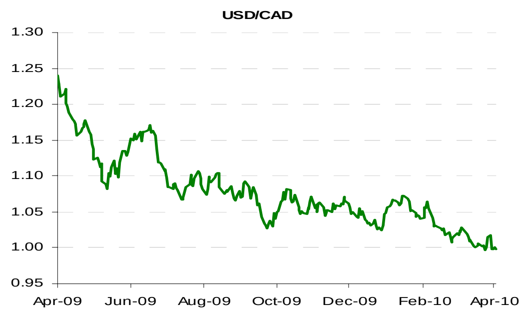






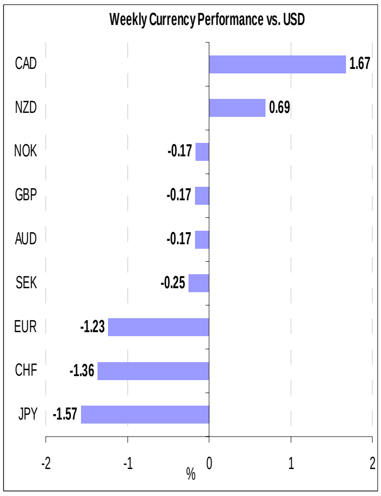


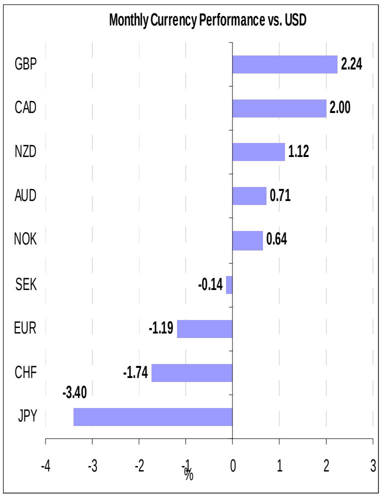


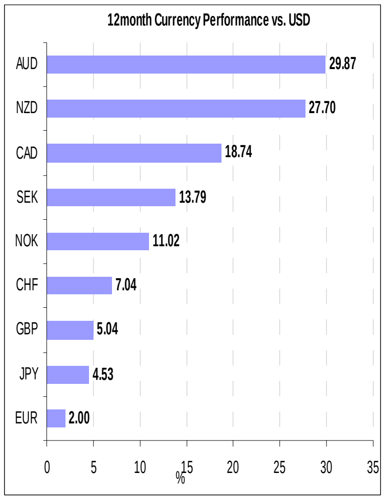


FX Snapshot

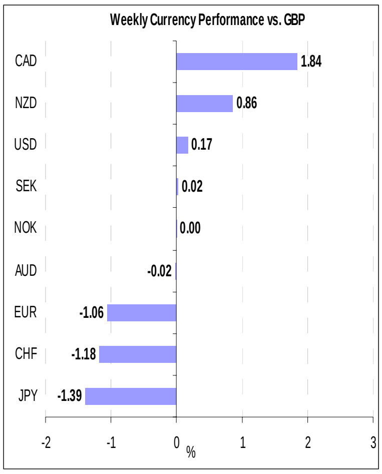
Currency performance vs. USD

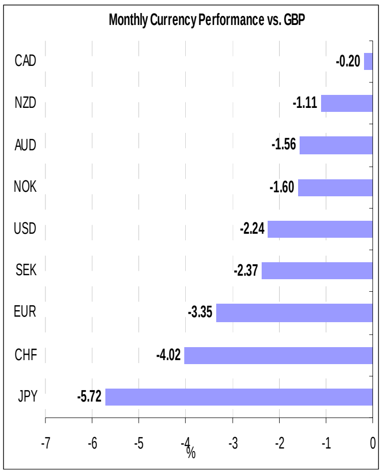


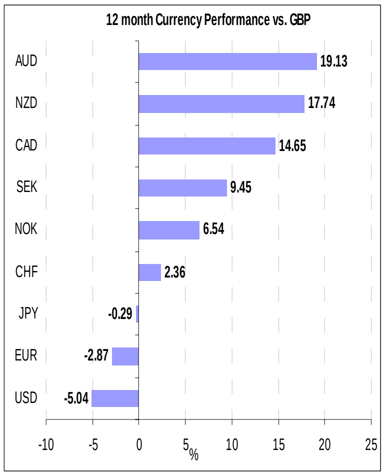




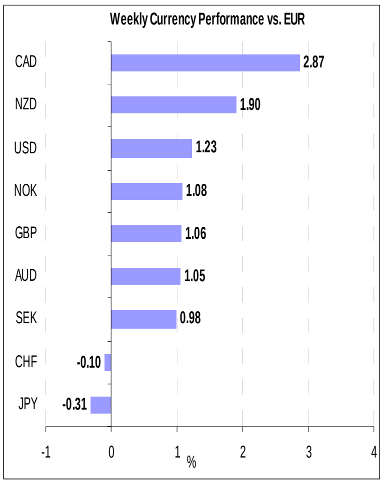
Currency performance vs. GBP

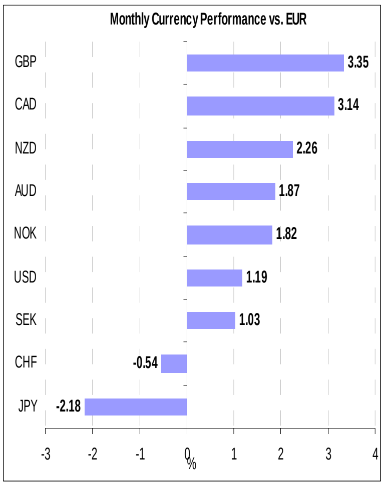


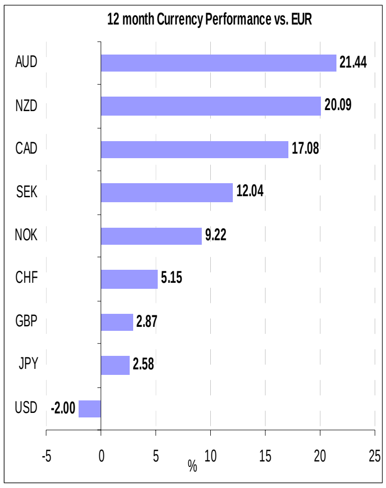




Currency performance vs. EUR







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