Lloyds TSB | Corporate Markets

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FX Strategy Weekly

Market Strategy

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Market Outlook

Tactical view:

= 'Risk off' mode: JPY extends gains

The rotation out of risk (equities, credit, commodities) continues to dictate safe-haven flows into the JPY, and to a lesser extent into the USD. The currency market remains very much agnostic to the macro data flow from the G10, instead putting greater emphasis on the direction of equities, credit and commodities. We look for the sensitivity to risk assets to remain elevated over the week ahead and markets to only pay minor interest to revised UK and US Q1 GDP data. A break of key technical levels in commodities and equities does not augur well for AUD, GBP, EUR and has raised the threat of a decline in GBP/USD to 1.40, with the JPY ideally placed to attract the rush out of commodity and higher yielding currencies if risk aversion does persist.

Recap

- Germany's unilateral decision to ban naked short selling of government bonds, CDS and shares of its top 10 financial institutions sent shockwaves through global financial markets, prompting participants to shun risk assets and currencies in favour of the USD, JPY and government bonds. The AUD dropped like a stone vs all G10 currencies, shedding a staggering 13% vs the JPY and 9% vs the USD. GBP/AUD rallied over 6%, taking out key resistance in the 1.70 area. The moves are collateral damage from the risk aversion trades that are stalking the EUR, though some credit for the flight out of the AUD is owed to geopolitical jitters on the Korean peninsula and the (exaggerated) reaction in commodities. The CRB index flirts with key support around 250, squeezing the commodity heavy FTSE-100 closer to 5,000 (-7%). GBP experienced a fairly mixed week, losing 3% vs the JPY, but gained ground vs the high yield and commodity currencies.

- UK CPI topped forecast estimates for a third month in four, climbing to 3.7% y/y in April vs 3.4% in March. RPI surged to 5.3% y/y vs 4.7%, and core CPI topped 3%. This is in contrast to the US where core CPI fell last month to 0.9% y/y, the lowest since 1966. The MPC minutes reaffirmed that inflation is projected to fall back to target, but the Bank has come under growing pressure for consistently underestimating and missing previous inflation forecasts. Retail sales rose a stronger than forecast 0.3% m/m in April.

- UK 5y swaps extended their slide below 2.50%, hitting a low of 2.43%. This caused the 3mth libor/5y swap curve to flatten to 180bp, the lowest level since May-09. The 2y/10y swaps curve flattened to 203bp. Gilts were bid for most of the week on flight-to-quality flows, with 10y yields dropping below 3.60% to a 3.54% low. The 10y gilt/bund spread widened a fraction to 90bp. The corporate market remains devoid of new sterling issuance in May.

	Close	Weekly Change
FX		**%**
GBP/EUR	1.1602	-0.49%
GBP/USD	1.4332	-1.92%
GBP/JPY	128.79	-4.98%
GBP/CHF	1.6539	1.27%
GBP/AUD	1.7411	6.76%
GBP/NZD	2.1453	4.95%
GBP/CAD	1.5287	2.56%
GBP/NOK	9.3839	3.78%
GBP/SEK	11.43	2.50%
EUR/USD	1.2353	-1.45%
USD/JPY	89.86	-3.12%
AUD/USD	0.8231	-8.15%
NZD/USD	0.6681	-6.55%
USD/CAD	1.0667	4.58%
USD/SEK	7.9756	4.51%
USD/NOK	6.5480	5.84%
USD/CHF	1.1540	3.26%
Swaps %		**bp**
2yr	1.388	-11.5
5yr	2.465	-26.8
10yr	3.454	-26.4
Equities		**%**
FTSE100	5073.13	-6.64%

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= 'Risk off' mode: JPY to extend gains

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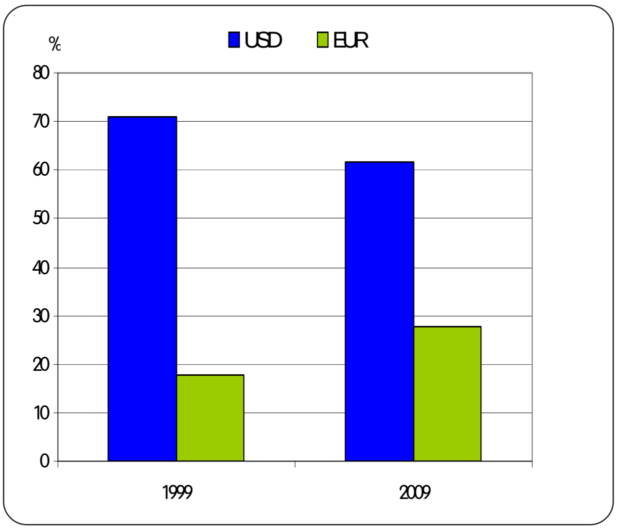
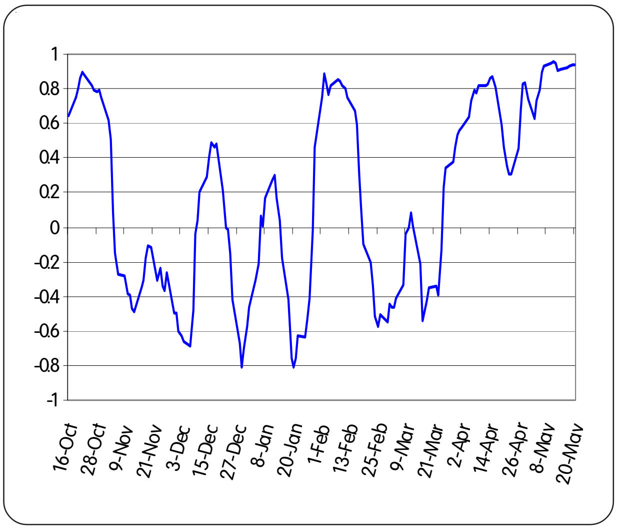
Global ccy reserves: EUR holdings to fall in next decade?



GBP/USD, where next? Track the CRB index (correlation 0.94)



USD

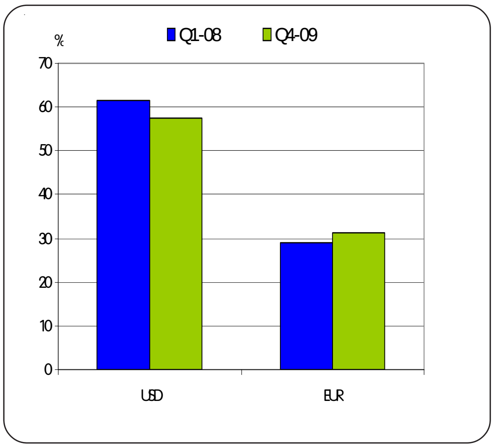
• One-way traffic and rotation out of risk (equities, credit, commodities) continue to dictate safe-haven flows into the JPY, and to a lesser extent into the USD, helping the dollar index to punch through 86.0. The FOMC debate over the timing of asset sales (before or after rate hike) and downward revision to inflation projections for 2010 are of secondary importance as long as the market remains fixated on selling risk. We reiterate our preference to buy USD dips and target 89.60 for the dollar index.

• The dollar index has rallied 12 big figures from 76.0 in December. At this rate, the index will trade just shy of 100 by November. The question from here is whether the pullback in equity and credit indices morphs into a more worrying drop in economic confidence, and threatens to nip the nascent recovery in the bud in the second half of 2010. This is not the mainstream view, but the rate at which risk appetite is imploding (watch JPY crosses), the VIX is surging and public spending is cut back, could be a recipe for economic momentum to stutter over the summer.

• In this context, we look for long speculative USD positions to stay above recent norms and potentially get more stretched, though the underperformance of USD/JPY vs EUR/USD and GBP/USD has to be considered and argues for a diversion from EUR, GBP and AUD Into JPY.

• The market remains very much agnostic to the macro data flow given the 'risk off'/'risk on' context. We look for sensitivity to equity/debt markets to remain elevated over the week ahead, despite the first-tier releases of durable goods orders, consumer confidence, revised Q1 GDP and persons; income and spending. The upward revision to the US GDP forecast for 2010 by the Fed is in contrast to the UK and the euro zone where labour markets and a public spending squeeze threaten to isolate the two regions at the bottom end of the G7 table.

Allocated ccy reserves: EUR share vs USD set to drop back below 30% going forward



EUR

• Efforts by EU officials to arrest the wave of EUR selling have been to no avail as this week's price action demonstrates, led by a descent in EUR/JPY below 112.0 and EUR/USD below 1.22. The unilateral decision by Germany to restrict naked selling of government bonds, CDS and financial stocks caused investors to raise new questions about the operational shortcomings of the EU institutional framework, where member states are simply bypassing the EC in their own (political) interest. In the meantime, we understand that the EU is updating its directives to impose stricter budget discipline, an initiative that has not been universally welcomed for countries outside the euro zone.

• Though sovereign primary funding requirements have moved into the background following the successful disbursement of EU funds to Greece on Tuesday and the decent sponsorship of EU debt auctions, fears of counterparty risk have not disappeared and continue to put upward pressure on libor/ois spreads. Disjointed observations by the EU 'elite' have not persuaded market practitioners to wade back into the EUR, even at the lowest level in four years vs the USD Risk reversal skews heavily skewed towards EUR puts vs USD and JPY (see chart).

• For EUR/USD, we lowered our short-term target to 1.20 where multiple layers of options structures are likely situated and so should in theory offer good protection. Follow-through buying on the EU750bln eur backstop mechanism never quite materialised. The ambiguous EU statements mean EUR/USD is set to remain a moving target in the short-term.

• The prospect of EUR reserve holdings being more actively diversified is especially true for the developing economies where most of the re-balancing vs the USD had taken place over the last decade. A 1.5% decline in EUR holdings in developing economies (allocated reserves only) corresponds to $32bln, though it could result in the EUR settling at a lower future equilibrium rate vs the USD. For global reserve holdings a 1% drop in EUR holdings corresponds to roughly $45bln, though again we specify that is based on allocated reserves only (i.e. 60% of the total reserves).

GBP

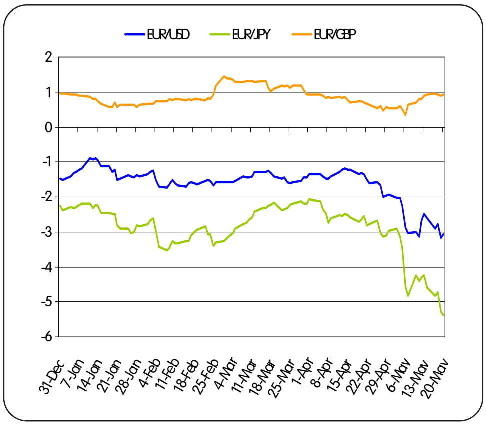
• We have referred to risk-correlation to explain the performance of GBP/USD over the last couple of weeks and have lowered our target to the 1.40-1.44 range as equities continue to wilt. A break of key technical levels in commodities does not augur well and has raised the threat of a slump to 1.40 as the CRB index falters (see 'near perfect' correlation chart on page 2). The CRB index dropped below 250 support on Friday, dragging the FTSE-100 closer to 5,000. The levels reached on the infamous May 6 now look within reach.

• Macro data has been categorically dismissed by the market not just for the USD but also for GBP as the stronger CPI and retail sales data for April can testify. We have no high hopes for a boost to GBP crosses from an upward revision to Q1 GDP next week Tuesday (consensus f/cast +0.3% q/q vs +0.2% prelim), or the CBI distributive trades survey for that matter (Friday). Risk sentiment has been extremely shaky since late April, pushing macro data to the side.

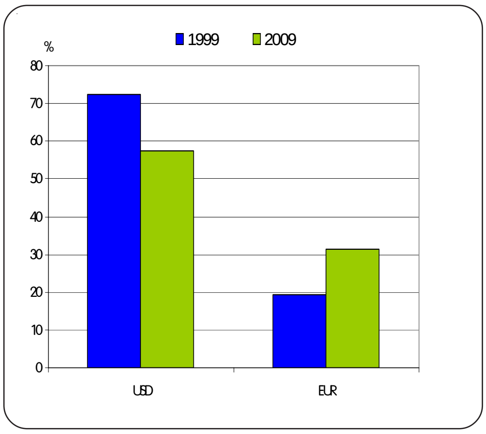
• GBP/AUD punched through 1.70 resistance, bringing 1.75 and 1.80 into reach as long speculative AUD positions are aggressively unwound vs the JPY. For GBP/JPY, lower trendline support has to hold in the 126.50 area to stop a deeper pullback to the January low (119.72). GBP/CAD has done well to take out 1.50 and could stretch gains to 1.55 in the near-term, aligned with our longer-term view. Resistance runs in the 1.5650 area.

• The synchronized price action in GBP/USD and EUR/USD along with flat UK/EU 2y rate differentials (40bp) have helped to cap downside in EUR/GBP around 0.8500. Though we remain medium-term EUR bears, the inability of GBP to carve out more sizeable gains on the back of broad based EUR selling is telling of underlying pessimism with regard to both the EUR and GBP vs the USD. We are still confident that a shift in EUR/GBP to the downside may occur as EUR portfolio holdings are reduced. Resistance is situated ii the 0.8700-50 area.

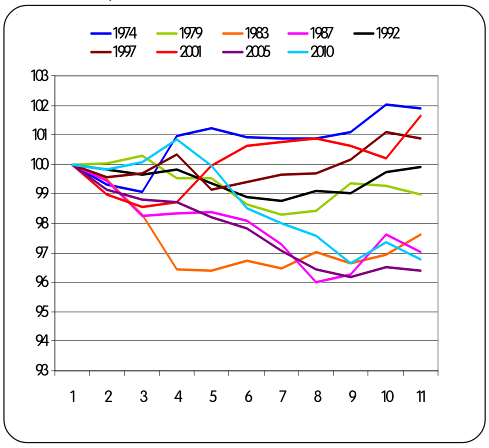
25D 3mth risk reversals still skewed to EUR puts



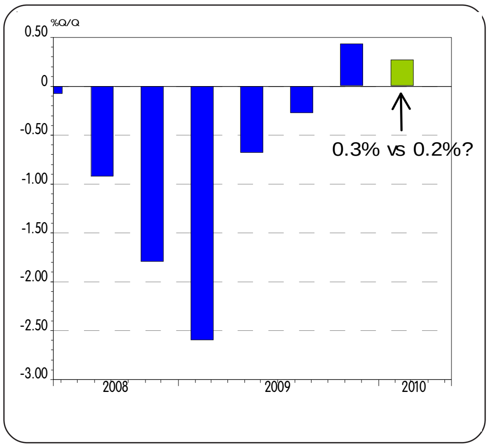
EM appetite for EUR to fall in next decade?



GBP/USD: post-election reaction, worst since '05



UK Q1 GDP set for upward revision

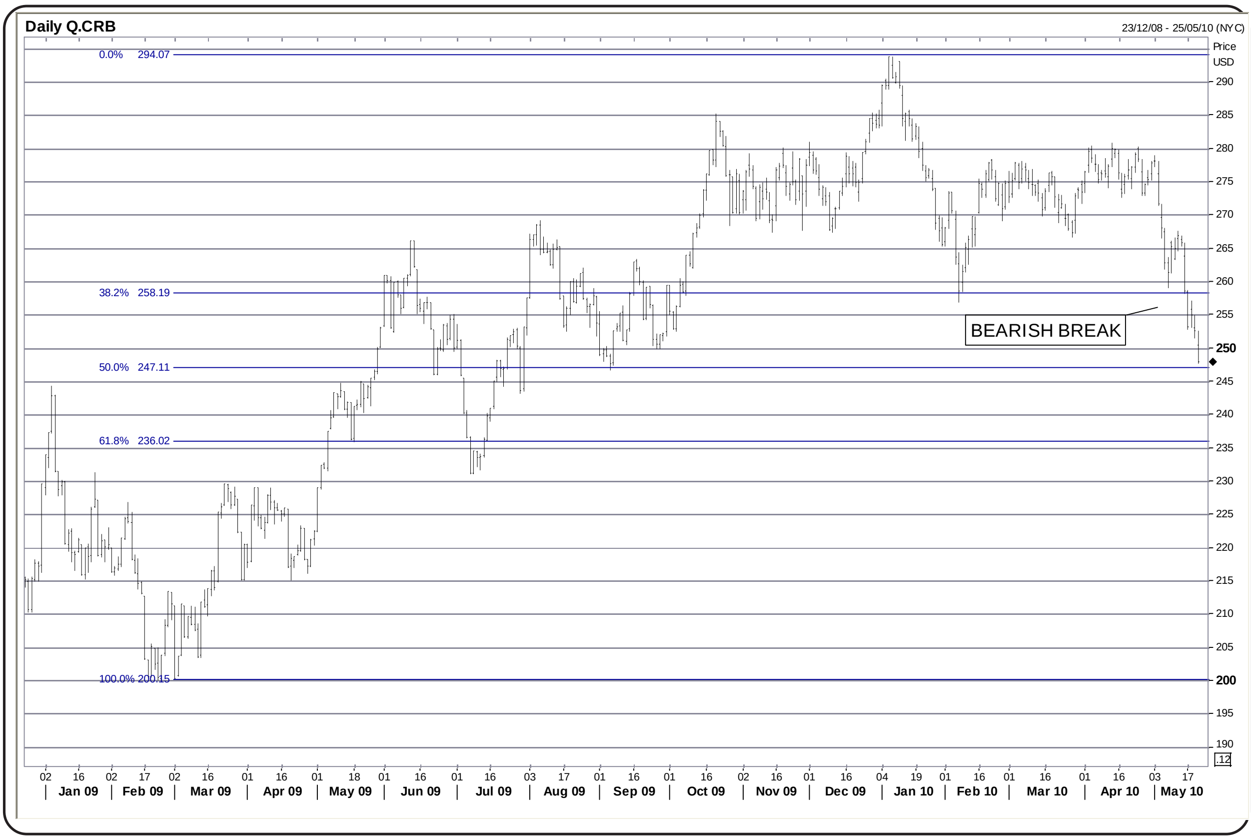


GBP/AUD: through 1.70 resistance, brings 1.80 into view

EUR/GBP: caught in 0.8450-0.88 range

Dollar index: uptrend still in place, target 89.60

CRB commodity index: bearish set-up, risk of pullback to 235-250 area



Quantitative Market Analysis

- **GBP/USD skew with CRB, oil peaks**
- **IMM positioning: JPY shorts halved**

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.

Speculative short GBP positions scaled a new high of 91,500 contracts, led by a jump in reported positions from 65,000 to 72,000. Reported short contracts jumped by 11,000 to 65,000, beating the previous high of March 23. The depreciation in GBP/USD stalled around 1.43 over the latter part of the week, suggesting that short positions may be close to stabilising.

The biggest swings were recorded for the JPY where net short positions vs the USD more than halved to 45,900. Reported short positions dropped from 65,000 to 34,500. The sharp pullback in USD/JPY below 89.0 on safe-haven flows will almost certainly be translated into a further dwindling of JPY shorts. EUR short contracts shot up from 112,000 to 124,000, led by a rise in reported positions to -113,000. Exposure to high yield and commodity positions was scaled back for a 4th successive week, with long AUD contracts dropping back to just 56,000, the lowest since February 23rd. Long CAD contracts were reduced to 71,300 , the lowest since March 2nd. The savage drop in AUD/JPY and CAD/JPY over the past few days points to a widening imbalance between JPY vs AUD and CAD contracts. AUD/JPY plunged nearly 10 big figures over three day to a 72.55 low. CAD/JPY dropped 7 big figures to a 83.04 low.

The US DXY extended its upward trend, gaining altitude above 86.0 and hit a high of 87.458. This supports our medium-target for a rally up to 89.0 as global risk aversion continues to drive flows out of high yield and commodity currencies, and speculation of EUR diversification grows. The FOMC revised up its growth forecasts for 2010, but views remain mixed over the timing of asset sales vs higher interest rates. A fall in US core CPI to 0.9% y/y in April, the lowest since 1966, means the Fed can bide its time, with a stronger USD on safe harbour buying helping to contain import price pressures.

Risk reversals remain universally skewed towards USD calls vs the G10 except vs the JPY. Though the extreme skew and positioning indicate the risk of a counter-trend move, the bearish backdrop for risk suggests appetite to flip long USD and JPY positions is probably thin. Short-dated volatility remains exceptionally high despite efforts by officials to calm markets down and challenge the extreme swings. AUD/USD, USD/CAD, and NZD/USD in particular registered monster moves in 1mth vol (AUD/USD +9; USD/CAD:+5). EUR/CHF 1mth vol jumped over 10.0. The VIX index gapped above 40.0 on Thursday, hitting 45.2 or the highest level since Mar-09.

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	**0.78**	-0.02	0.65	0.40	**0.79**	**0.95**	**0.92**
10 YR SPD	-0.06	-0.73	-0.75	-0.58	**0.80**	**0.87**	**0.90**
S&P500	**0.89**	**-0.93**	**0.92**	**0.91**	**0.78**	**0.90**	**0.94**
Gold	-0.57	0.56	**-0.84**	-0.74	-0.40	-0.55	**-0.78**
Oil	**0.93**	**-0.81**	**0.95**	**0.97**	**0.83**	**0.94**	**0.98**
Relative Yield Curve	**0.89**	0.47	**0.83**	**0.90**	-0.75	0.69	0.63
CRB	**0.95**	**-0.89**	**0.95**	**0.97**	**0.81**	**0.95**	**0.98**

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).

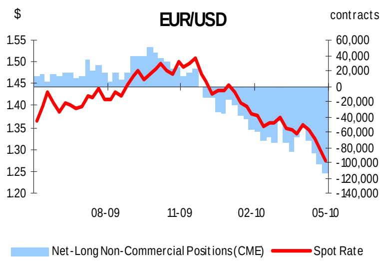
G10 correlations with 2y interest rate differentials are still significant for EUR/JPY and AUD/JPY but have started to fade for EUR/USD. For AUD/JPY and EUR/JPY, 10y rate differentials continue to play a powerful role in driving price levels. This is proven for example by the compression in the 10y AU/JGB spread to 413bp and corresponding collapse in AUD/JPY below 75.0, with the elevated correlation of AUD/JPY with the S&P (0.90) also playing a key part in the sharp reversal.

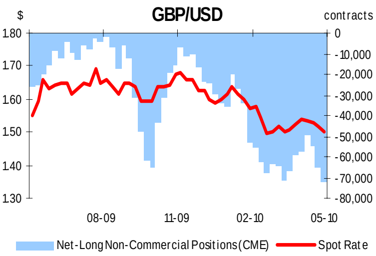
In terms of risk assets (S&P 500), the correlation in GBP/USD picked up to 0.91, as did the correlation with oil. The sharp decline in the S&P through 1,100 and crude below $70pb explain for most of the depreciation in GBP/USD, though losses have slowed in the 1.43 area. The correlation of GBP/USD with the CRB commodity index (0.97) is striking and has to be closely monitored for future performance of the currency pair. The same applies for AUD/JPY and EUR/JPY.

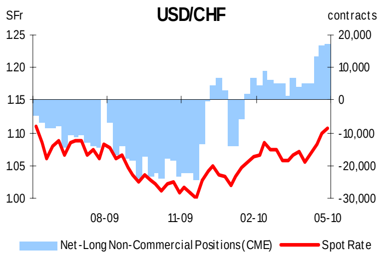
The gulf between EUR/USD and the EU/US economic surprise index just got wider over the past week to reach extreme levels. A similar pattern is observed for GBP/USD, though the spread between currency performance and economic surprises is not as exaggerated.

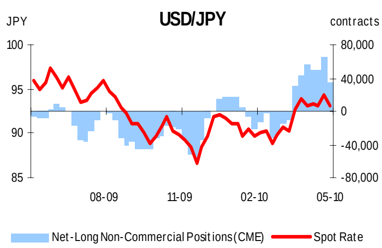
FX & Commodity Futures Positioning

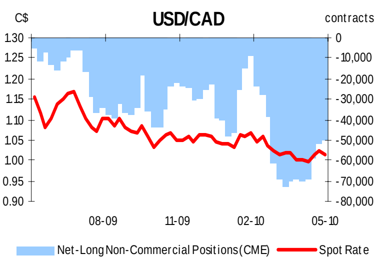
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

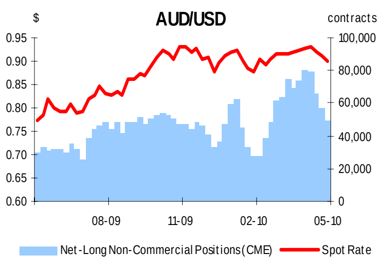


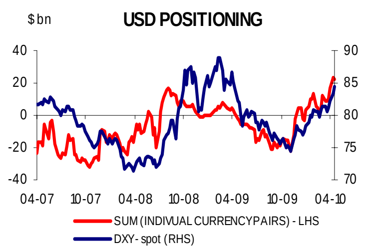


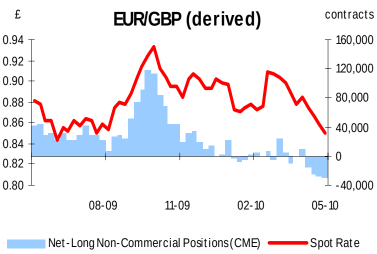


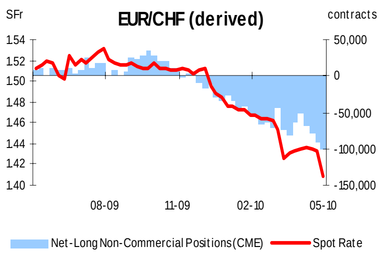


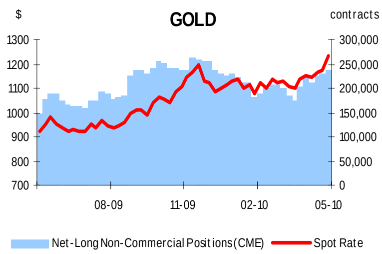


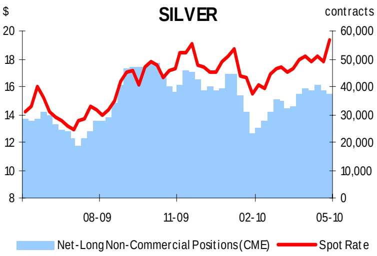


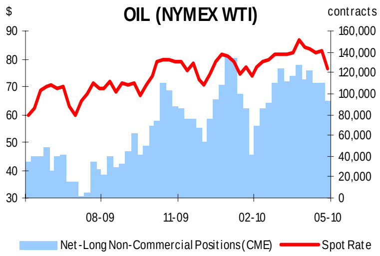


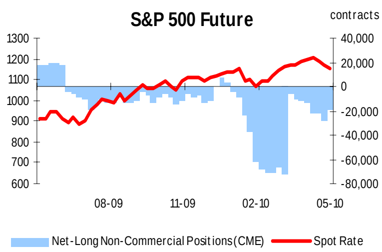


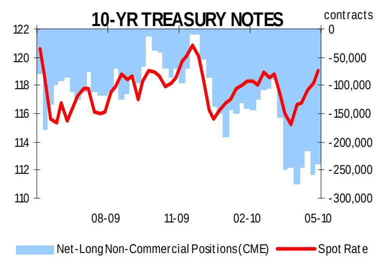


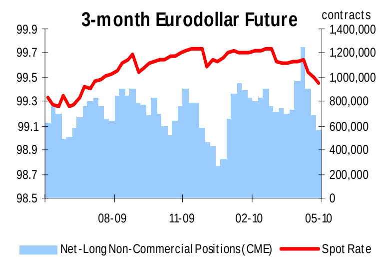








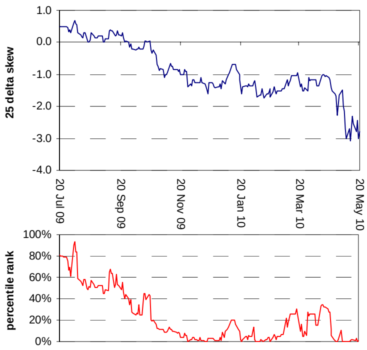




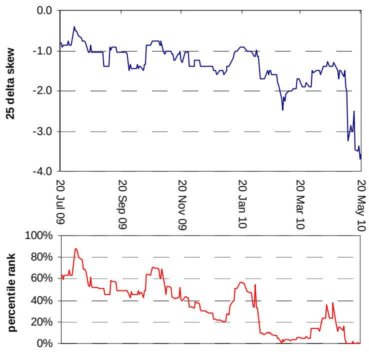
FX Options: Risk Reversal Skews

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.

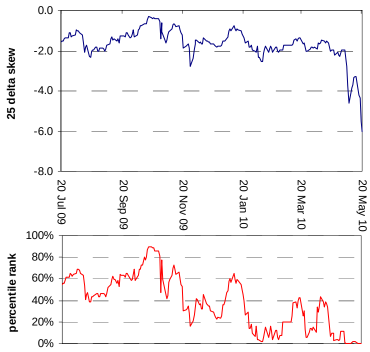
EURUSD



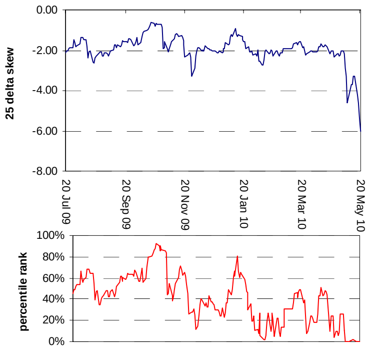
GBPUSD



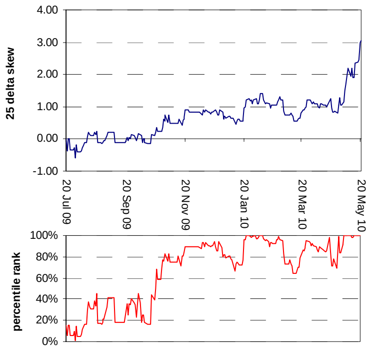
AUDUSD



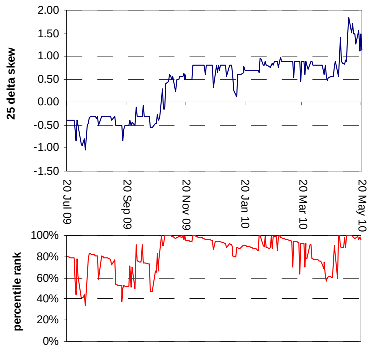
NZDUSD



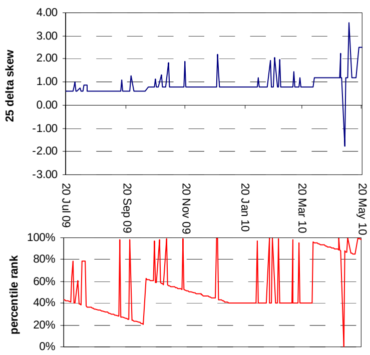
USDCAD



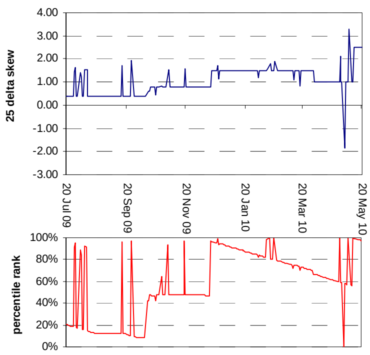
USDCHF



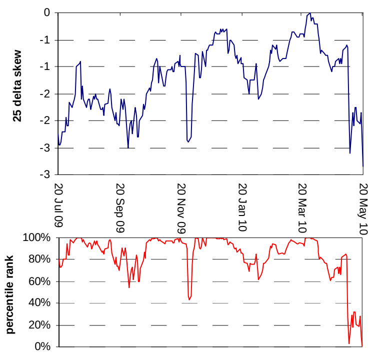
USDSEK



USDNOK

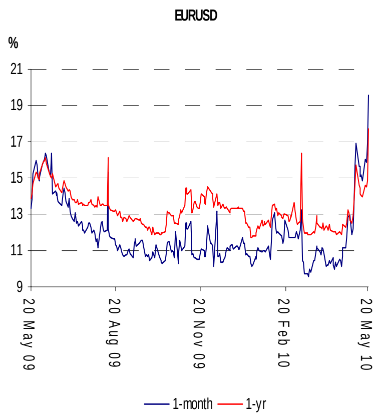


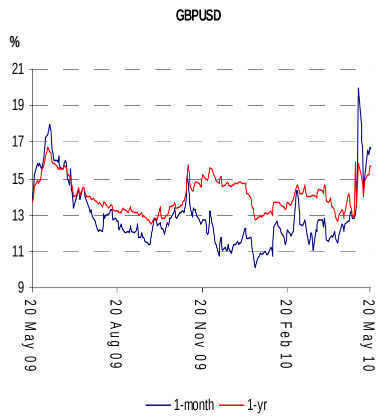
USDJPY

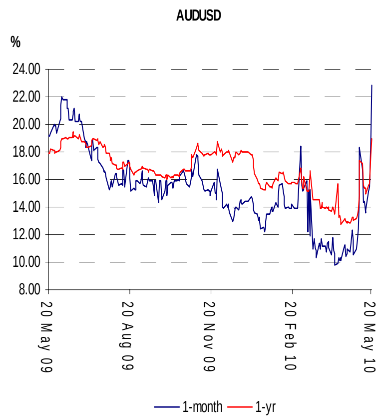


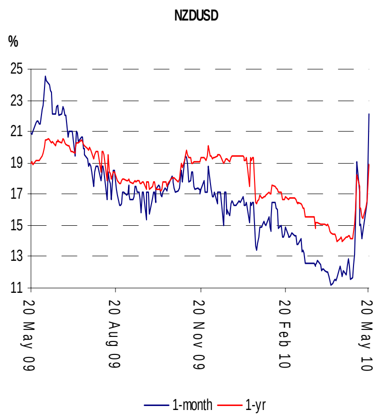
FX Options: Implied volatility

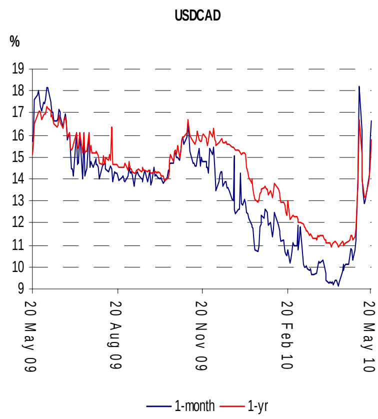
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

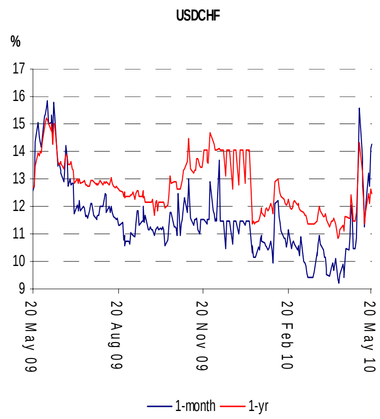


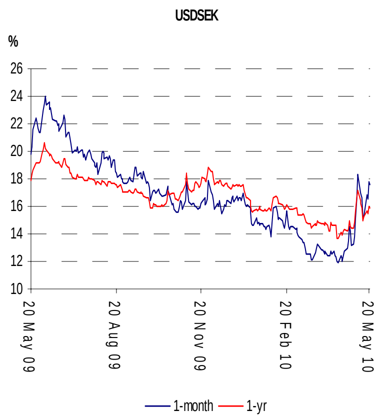


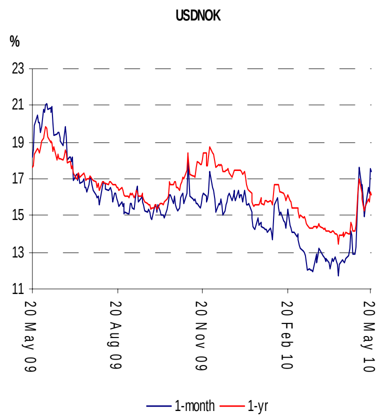


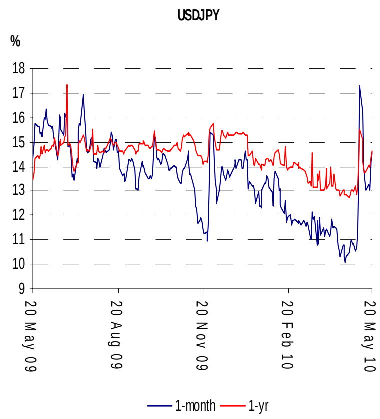






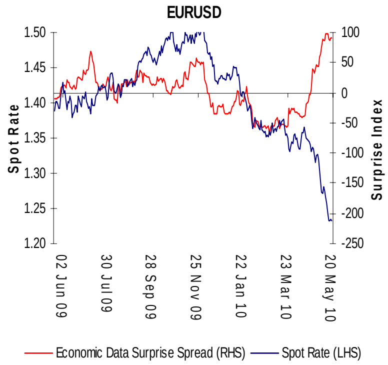


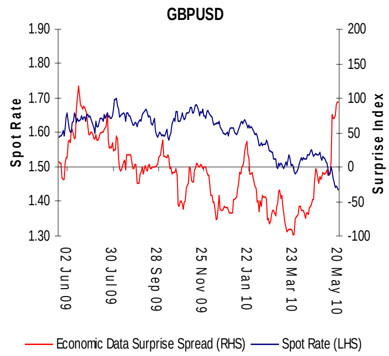


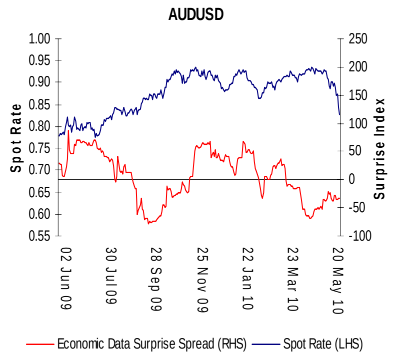


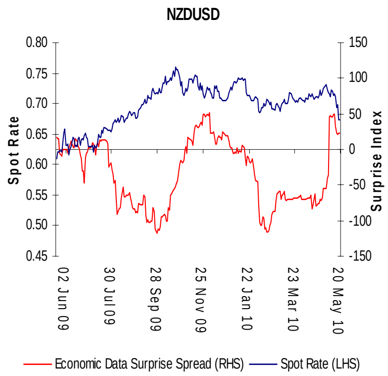
Economic Data Surprises

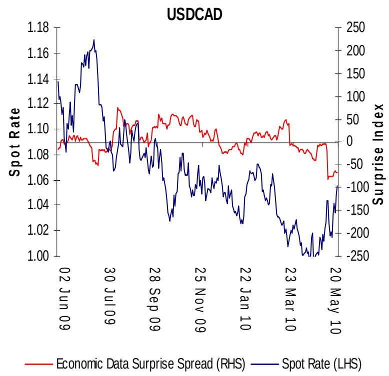
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

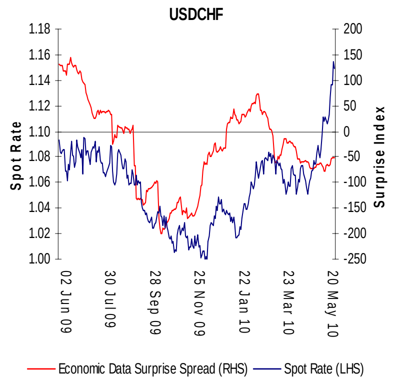


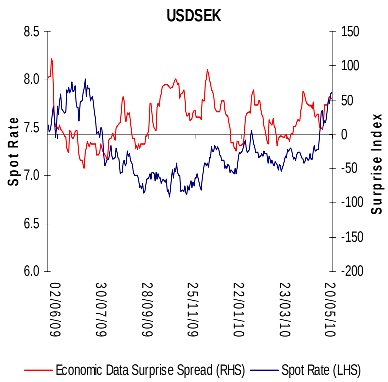


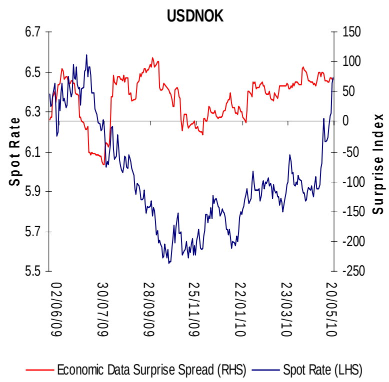


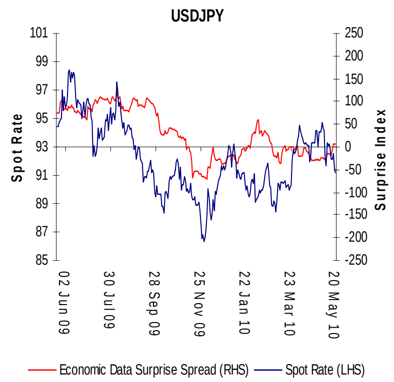






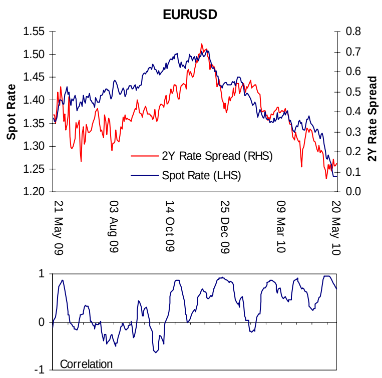


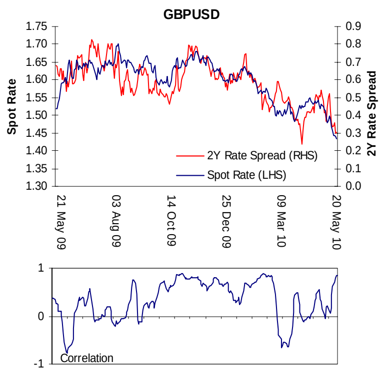


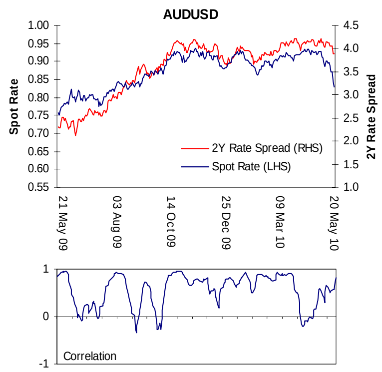


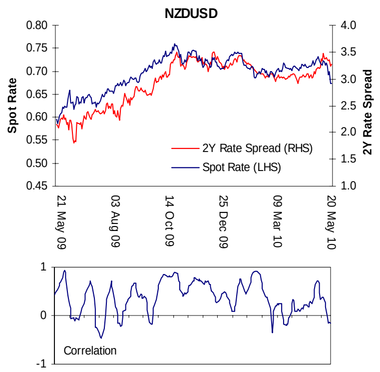
Interest Rate Spreads vs. FX

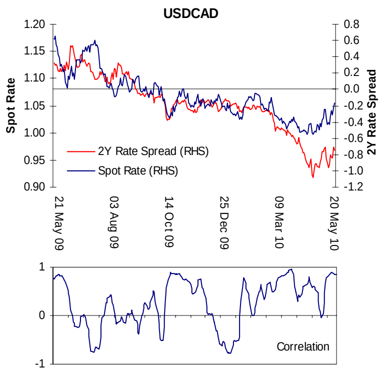
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

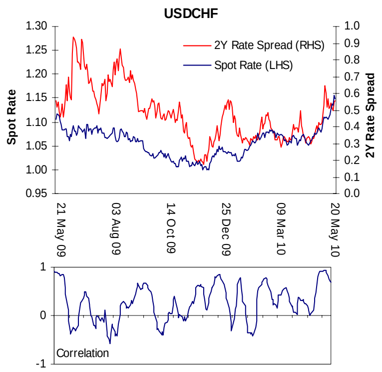


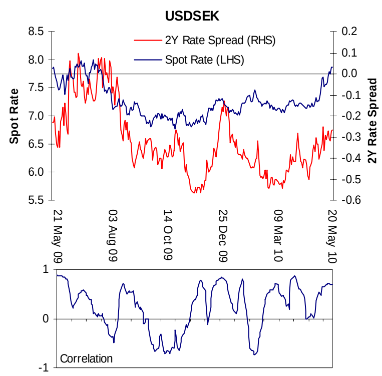


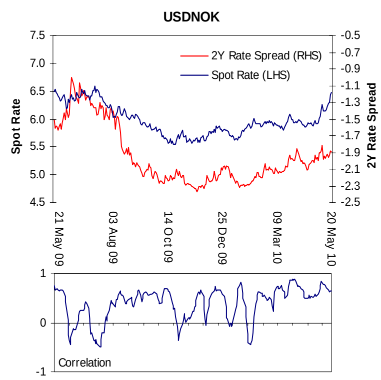


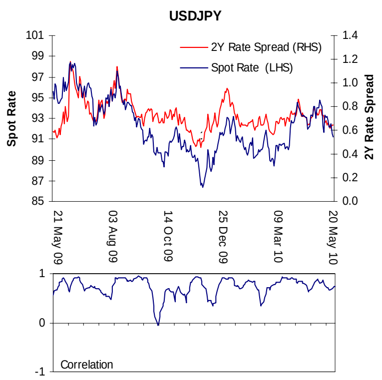






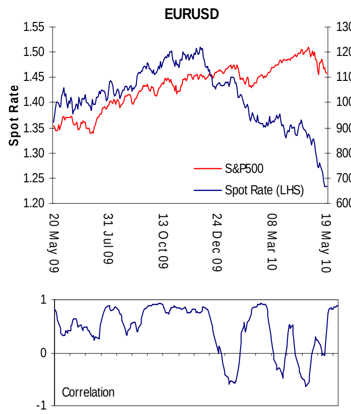


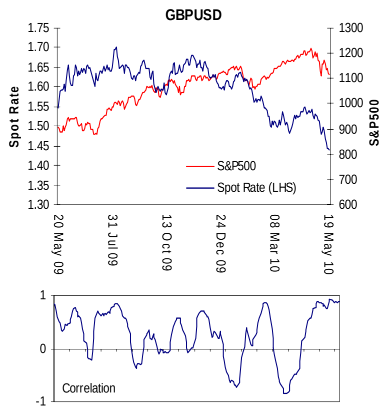


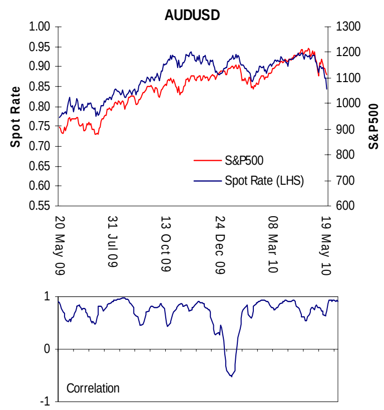


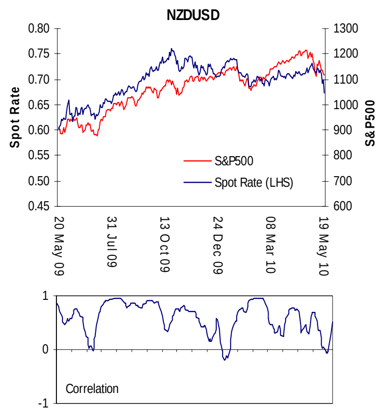
S&P500 vs. FX

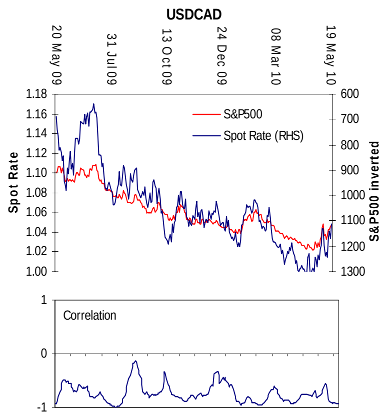
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

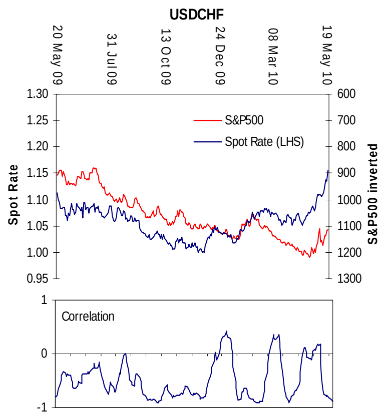


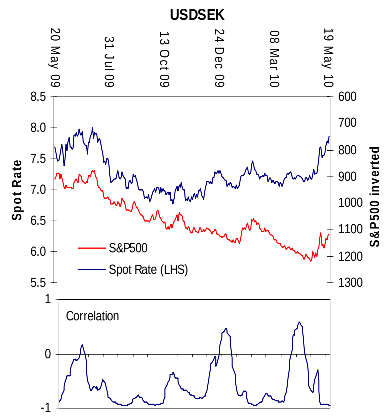


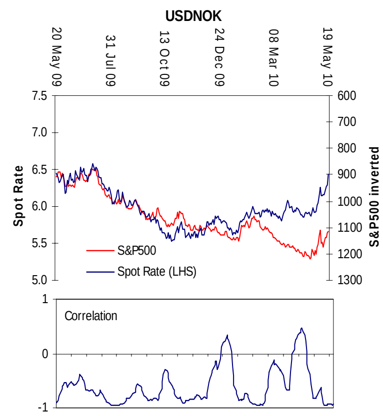


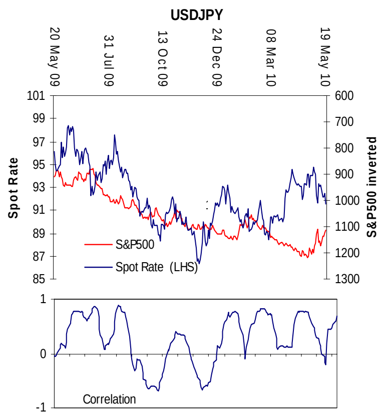






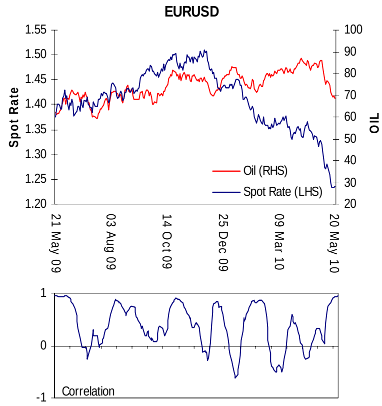


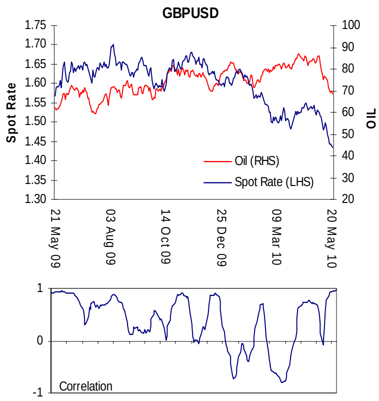


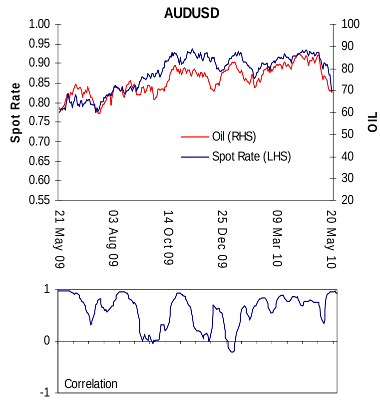


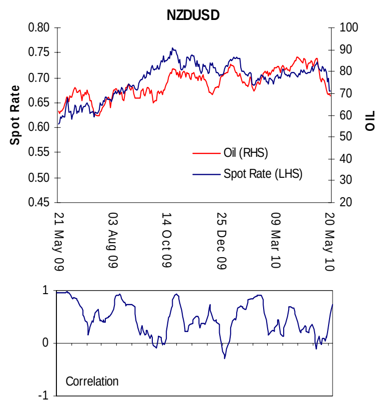
Commodities vs. FX

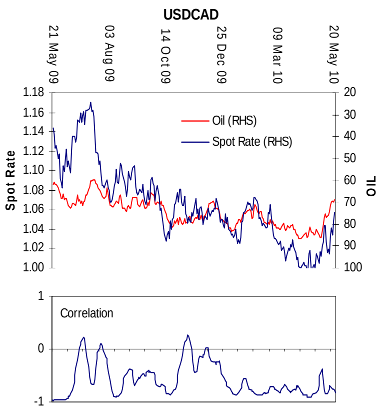
The charts below show oil prices plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

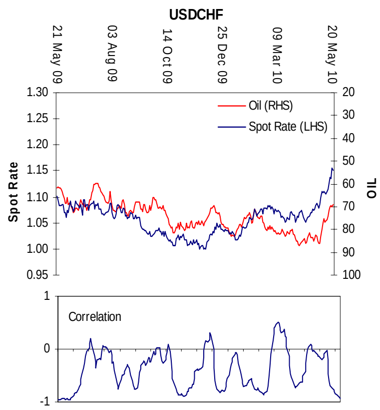


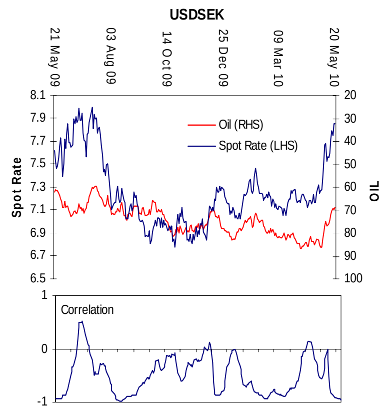


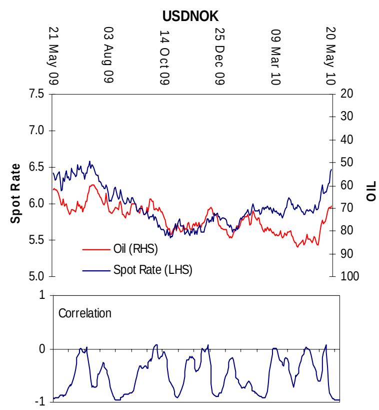


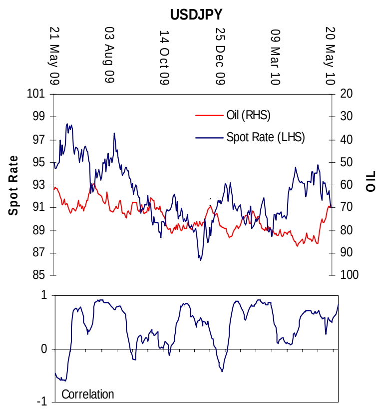








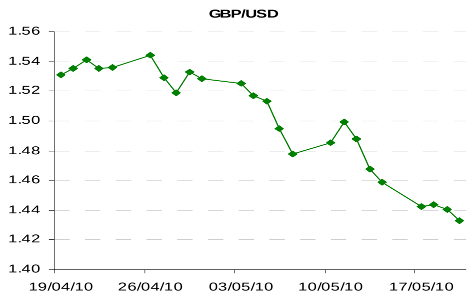


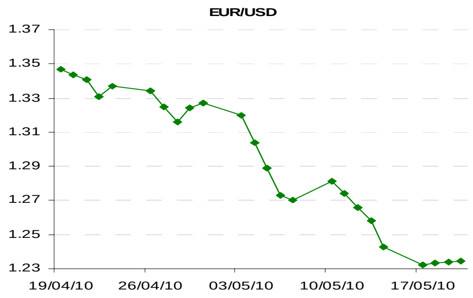


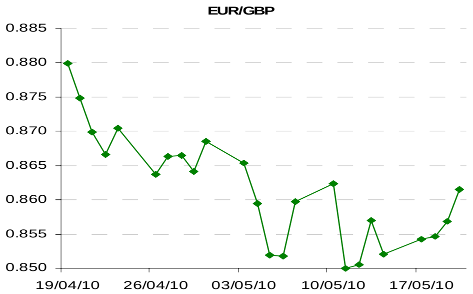
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

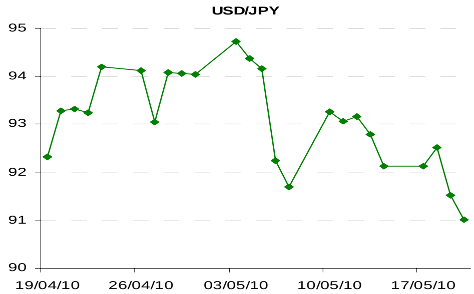
Market Review

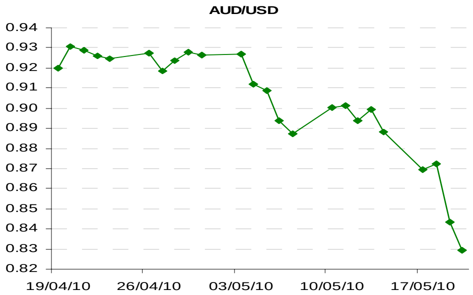
Short-term G-10 FX Charts

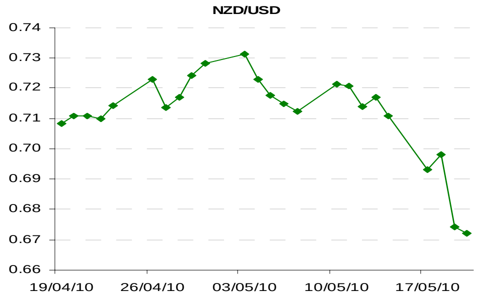


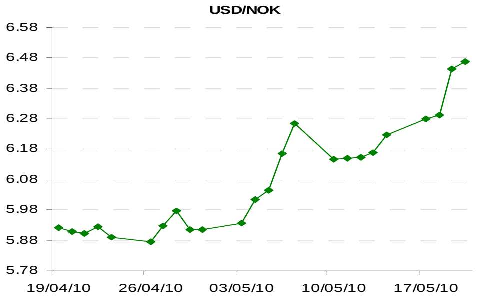


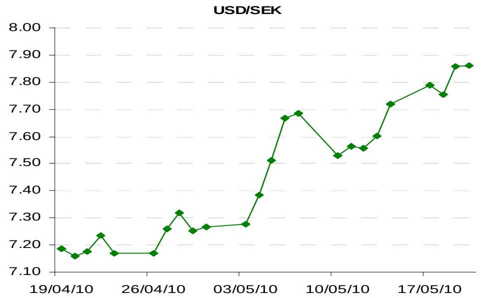


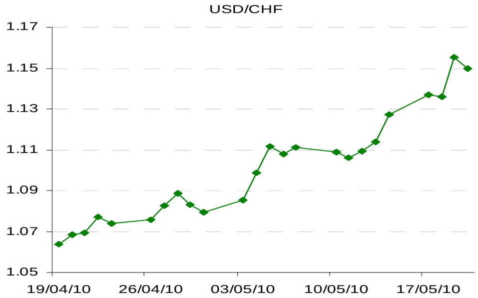


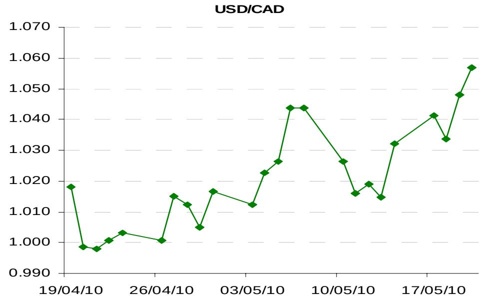




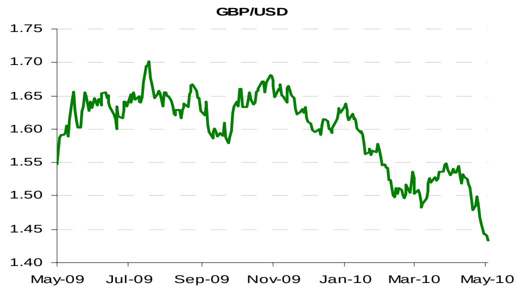


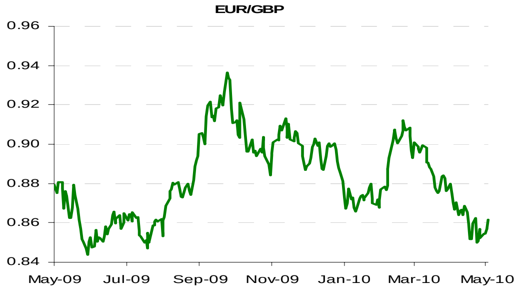


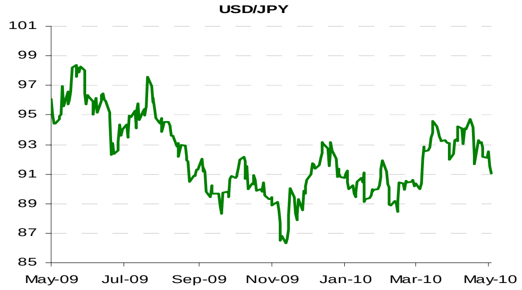


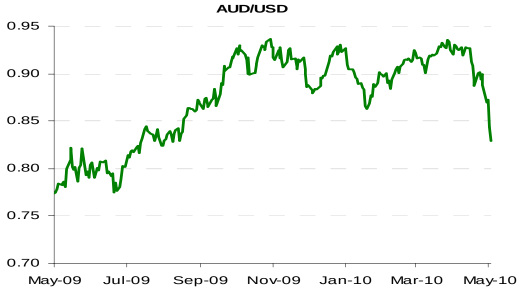


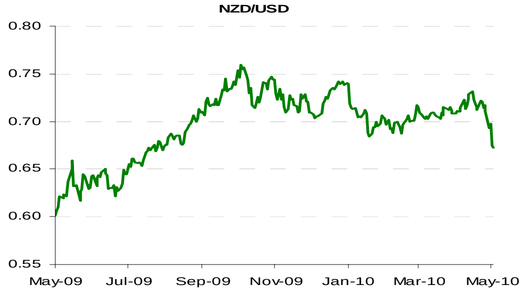
Medium-term G-10 FX Charts

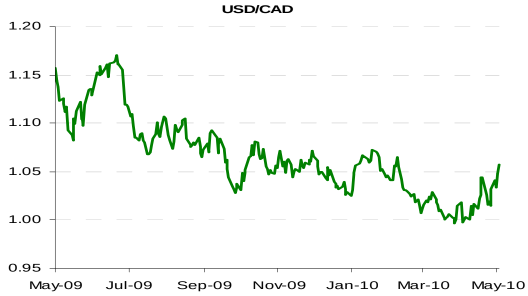






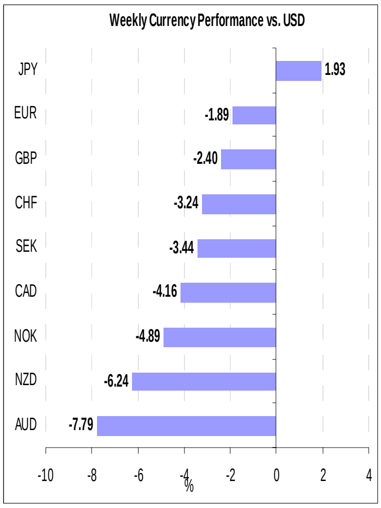


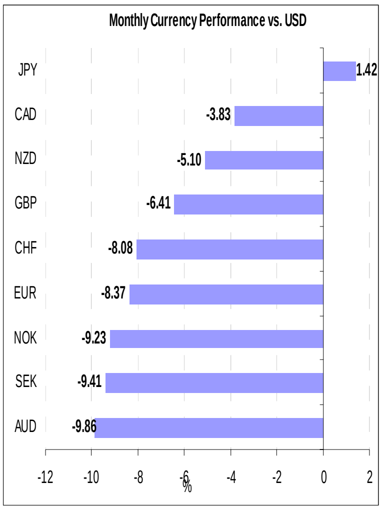


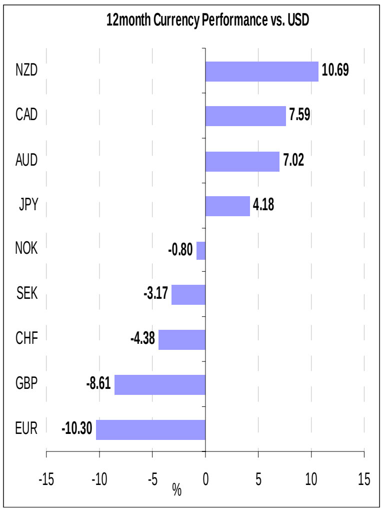


FX Snapshot

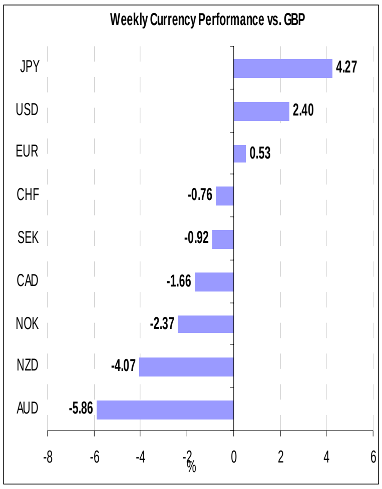
Currency performance vs. USD

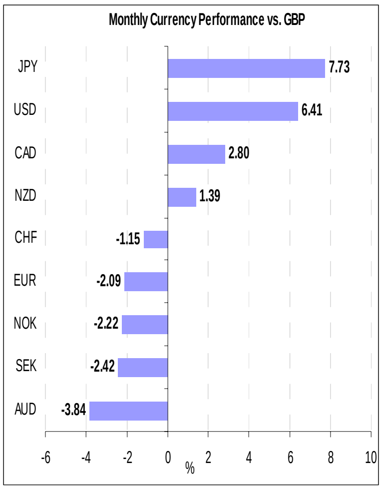


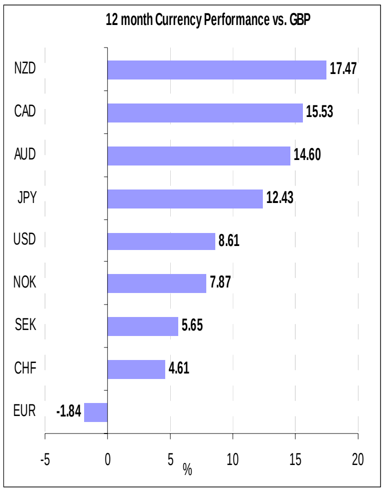




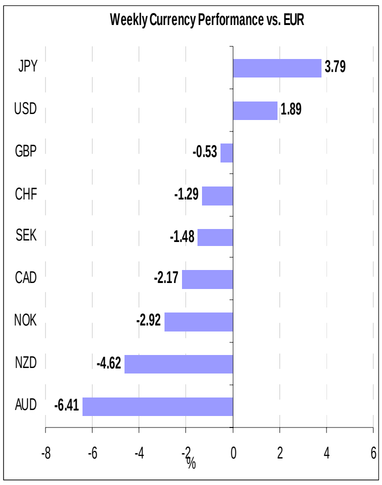
Currency performance vs. GBP

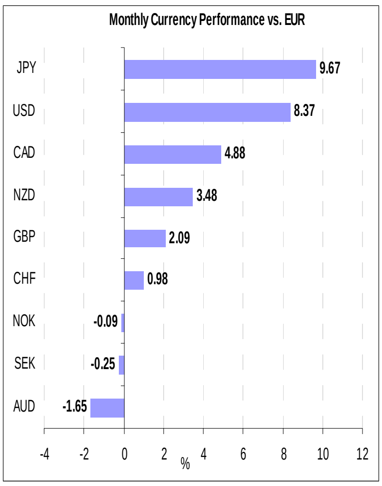


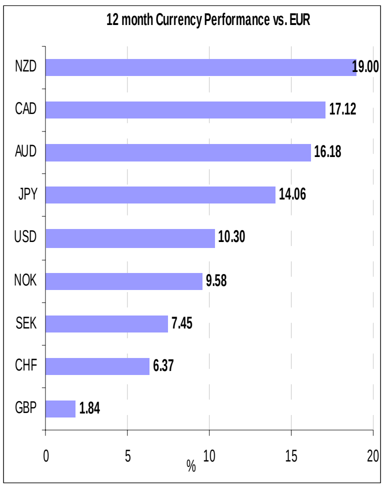




Currency performance vs. EUR







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