Friday, 28th May 2010

FX Strategy Weekly

Market Strategy

Kenneth Broux
Senior Market Economist
0207 158 1750
kenneth.broux@lloydsbanking.com

Market Outlook

Tactical view:

= Risk sentiment fragile

= Will CAD capitalise on blockbuster NFP gain, BoC rate hike?

Risk assets continue to demonstrate very choppy and occasionally counter-intuitive price action, keeping volatility in major G10 crosses above recent norms. US non-farm payrolls data, consensus +500k, should direct price action next week but with the Fed sidelined, concerns over counterparty risk, liquidity and sovereign debt will again determine appetite for risk strategies. A rate hike by the Bank of Canada and strong US employment data mean the CAD should be ideally positioned to outperform in the G10, unless this week's bounce in equities proves a dead cat bounce and the tentative reversal in leading macro data is repeated, prompting participants to seek refuge in the USD and JPY.

Recap

- The AUD outclassed its G10 peers this week backed by a relief bounce in risk assets and a recovery from technically oversold conditions. The currency clawing back partial losses of recent weeks, logging gains of 3.6% vs the EUR, 3.3% vs the JPY and 1.4% vs GBP. The EUR fell across the board, though comments by China on the EUR as a key currency in its reserve holdings helped EUR to contain losses vs the USD to 1.7%. A reversal in risk briefly lifted the FTSE back over 5,200, but confidence remains shaky as rising libor and tightening in money market spreads leak into confidence and economic data is showing signs of turning over at the start of Q2. GBP gained 0.3% vs the US but fell 0.6% vs the EUR, staying within the narrow confines of recent trading ranges.

- UK Q1 GDP was revised up to 0.3% q/q vs 0.2% q/q, supported by stronger data for business investment (first gain since Q2-08) and manufacturing output. Consumer confidence fell in May to -18 vs -16 in April, a 5-month low. The biggest surprise was the major reversal in the CBI distributive trades survey from +15 in April to -17 in May. Retailers are clearly anticipating sales volumes to deteriorate over the next three months, even without discounting a possible rise in VAT. MPC member Posen hinted that more QE could be possible and that asset purchases would not necessarily cause higher inflation.

- UK 5y swaps bounced off the 2.43% low, briefly climbing over 2.60%. With 3mth Libor edging up just 1bp to 0.71%, the 3mth Libor/5y swaps spread widened to 186bp. The 3mth Libor/ois spread widened to 22bp, the highest since last September. The 2y/10y swaps curve steepened to 206bp. Profit taking lifted 10y gilts briefly back over 3.60% but reversed back to 3.57% into Friday'; close on weaker stocks and month-end extension buying. The 10y UK/EU swap spread shot up 12bp to 59bp. The 4bln 2050 IL was priced yesterday at 1bp over the 2047 IL, or a real yield of 0.76%.

	Close	Weekly Change %
FX		
GBP/EUR	1.1040	-0.64%
GBP/USD	1.5185	0.32%
GBP/JPY	137.22	0.40%
GBP/CHF	1.6094	-1.05%
GBP/AUD	1.6590	-0.52%
GBP/NZD	2.1680	-0.18%
GBP/CAD	1.5467	-0.71%
GBP/NOK	8.8606	-0.70%
GBP/SEK	10.72	-0.40%
EUR/USD	1.3755	0.95%
USD/JPY	90.36	0.09%
AUD/USD	0.9153	0.84%
NZD/USD	0.7005	0.52%
USD/CAD	1.0186	-0.99%
USD/SEK	7.0605	-0.74%
USD/NOK	5.8353	-1.00%
USD/CHF	1.0598	-1.34%
Swaps %		**bp**
2yr	1.624	-6.8
5yr	2.936	-9.9
10yr	3.895	-2.5
Equities		**%**
FTSE100	5625.65	0.46%

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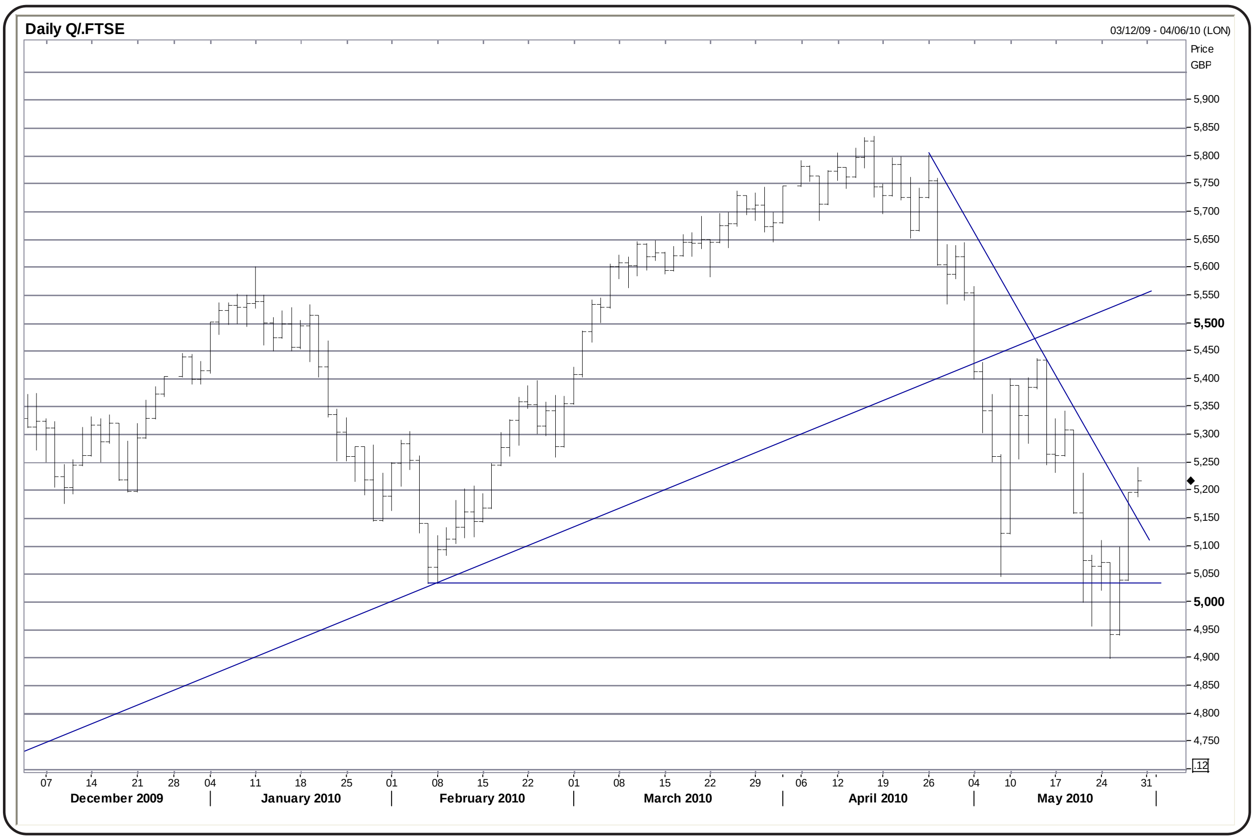


Crude oil: targeting a return to the bullish trend channel

Kenneth Broux - Senior Market Economist
contact: +44 207 158 1750

28 May 2010

G10 FX - the EUR and global currency reserves

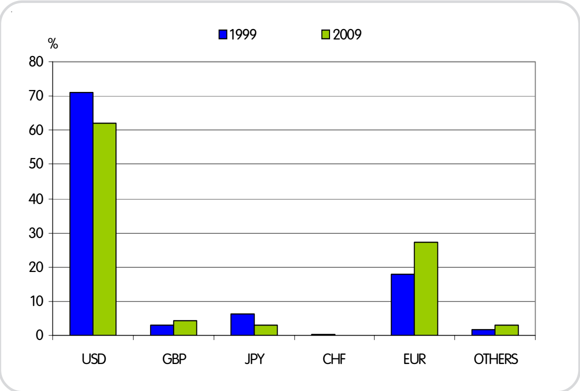
Comments from China on the management of its currency reserves provided some interesting points of discussion this week and helped EUR/USD to bounce off its intra-week lows. The statement by SAFE that the role of the EUR in its total reserves, estimated at $2.4tln on March 31st, would stay on the same trajectory despite the sovereign debt crisis and fears of contagion will have been welcomed in many official EU circles, but have not changed our impression that the status of the EUR as a quasi-reserve currency has been undermined. Though the ECB has repeatedly emphasised that it never set out to promote a reserve status for the EUR as an alternative to the USD, the currency's popularity and its dominance in the global capital markets have brought many advantages over the years, not least in building up the credibility of the ECB and the resulting anchoring of inflation expectations.

Secretive meetings between Chinese and EU representatives are alleged to have taken place since the crisis in Greece and bilateral discussions have reportedly taken place over the instability and extraordinary volatility in EU debt markets that has translated into a 13% drop in EUR/USD since the start of the year. SAFE reportedly holds an estimated 500bln euro in sovereign euro zone bonds. Though China says that fluctuations in the EUR would influence the country's thinking in any decision to allow the yuan to strengthen, it said it cannot afford currency swings to slow its economy. Fresh from his visit to Beijing last week, this also explains the stop of US Treasury Secretary Geithner to Berlin this week for a meeting with German officials and the ECB. Comments on the EUR by German Chancellor Merkel and the unilateral decision by Germany to impose trading bans have further undermined confidence in the single currency, causing volatility to surge to the frustration of many G20 members including China where an (orderly) strengthening of the yuan is considered to deflect speculative capital inflows and control inflation.

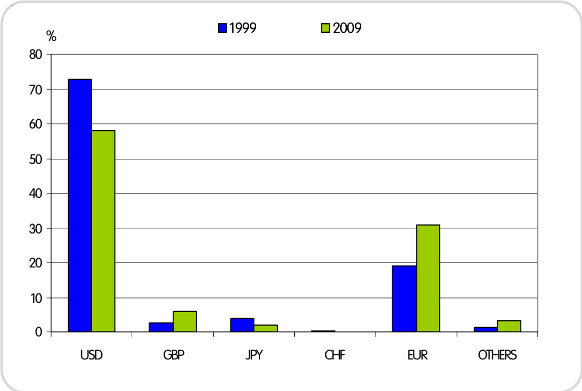
China along with other developing economies responsible for managing the world's largest currency reserve pools have traditionally been very coy about disclosing the exact breakdown of their currency holdings. These have been typically accounted for as 'unallocated reserves' in the official reserve data compiled by the IMF. Though China has pledged that strategic reserve swings away from the EUR are unlikely, there is a strong likelihood that the meteoric rise of the EUR in global reserves since its inception in 1999 may be reversed, putting downward pressure on the EUR vs its G10 peers, including the USD.

Based on the available data from the IMF disseminated below, we calculate that a 1% decline and transfer of world EUR holdings (into USD) corresponds to a notional drop of 64.5bln eur ($79.95bln at 1.24). The substantial increase over the past decade of the EUR in allocated world and emerging market reserves and the equally strong increase in unallocated reserves mean a lower equilibrium value for EUR/USD (and G10) could follow if emerging market reserve managers in particular decide to recycle a lower proportion of USD denominated trade, current account and petro-dollar surpluses.

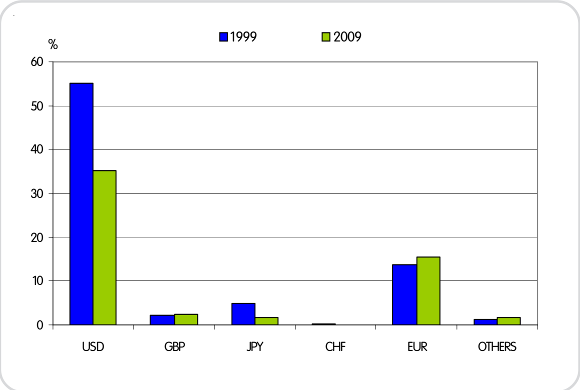
Allocated reserves - World



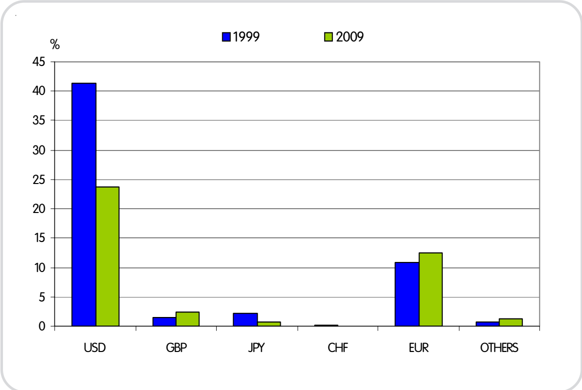
Allocated reserves - Emerging economies



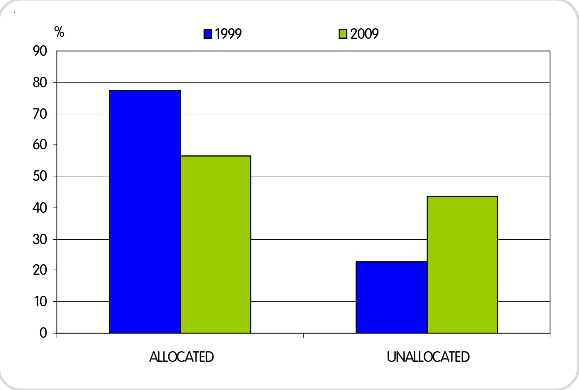
Total (allocated + unallocated): World



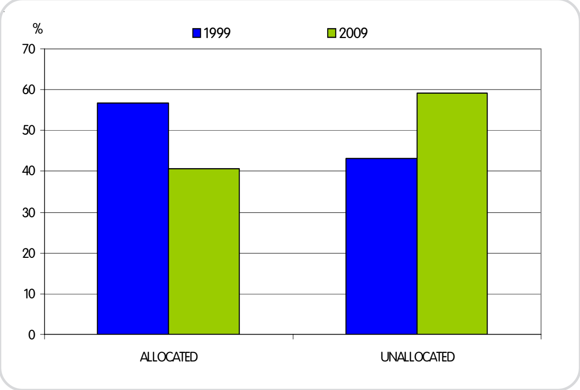
Total (allocated + unallocated): Emerging economies



World - allocated vs unallocated reserves



Emerging economies - allocated vs unallocated reserves



World - allocated vs unallocated reserves, %

	1999	2009
ALLOCATED	77.4	56.5
UNALLOCATED	22.6	43.5

Emerging economies - allocated vs unallocated reserves, %

	1999	2009
ALLOCATED	56.8	40.8
UNALLOCATED	43.2	59.2

Allocated reserves - World, %

	1999	2009
USD	71.0	62.1
GBP	2.9	4.3
JPY	6.4	3.0
CHF	0.2	0.1
EUR	17.9	27.4
OTHERS	1.6	3.1

Allocated reserves - Emerging economies, %

	1999	2009
USD	72.7	58.2
GBP	2.5	5.9
JPY	4.0	1.9
CHF	0.5	0.0
EUR	19.0	30.8
OTHERS	1.4	3.2

Total (allocated + unallocated): World, %

	1999	2009
USD	55.0	35.1
GBP	2.2	2.4
JPY	4.9	1.7
CHF	0.2	0.1
EUR	13.9	15.5
OTHERS	1.2	1.8

Total (allocated + unallocated): Emerging economies, %

	1999	2009
USD	41.3	23.7
GBP	1.4	2.4
JPY	2.2	0.8
CHF	0.3	0.0
EUR	10.8	12.6
OTHERS	0.8	1.3

World reserves (2009) - 1% drop in EUR vs USD share = $79.95bln, or 64.5bln eur (at 1.24)

BEFORE

TOTAL	8,086,805	% share
USD	6,357,896	78.6
GBP	194,183	2.4
JPY	137,680	1.7
CHF	5,318	0.1
EUR	1,249,954	15.5
OTHERS	141,774	1.8

AFTER

TOTAL	8,086,805	% share
USD	6,437,850	79.6
GBP	194,183	2.4
JPY	137,680	1.7
CHF	5,318	0.1
EUR	1,170,000	14.5
OTHERS	141,774	1.8

Quantitative Market Analysis

- **Return of USD/JPY correlation with 10y yield spread**
- **AUD and CAD longs fall to 3-mth low**

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 and EUR positions fell back to -80,900 and -107,900 contracts, respectively, mainly led by a decline in non-reported positions. For GBP/USD and EUR/USD, this week's price action suggests that positioning [probably remained largely unchanged. GBP/USD ran into resistance in the 1.46 area as equities blow hot and cold. The comments by China on the composition of its currency reserves provided a short-term fillip for EUR/USD, but absence of follow through buying indicates a reluctance to cut EUR shorts in a more decisive way. This was also illustrated in other EUR crosses and the broad based fall in EUR vs all G10 currencies over the last week.

Long AUD and CAD positions continue to take big hits, with bullish sentiment falling to the lowest level since February 16 (AUD, 35,600 contracts) and February 23 (CAD, 54,900 contracts). The moves come despite the prospect of a first rates hike in Canada next week, and still superior rate differentials for the AUD vs the G10. Short JPY positions vs the USD rose by 8,000 contracts to 54,700, despite the fragile state of confidence in risk assets. The release of US non-farm payrolls, and central bank rate decisions in the UK, the Euro zone and Canada mean the week ahead could be subject to substantial IMM swings and elevated volatility.

The US DXY saw its progress stalled around 87.45, but a technically bullish formation will in our view steer the dollar index higher over the trading sessions ahead. A test of 87.46 clears the path for a move up to 89.0 as global risk aversion causes participants to reassess prospects for high yield and commodity currencies, and favour safe haven dollar bids.

We detect no major changes in risk reversal skews. Except for AUD/USD and NZD/USD, and to a lesser extent USD/CAD, reversals remain heavily biased towards USD calls especially for EUR and GBP. The same also applies for SEK and NOK. We have warned that extreme skews and positioning could be a precursor to a counter-trend move, but the fragile risk sentiment backdrop tells us that a major reversal is probably unlikely in the short-term. Though we noted a decline this week, short-dated volatility is still above historical norms especially for the EUR crosses (EUR/USD and EUR/CHF). 1y vs 1mth volatility fell back for most crosses, resulting in flatter curves. The VIX index reversed course dropping back below 40, but found support above 30, above the average for the last three quarters.

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	**0.88**	0.43	0.47	0.50	**0.75**	**0.97**	**0.91**
10 YR SPD	-0.41	**-0.76**	-0.59	-0.42	**0.93**	**0.86**	**0.92**
S&P500	**0.96**	**-0.96**	**0.86**	**0.89**	**0.96**	**0.97**	**0.94**
Gold	-0.22	0.12	-0.61	-0.48	-0.23	-0.23	-0.49
Oil	**0.87**	**-0.79**	**0.95**	**0.97**	**0.84**	**0.87**	**0.95**
Relative Yield Curve	**0.93**	0.73	**0.79**	**0.89**	**-0.89**	**0.89**	-0.45
CRB	**0.94**	**-0.90**	**0.94**	**0.97**	**0.91**	**0.94**	**0.97**

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).

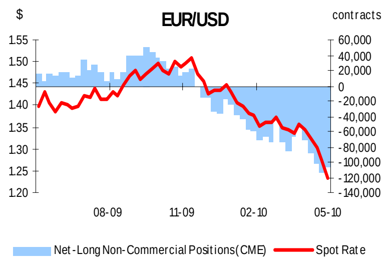
G10 correlations with 2y interest rate differentials are still significant for EUR/JPY and AUD/JPY and gained in importance for AUD/USD. For AUD/JPY and EUR/JPY but again in USD/JPY, 10y rate differentials play a powerful role. For USD/JPY this marks a sea change from recent weeks when rate differentials have had no traction with USD/JPY. This bears close watching in the days head, especially with USD/JPY flirting with a rally though 91.50. A strong NFP number could drag 10y US yield higher relative to JGB's driving a rally in USD/JPY closer to 92.0.

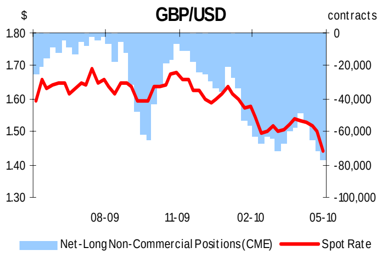
In terms of risk assets (S&P 500), the correlation in GBP/USD dropped marginally to 0.891. AUD/USD with the S&P rose to 0.96, as did the correlation with USD/JPY. The correlation of GBP/USD with the CRB commodity index was unchanged at 0.97 and calls for commodity price trends to be closely monitored for performance of the currency pair. The same still applies for AUD/JPY and EUR/JPY.

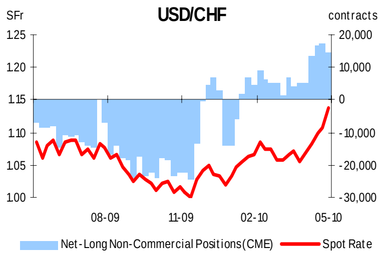
The gulf between EUR/USD and the EU/US economic surprise index stabilised over the past week. The country PMI and ISM surveys as well as US payrolls are likely to have a major impact on the surprise indices but we are cautious not to read too much into any deviations for currencies as other factors sill take precedence (sovereign debt, equities, etc).

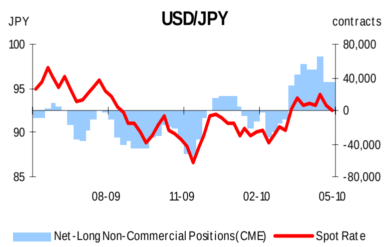
FX & Commodity Futures Positioning

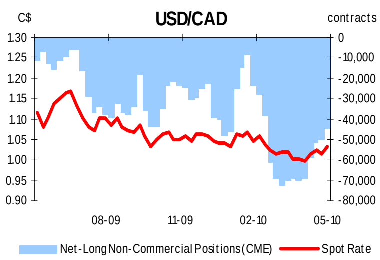
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

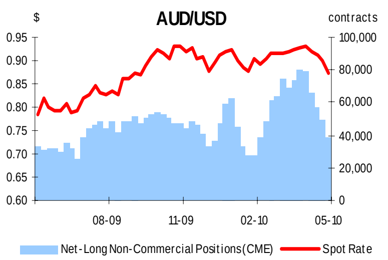


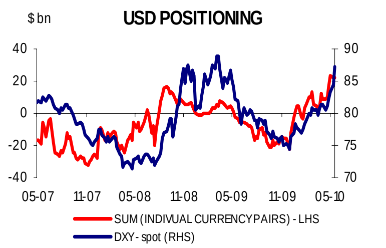


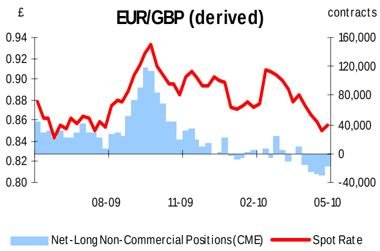


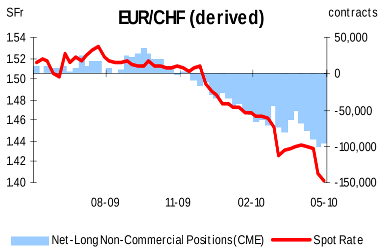


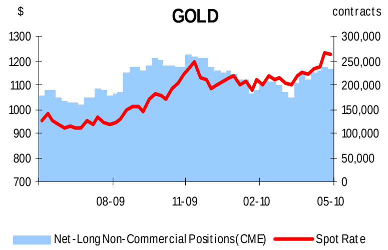


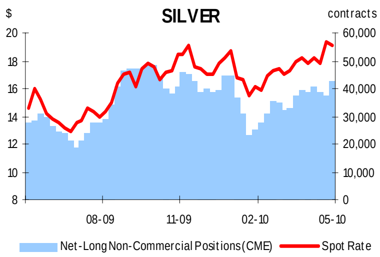


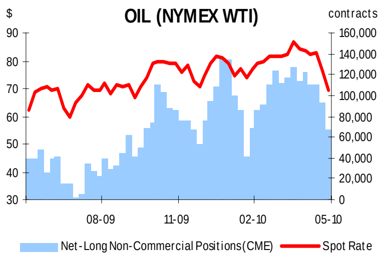


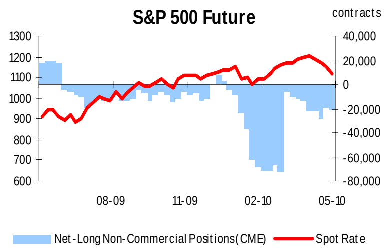


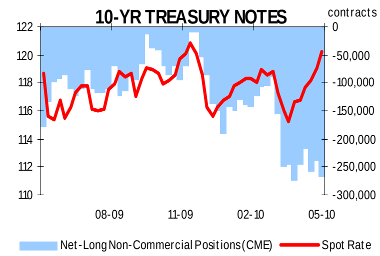


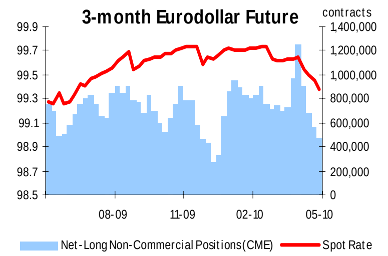






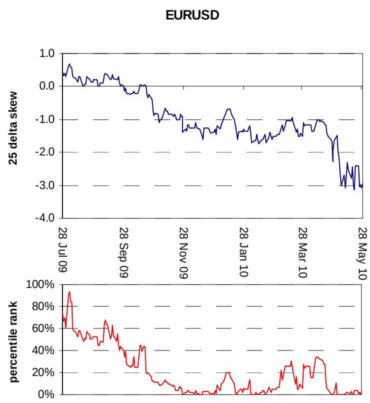


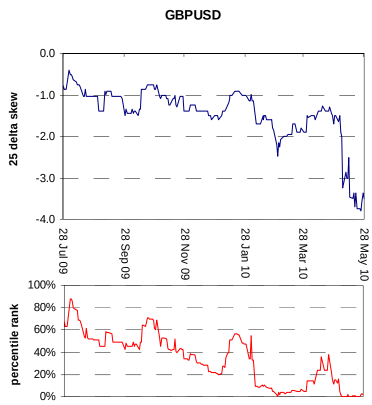


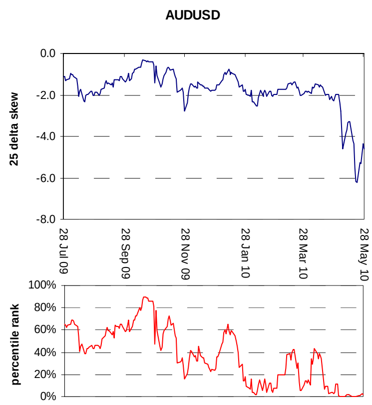


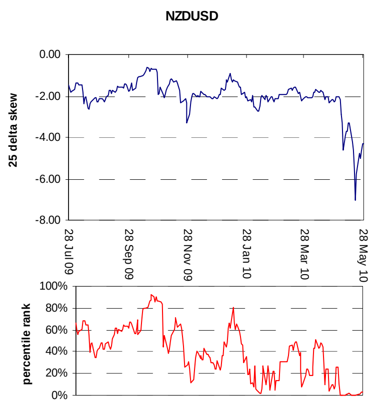
FX Options: Risk Reversal Skews

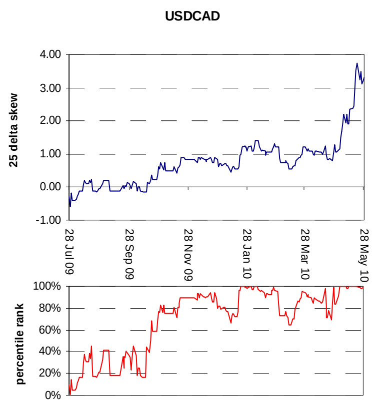
The risk reversal skew is the difference in volatility between similar out-of-the-money call and out-of-the-money put options. A positive risk reversal means that the implied volatility (used for pricing) of the call is greater than that of the put. In this section, the skew is based on 1-month 25 delta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

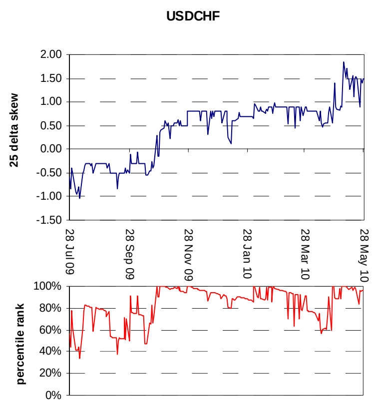


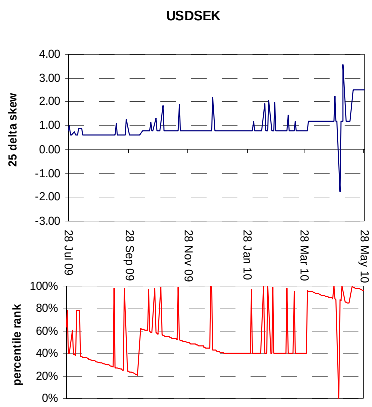


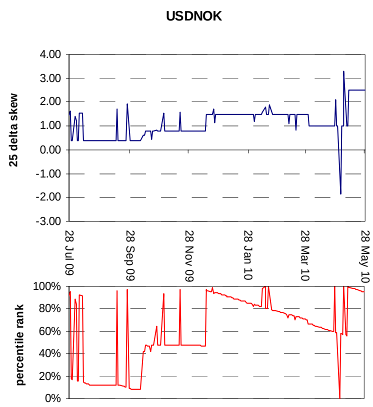


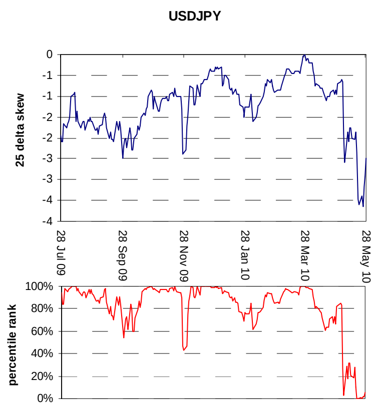






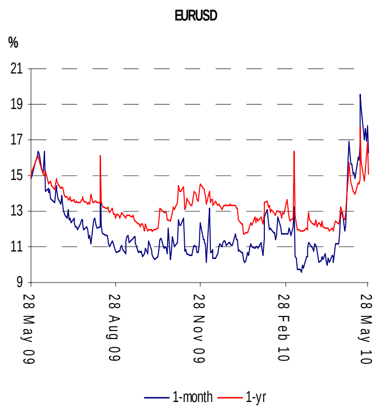


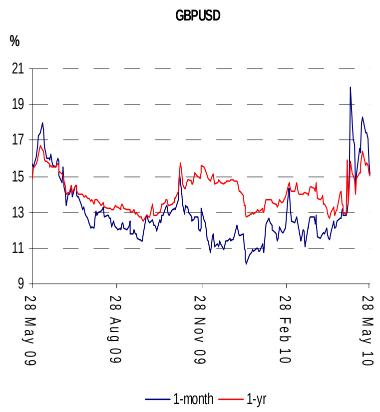


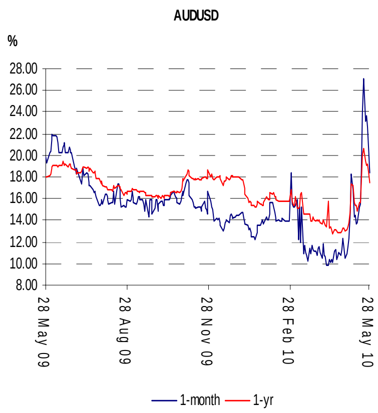


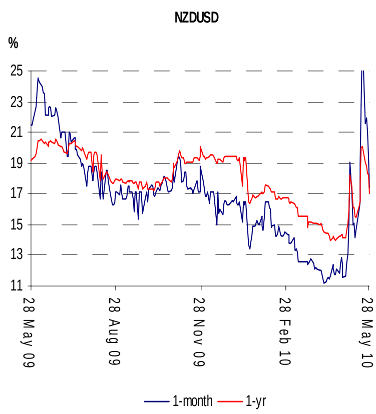
FX Options: Implied volatility

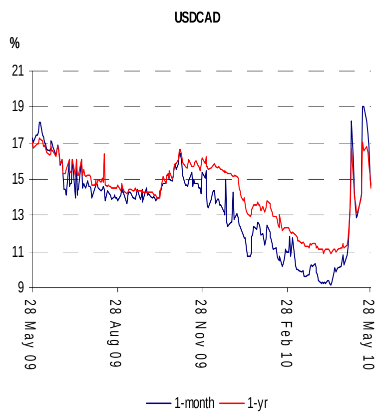
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

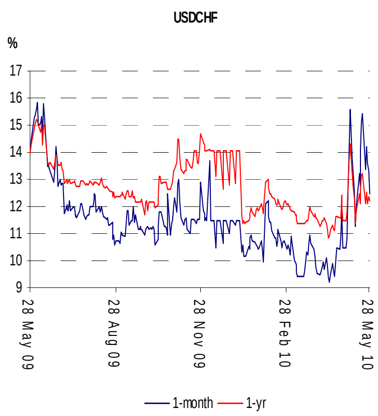


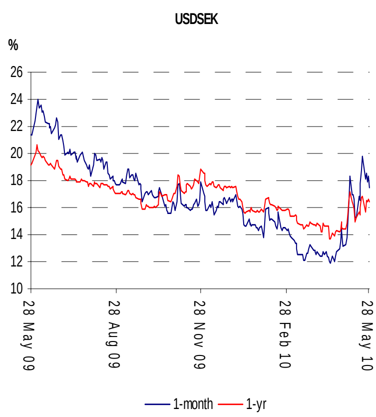


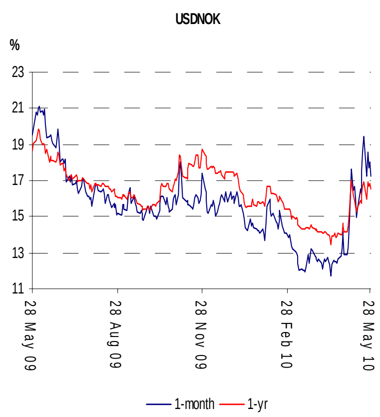


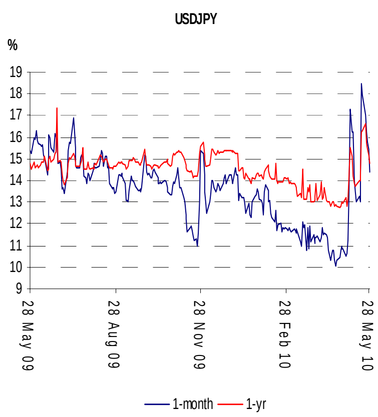






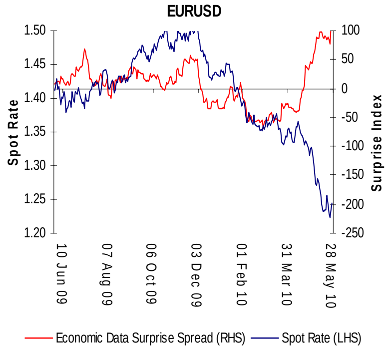


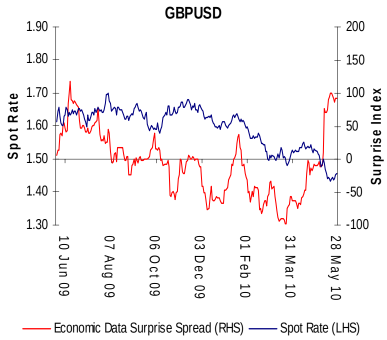


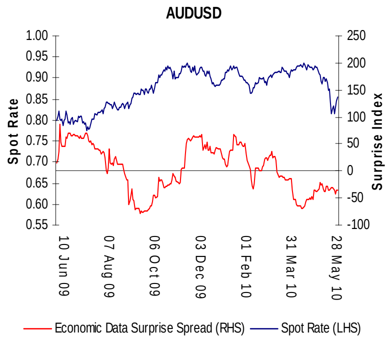


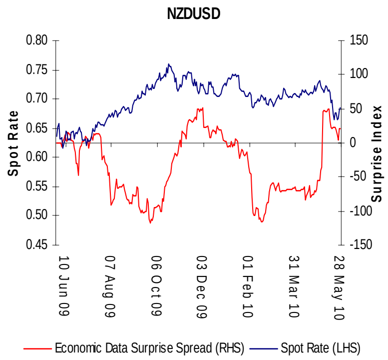
Economic Data Surprises

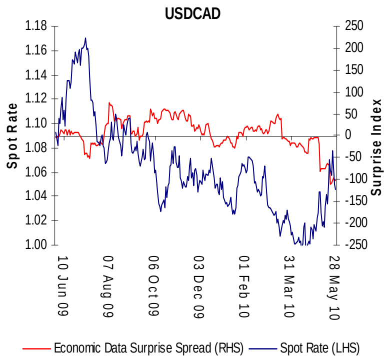
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

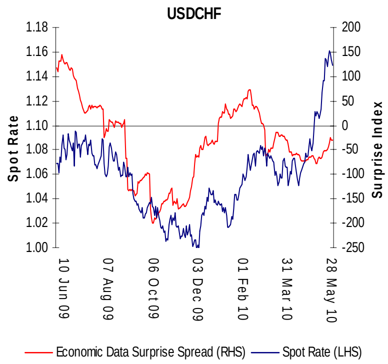


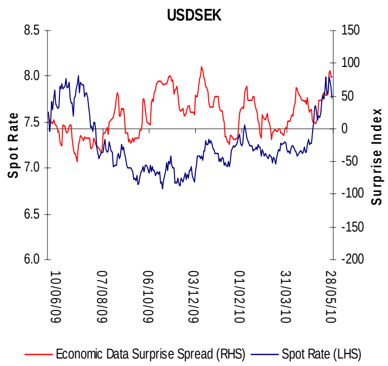


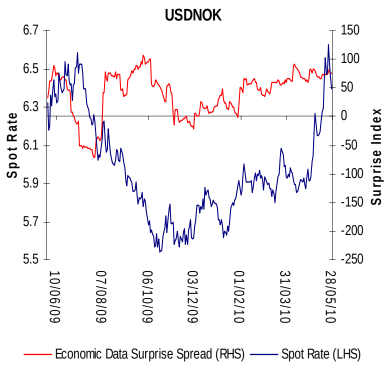


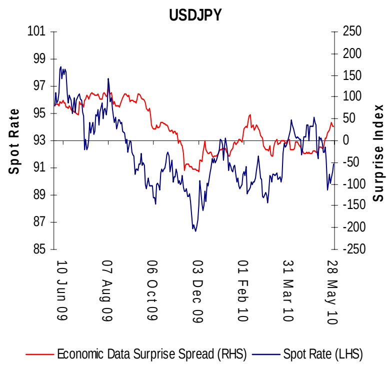






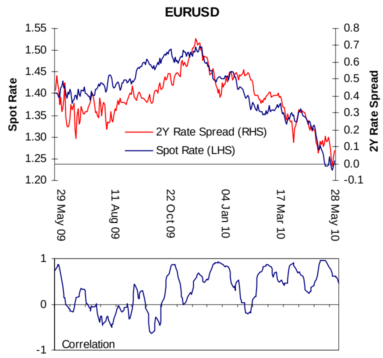


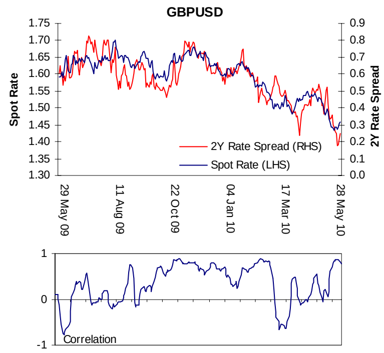


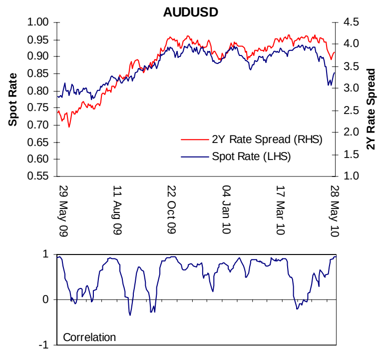


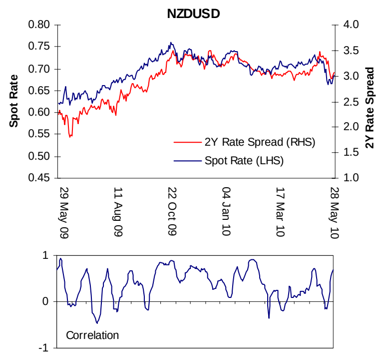
Interest Rate Spreads vs. FX

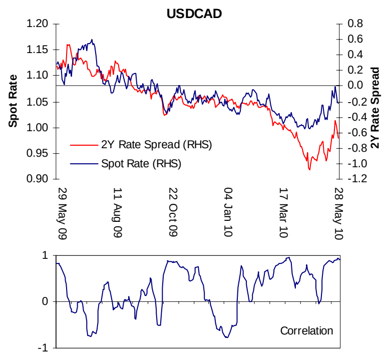
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

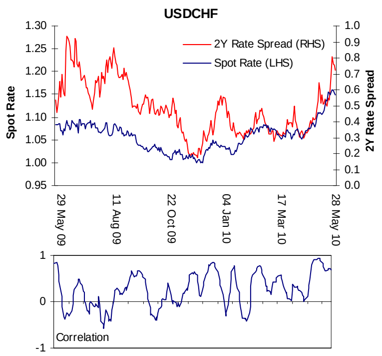


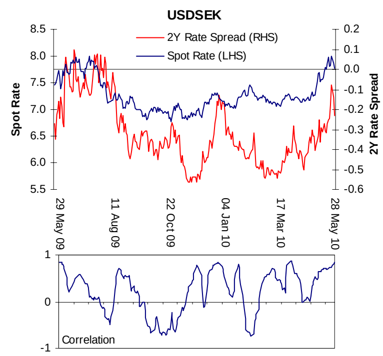


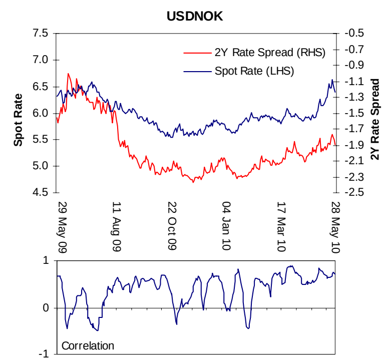


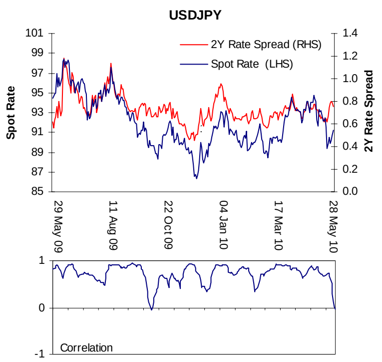






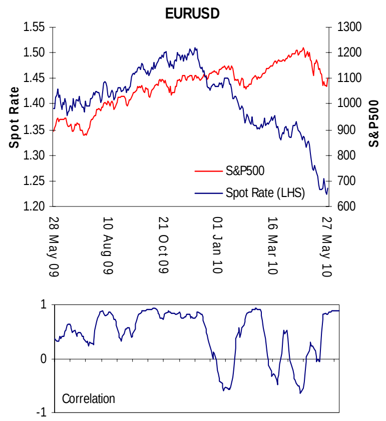


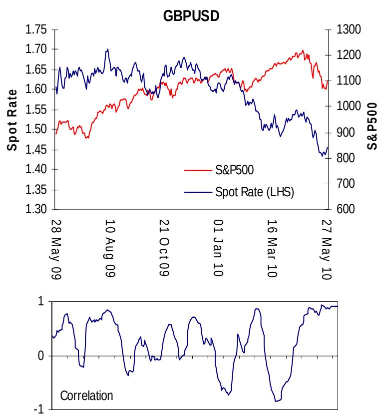


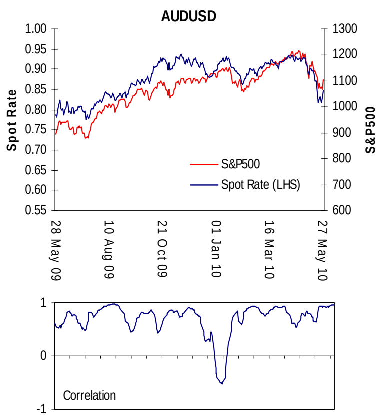


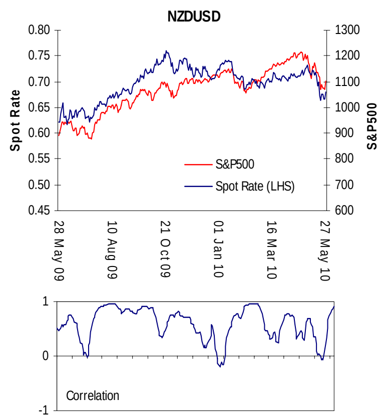
S&P500 vs. FX

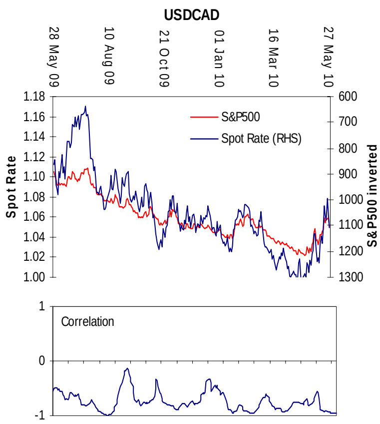
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

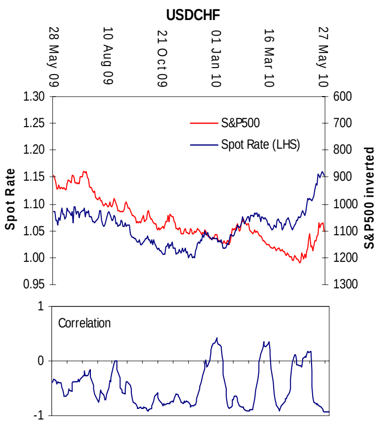


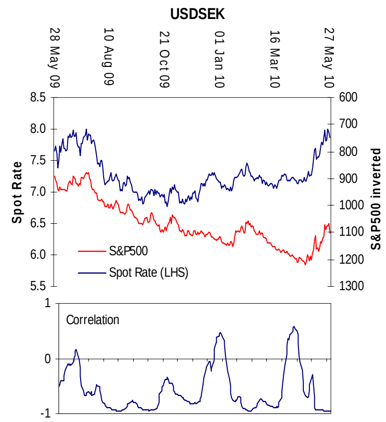


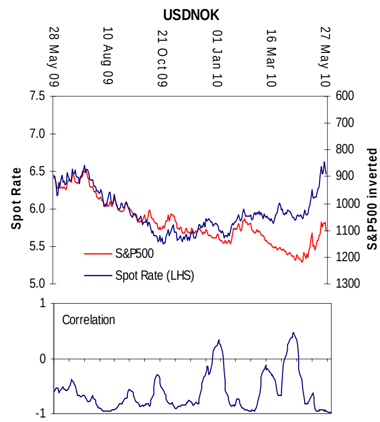


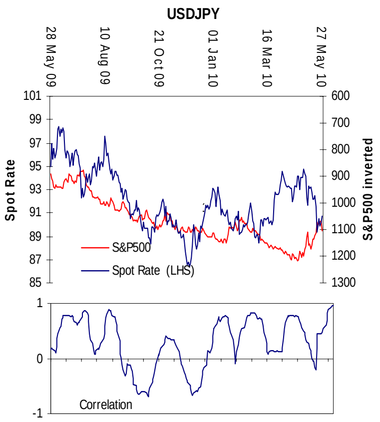






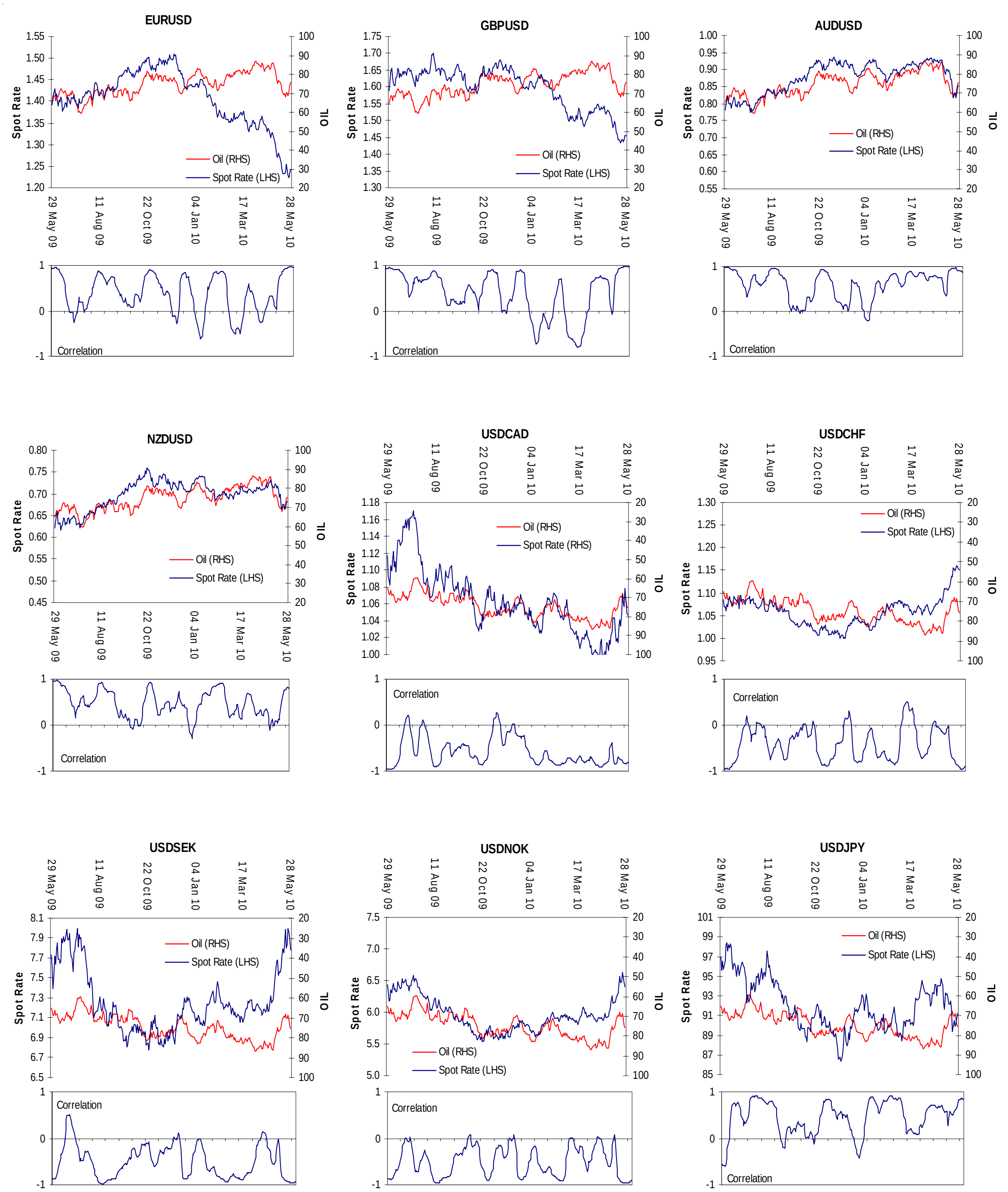






Commodities vs. FX

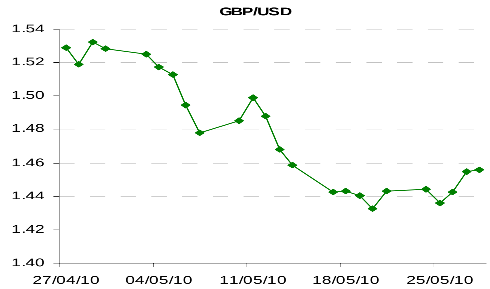
The charts below show oil prices plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

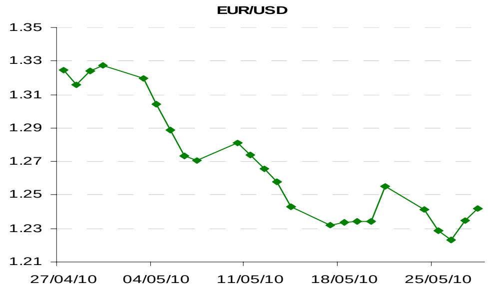


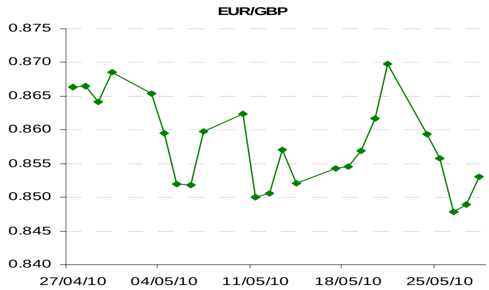
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

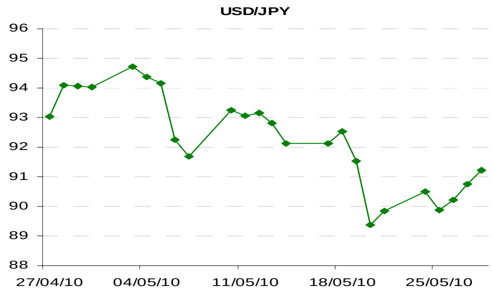
Market Review

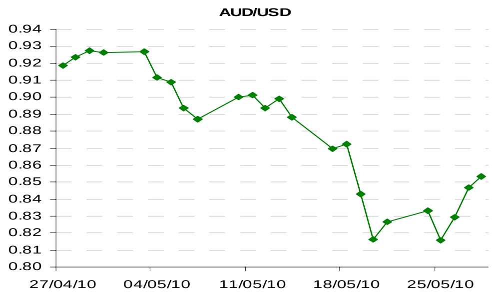
Short-term G-10 FX Charts

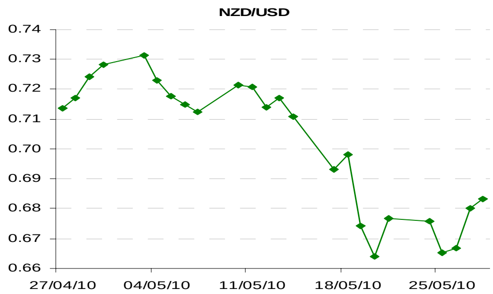


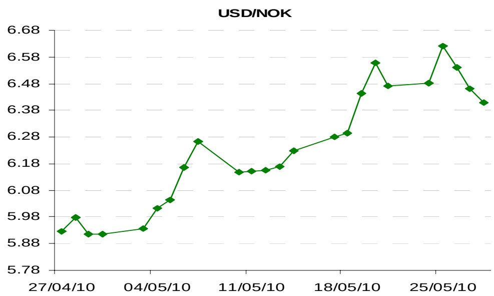


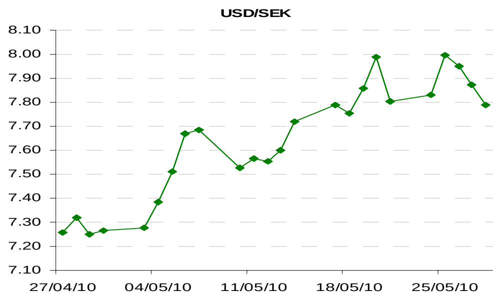


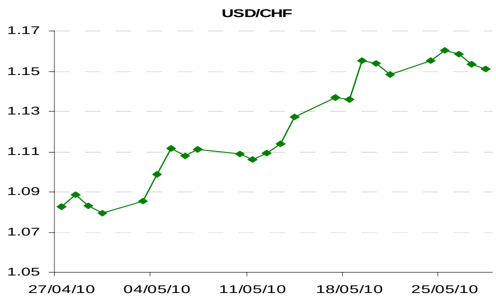


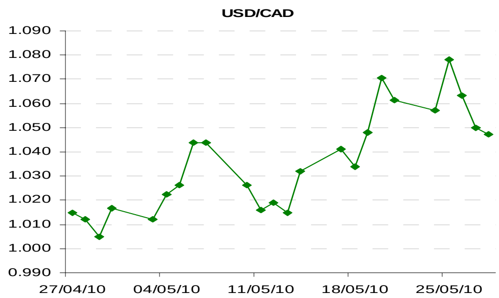




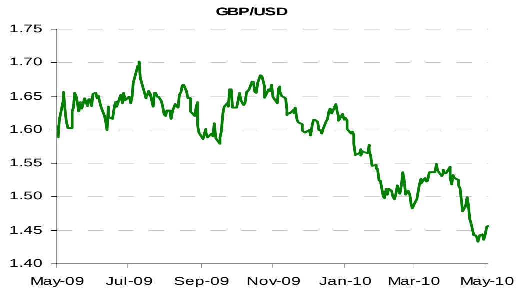


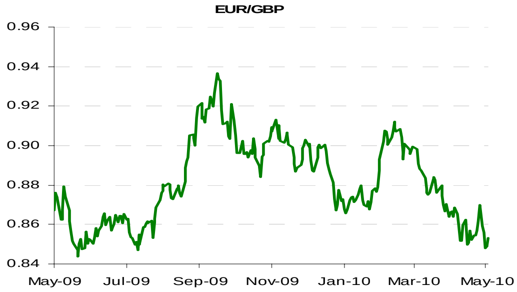


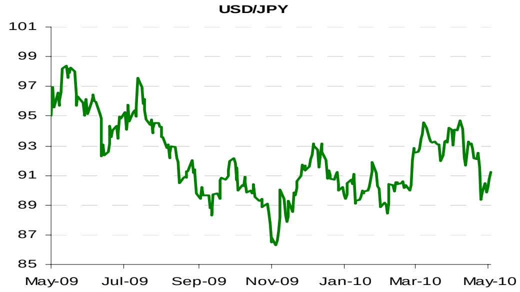


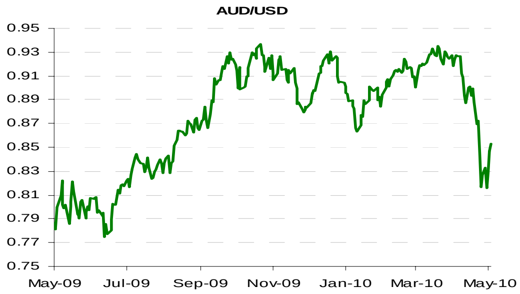


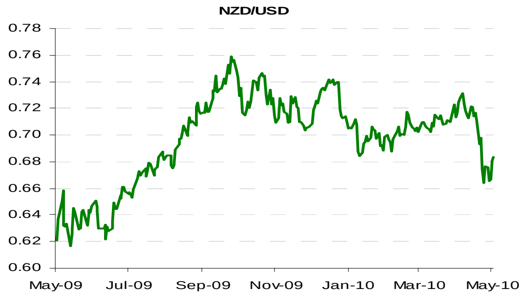
Medium-term G-10 FX Charts

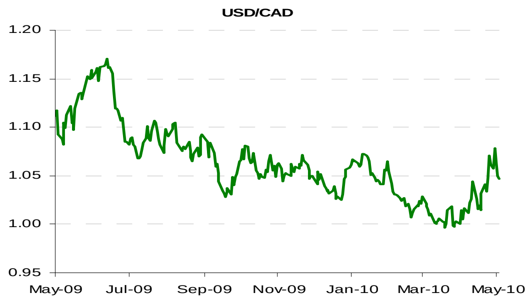






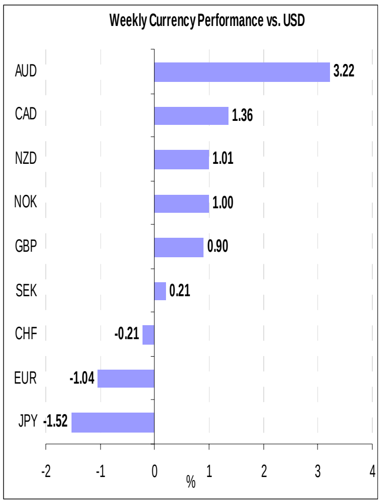


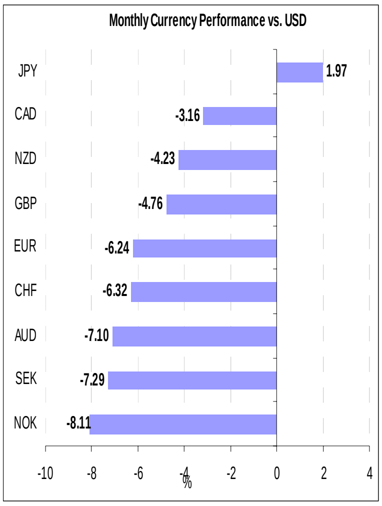


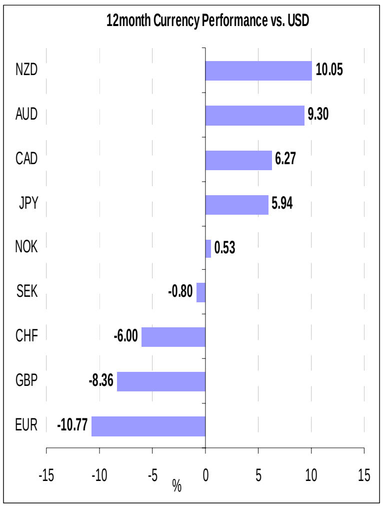


FX Snapshot

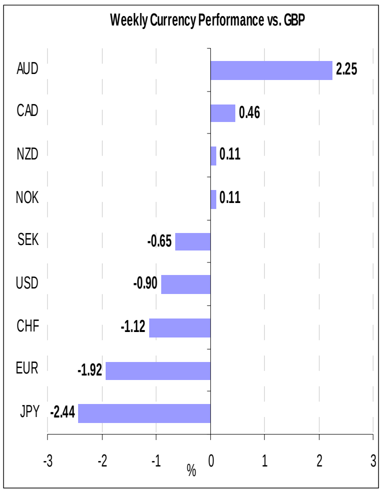
Currency performance vs. USD

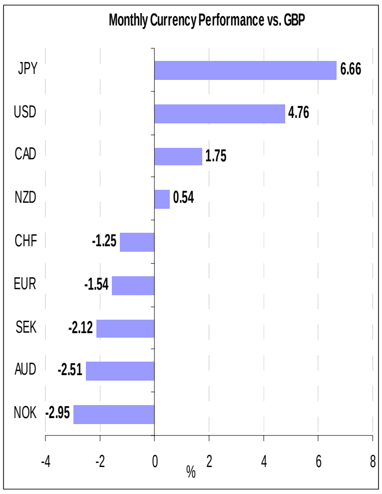


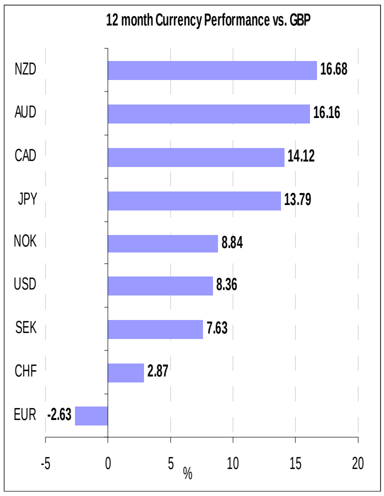




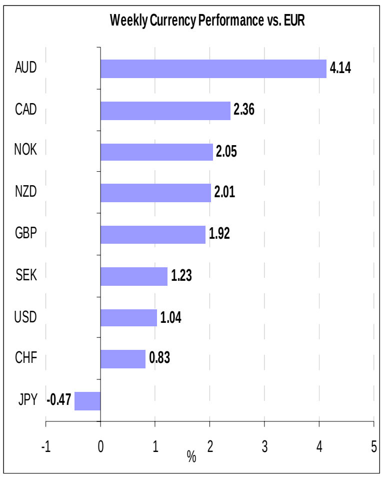
Currency performance vs. GBP

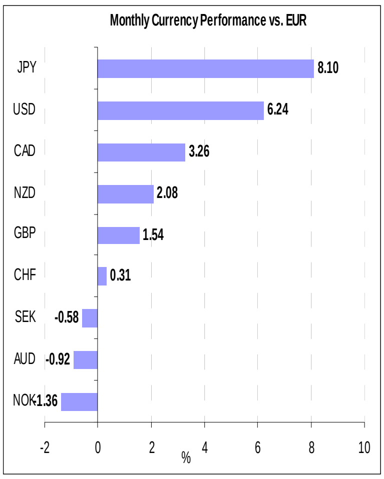


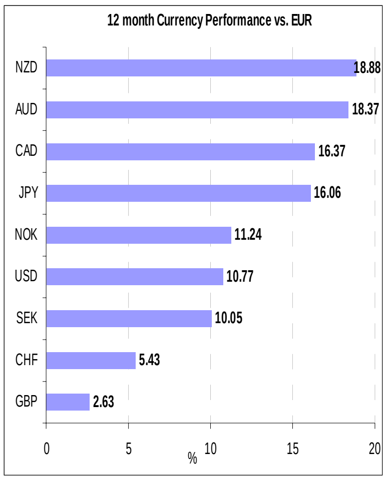




Currency performance vs. EUR







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