Friday, 11th June 2010

# FX Strategy Weekly

Market Strategy

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

## Market Outlook

Tactical view:

= EUR/CHF: lurch lower on SNB liquidity decision?

A rally in risk assets was accompanied by a fall in ST volatility this week, boosting demand for AUD, NZD and CAD. A rejection of key resistance targets and a lack of conviction in stocks leaves many participants pondering whether to further reduce risk exposure until clearer trends emerge. The performance of sovereign debt and talk of a yuan reval will dictate near-term direction, though Q2 corporate updates from the US will soon appear on the radar as we move into the second half of June. A more hawkish inflation message from the SNB next week or a decision to drain liquidity could cause selling of EUR/CHF to resume. We continue to treat rallies in EUR/G10 with suspicion and reiterate our medium-term EUR/USD target of 1.15.

## Recap

- The fx summary virtually reads like a copy of two weeks ago with the AUD outclassing the G10 table backed by a relief bounce in risk assets and a recovery from technically oversold conditions. The currency rallied 2.9% vs the USD through 0.84 and gained 2.6% vs the JPY and 2.5% vs GBP below 1.72. Supportive comments by China briefly lifted EUR/USD over 1.21 but the cross ran into profit taking on Friday. A poor overall performance for GBP resulted in sterling losing ground against all but two currencies of the G10, namely the USD and the JPY. GBP/USD hit a 1.4759 high on Friday but reversed sharply into the close to finish below 1.4550, near the middle of the 4-week trading range. EUR/GBP bounced off a 0.8211 low to close over 0.83.

- The BoE left Bank Rate on hold at 0.50% and the asset purchase limit was also left unchanged, at £200bln. Inflation expectations accelerated to 3.3% from 2.5% according to the quarterly BoE survey, but proved no fillip to GBP or a concern to gilts as risk aversion drove yields lower. The UK global trade deficit narrowed to £7.27bln in April from £7.52bln in March. Input prices fell a smaller than forecast 0.6% m/m in May. Output prices rose 0.3% m/m (up 0.1% excluding energy). Manufacturing output fell 0.4% m/m in April, registering its first drop in three months. Confidence in economic recovery was buoyed by solid NIESR GDP data. Covering the three month period to May, GDP rose 0.6% q/q. Data for the quarter to April was revised up to 0.7% from 0.5%.

- UK 5y swaps closed below 2.50% after running up to a high of 2.57%. 3mth Libor held steady at 0.73%, causing the 3mth Libor/5y swaps curve to flatten to 176bp. The 3mth Libor/ois spread widened a fraction to 24bp. The 2y/10y swaps curve flattened to 194bp, the lowest since last October. Profit taking after a solid new 10y auction pushed 10y gilts to 3.58% on Thursday, but buyers returned on Friday, squeezing yields back below 3.50%. National Express (225mln) and KFW (800mln) were the two issuers of sterling paper.

| | Close | Weekly Change |
|---|---|---|
| **FX** | | **%** |
| GBP/EUR | 1.2029 | -0.41% |
| GBP/USD | 1.4509 | 0.38% |
| GBP/JPY | 132.93 | 0.07% |
| GBP/CHF | 1.6732 | -0.41% |
| GBP/AUD | 1.7127 | -2.44% |
| GBP/NZD | 2.1087 | -2.15% |
| GBP/CAD | 1.5068 | -1.91% |
| GBP/NOK | 9.4182 | -1.21% |
| GBP/SEK | 11.54 | -0.46% |
| EUR/USD | 1.2062 | 0.79% |
| USD/JPY | 91.62 | -0.30% |
| AUD/USD | 0.8471 | 2.88% |
| NZD/USD | 0.6881 | 2.59% |
| USD/CAD | 1.0384 | -2.31% |
| USD/SEK | 7.9506 | -0.84% |
| USD/NOK | 6.4908 | -1.57% |
| USD/CHF | 1.1532 | -0.77% |
| **Swaps %** | | **bp** |
| 2yr | 1.470 | -3.5 |
| 5yr | 2.493 | -6.0 |
| 10yr | 3.413 | -5.2 |
| **Equities** | | **%** |
| FTSE100 | 5163.68 | 0.74% |

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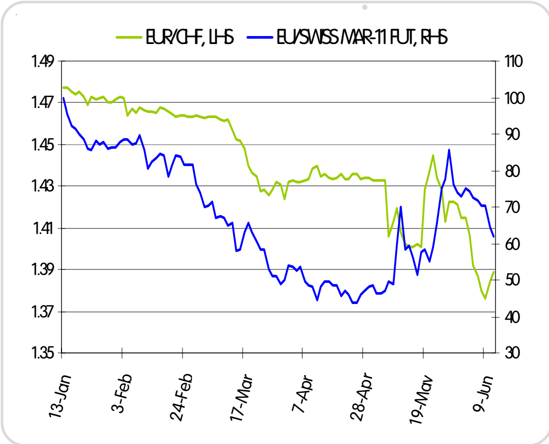
**Kenneth Broux - Senior Market Economist**
**contact: +44 207 158 1750**

## G10 FX update - EUR/CHF - SNB meeting on June 17

3-mth target: 1.35

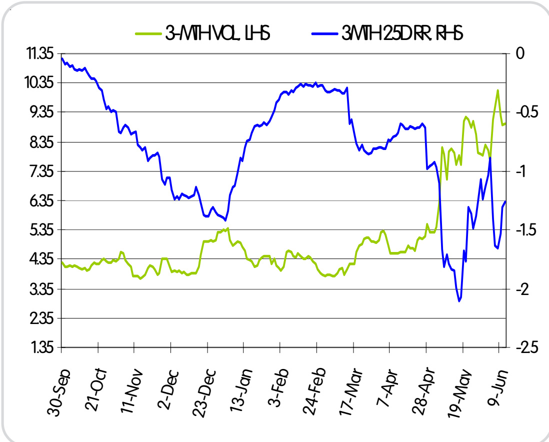
Extreme levels of volatility in EUR/CHF have been observed and will in our view continue to characterise the short and medium-term outlook. After trading in a 1.46-1.48 range over the best part of Q1, the cross registered sharp swings to the downside punctuated by occasional relief rallies in March, May and June, taking out key technical levels at 1.46, 1.43 and 1.40. The pair hit a 1.3734 low on June 9. Intervention policies by the SNB and developments in Eastern European credit and mortgage markets are likely to be a key factor in the direction of EUR/CHF over the forecast horizon which we believe offers scope for additional depreciation in the short-term.

EUR/CHF: narrowing rate futures weigh



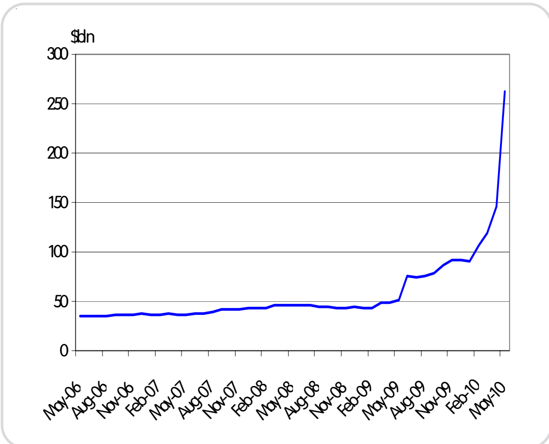

The volatility in EUR/CHF can be partially attributed to the EU sovereign debt crisis and SNB intervention to curb excessive appreciation of the Franc. The systematic intervention by the SNB is conducted through the purchase of foreign currency incl EUR denominated bonds. The SNB has been operating a de facto policy of quantitative easing since March last year, resulting in an extraordinary upswing of the Bank's currency reserves. Total currency reserves surged more than 50% last month alone to just over $260bln to stop EUR/CHF from grinding further below 1.38. Total reserves stood at just $52bln a year ago.

Volatility set to stay above historical norm?




Though Swiss CPI inflation is still forecast to edge back up to 2% over the next two years, the SNB is worried that Franc strength vs the EUR, the currency of its main trading partner, could cause deflationary pressures to return. The safe haven status has also helped the Franc to strengthen as fears of debt and credit contagion from Greece spreads through the euro zone. How the EU debt crisis evolves and whether the 440bln euro Stability Mechanism is eventually triggered may play a prominent role over the direction of EUR/CHF as markets consider the implications of ambitious fiscal consolidation programmes on euro zone economies and the ability to service public debt. Wild swings in EUR/HUF on June 6 demonstrated that moves in EUR/CHF may also depend on economic and credit developments in Eastern Europe where EU banks carry a high exposure through Franc denominated mortgages.

SNB currency reserves have exploded




With inflation in Switzerland running ahead of the March SNB projections and the economy and exports so far doing well to resist the stronger Franc, questions are now raised whether and how soon the SNB will end its ultra-loose monetary policy strategy. With interest rates pinned at 0.25% since March-08, the SNB may decide to start mopping up excess liquidity, with higher rates following later this or early next year. This is in contrast to the ECB where additional liquidity operations were decided this week to bolster inter-bank lending. We also expect the refi rate to stay on hold for longer.

EUR/CHF: intermediate bounce before downtrend resumes

# Quantitative Market Analysis

- **EUR/USD and GBP/USD vol curves turn positive**
- **Oil & CRB correlation with GBP/USD still elevated**

## 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 have rebounded over the last two weeks though the rally up to 1.4759 in GBP/USD argues against a further speculative shorting of GBP. Overall positions stood at -93,600 contracts, just off the 97,000 high recorded at the end of May. By contrast, EUR short positions dropped back below the 100,000 mark to 97,000 contracts, mainly led by a decline in reported positions (-13,000 contracts). EUR/USD trends this week indicate that EUR positioning vs the USD may not have altered much over the course of the week, with supportive comments by China only offering marginal relief.

Long AUD and CAD positions were whittled down further, with long AUD speculative positions cut back for a 7th successive week to only 13,300 contracts. Long CAD positions fell by only 5,000 contracts to 41,900, causing long CAD/AUD positioning widening for a 6th successive week to 23,000 contracts. The pullback in CAD/AUD through 1.14 means the spread probably narrowed over the past week as 1.13 comes into view. The RBA minutes could be instructive for the AUD crosses next week. Following the latest solid employment stats, a further tightening in policy is not unrealistic in the second half of 2010. For EUR/CHF, a decline in EUR shorts vs CHF (derived from EUR/USD and EUR/CHF) is at odds with the bounce in the currency pair through 1.39. The SNB meeting next week (June 17) could have a major say over speculative CHF positioning.

The US DXY eased back below 88.0, but a bounce off 86.943 trendline support on Friday should bode well for a rally up to the June highs above 88.50 next week if equities languish. We reiterate our call for a move up to 89.0 led by EUR/USD.

Risk reversals moved away fractionally from still extreme EUR/USD bearishness and saw similar less bearish skews in GBP/USD and AUD/USD confirmed vs last week. The same applies for NZD/USD. Skews in USD/CAD hint at some improvement in CAD sentiment, a tendency underlined by the dip in USD/CAD below 1.04. Skews in USD/JPY have moved a long way from excessive bearishness, returning to the less extreme norms observed in early May. A sharp fall in short-dated vol caused 1mth/1y vol curve to steepen in EUR/USD to 0.65, marking a major reversal from the -2.4 low in May. For GBP/USD, 1mth vol (12.06) dropped through 1y vol (13.06), causing the vol spread to turn positive for the first time since early May. The VIX index fell back 5pts below 30 to 29.43.

Table 1: 1-month rolling correlations

| | AUDUSD | USDCAD | EURUSD | GBPUSD | USDJPY | AUDJPY | EURJPY |
|---|---|---|---|---|---|---|---|
| 2 YR SPD | 0.73 | **0.85** | 0.21 | 0.21 | 0.34 | **0.89** | **0.91** |
| 10 YR SPD | -0.67 | -0.43 | 0.27 | -0.38 | 0.64 | 0.72 | **0.90** |
| S&P500 | **0.92** | -0.75 | **0.82** | 0.62 | 0.70 | **0.90** | **0.94** |
| Gold | 0.38 | -0.59 | -0.22 | 0.45 | 0.62 | 0.46 | 0.13 |
| Oil | 0.55 | -0.70 | 0.30 | **0.85** | 0.60 | 0.59 | 0.51 |
| Relative Yield Curve | **0.92** | **0.81** | -0.10 | 0.57 | -0.67 | **0.88** | **-0.81** |
| CRB | **0.92** | **-0.84** | **0.78** | **0.82** | 0.70 | **0.90** | **0.91** |

## 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).

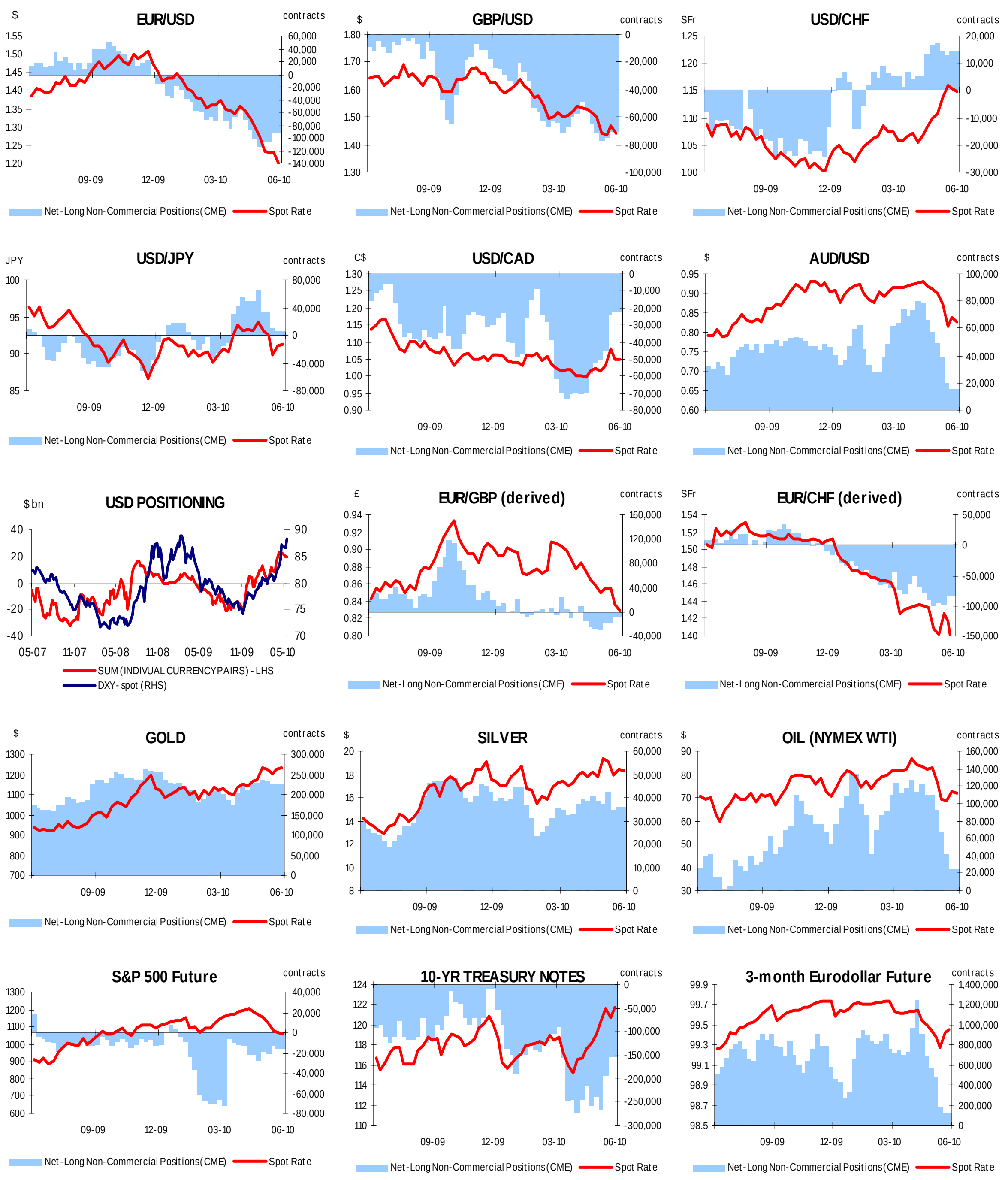
G10 correlations with 2y interest rate differentials are unchanged and still statistically significant for EUR/JPY (0.91) and AUD/JPY (0.89) but eased back for AUD/USD (0.73). 10y rate differentials are only significant for EUR/JPY as demonstrated in the rally for EUR/JPY through 110 on a 3bp widening in 10y bunds over JGBs. The correlation of 2y and 10y rate spreads with USD/JPY has completely broken down from a few weeks ago to insignificant levels. Correlation of USD/JPY with other assets is equally low, offering no clear guidance on future price trends.

In terms of risk assets (S&P 500), the correlation in GBP/USD fell to 0.62 but remains elevated for AUD/USD and EUR/JPY (0.94). The correlation of GBP/USD with the CRB commodity index (0.82) and oil (0.85) continues to impress and offers good short-term guidance.

The eurozone data surprise index still outperforms the US index (strong German industry data vs weak US retail sales to cit one example) but is hardly finding traction in EUR/USD. We do not expect macro data to play a determinant role in the short term, with the ECB decision to provide unlimited 3-mth LTRO unlikely to do the EUR many favours.

# FX & Commodity Futures Positioning

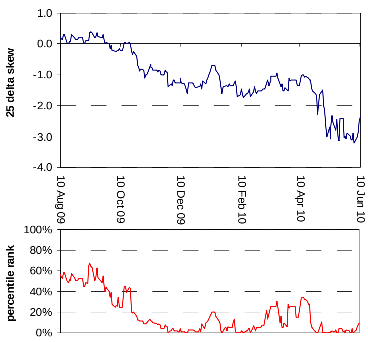
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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



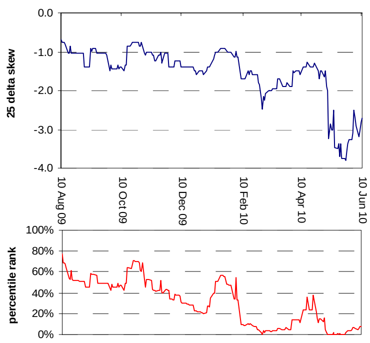
# FX Options: Risk Reversal Skews

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.

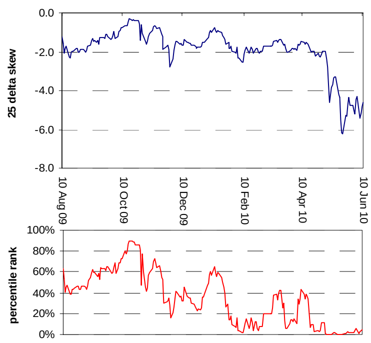
EURUSD



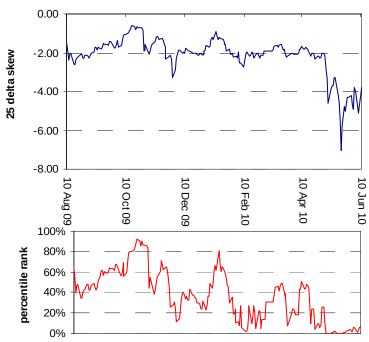

GBPUSD



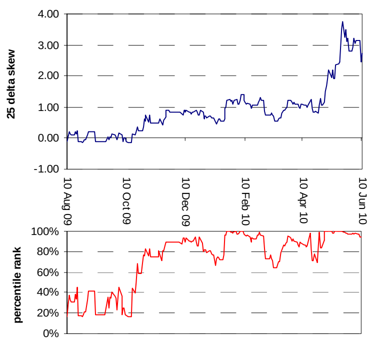

AUDUSD



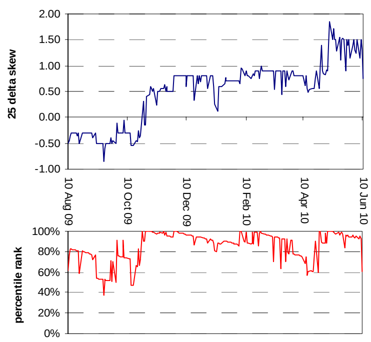

NZDUSD



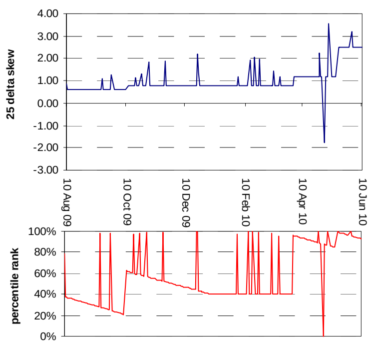

USDCAD



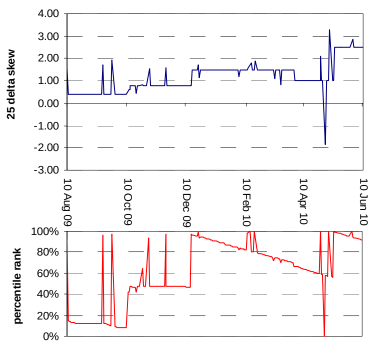

USDCHF



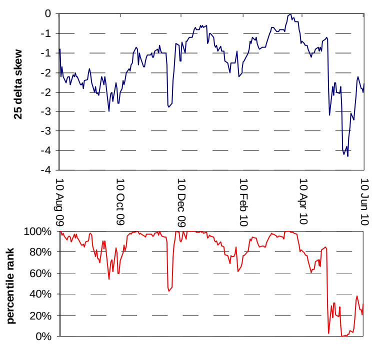

USDSEK




USDNOK

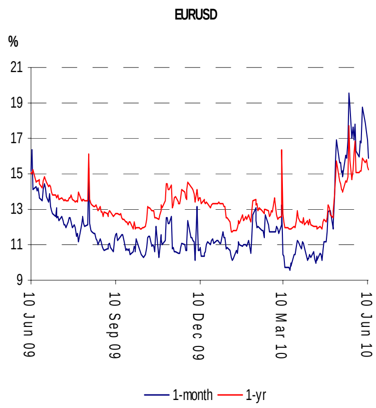


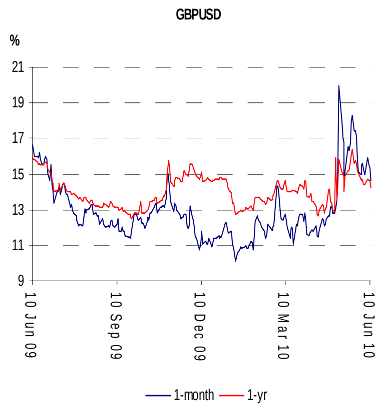

USDJPY

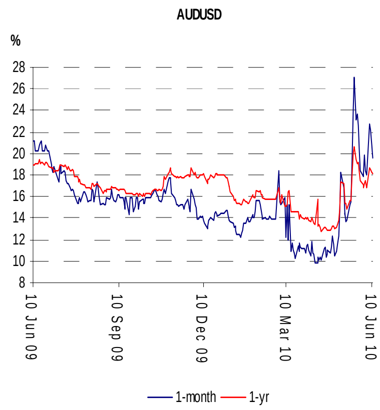


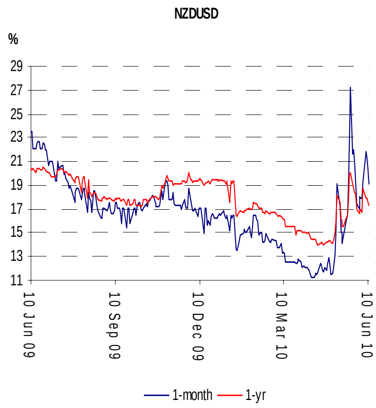
# FX Options: Implied volatility

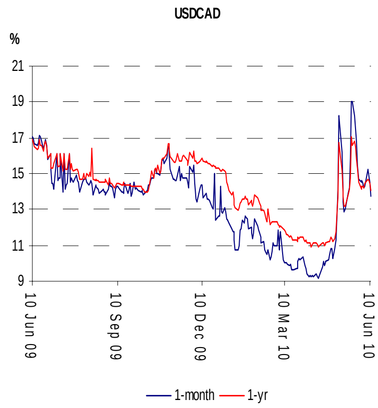
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

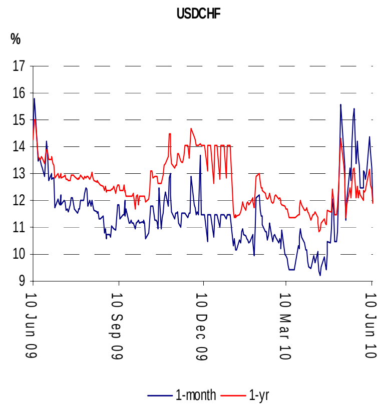


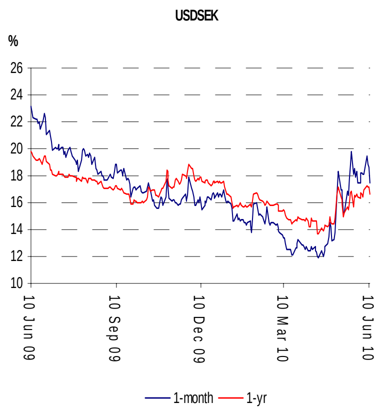



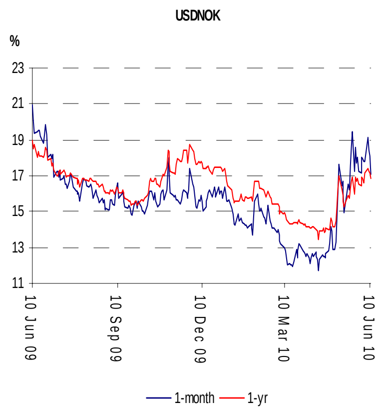



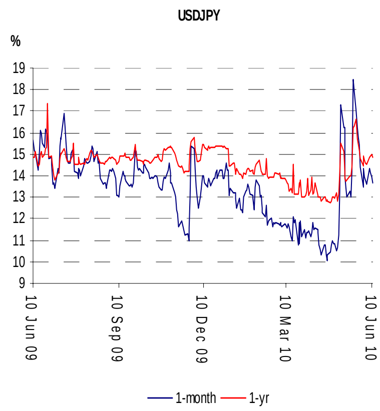



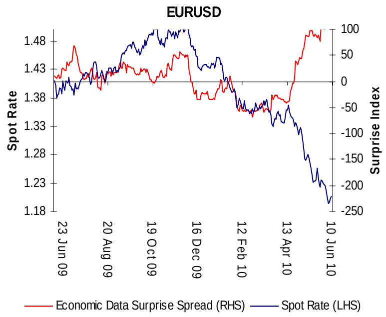



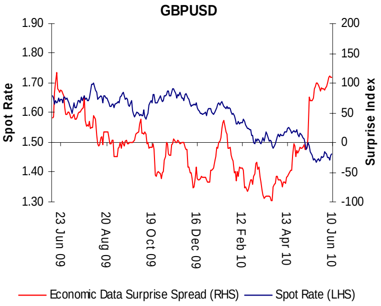



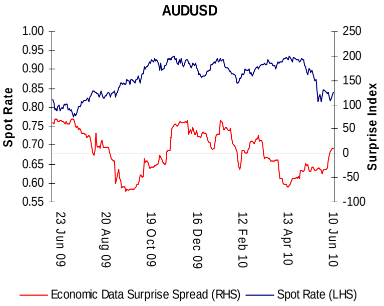



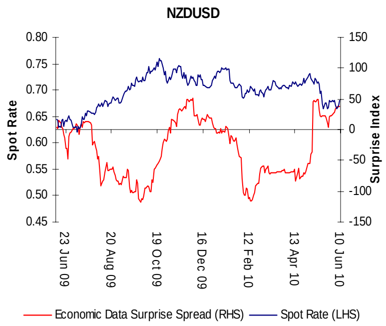
# Economic Data Surprises

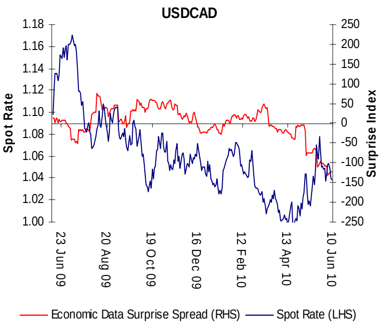
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

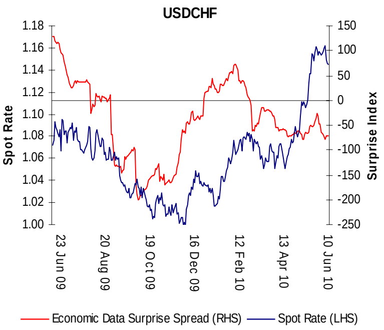


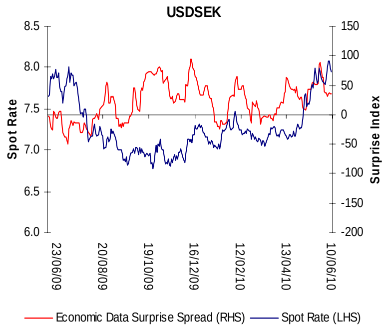



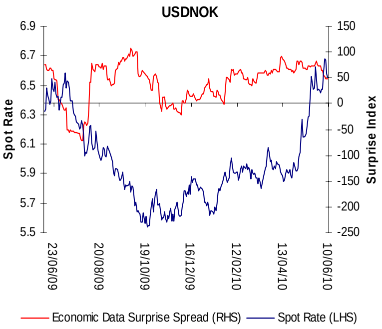



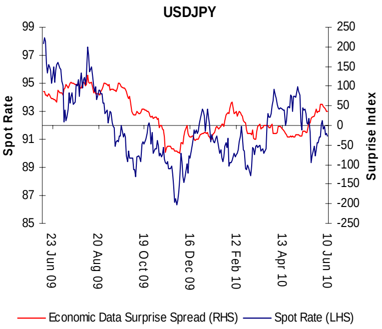



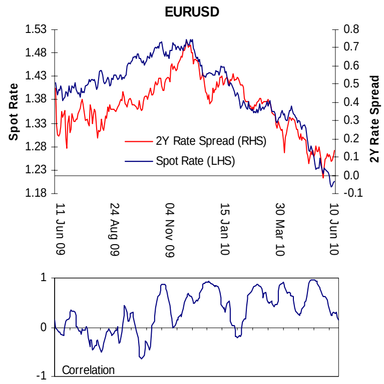



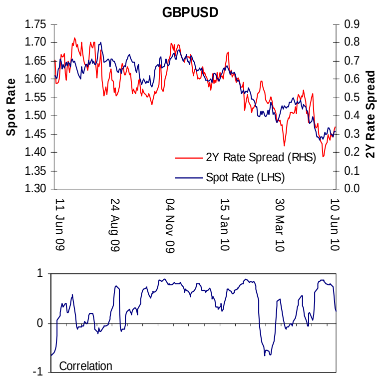



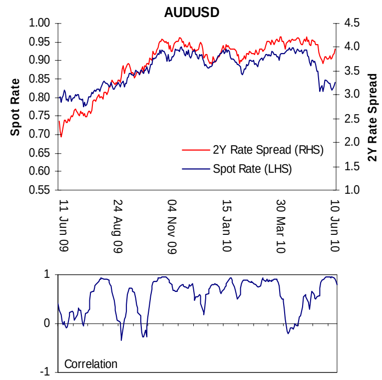



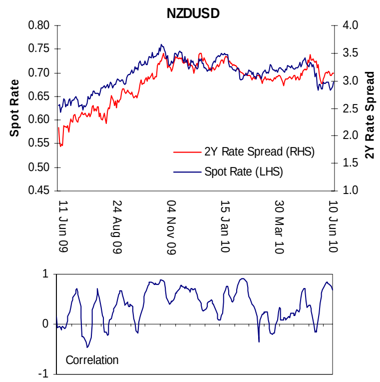
# Interest Rate Spreads vs. FX

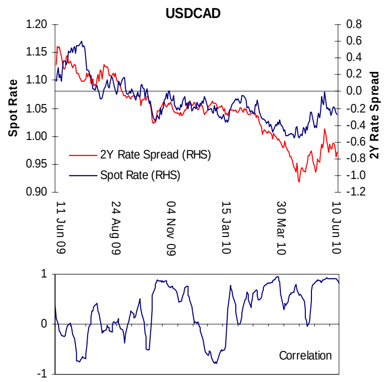
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

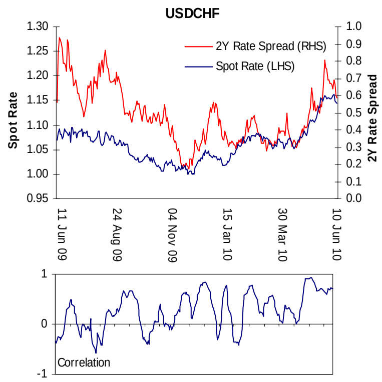


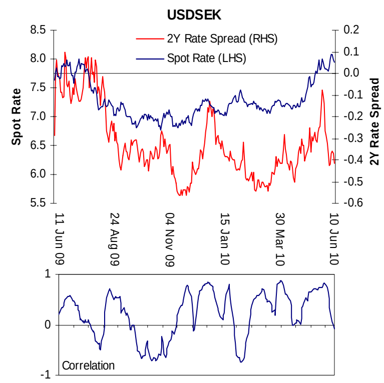



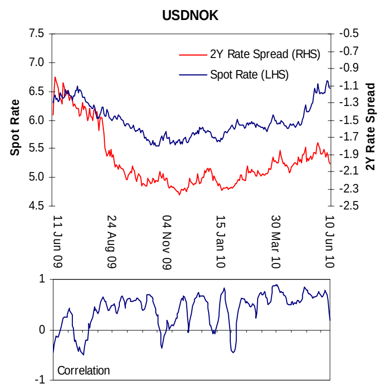



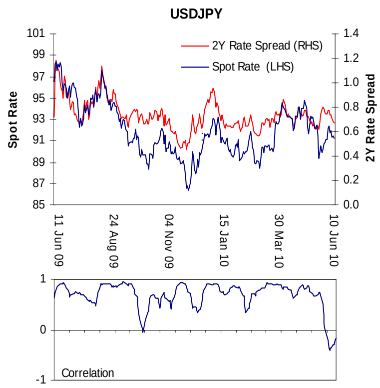



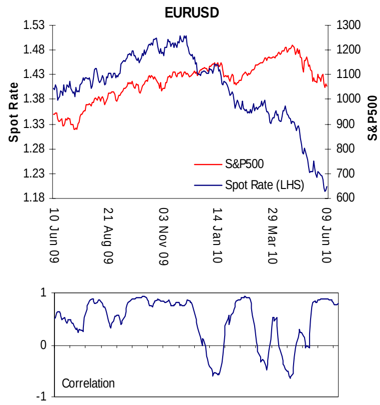



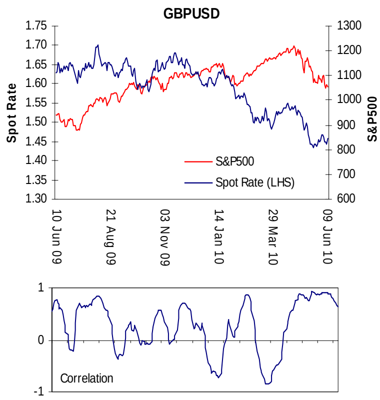



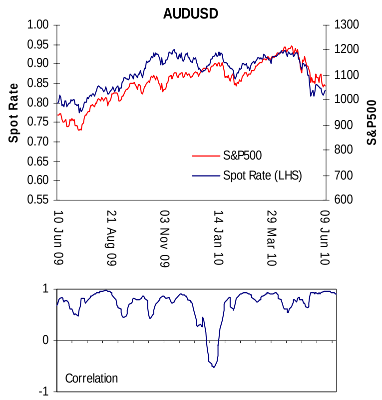



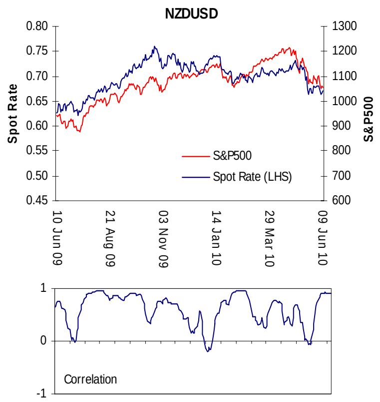
# S&P500 vs. FX

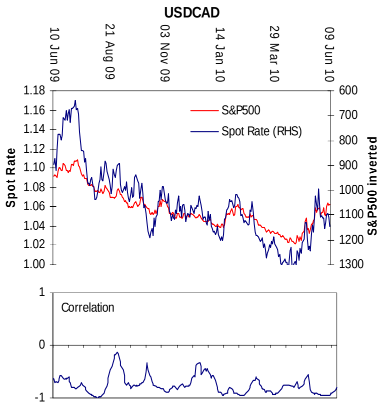
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

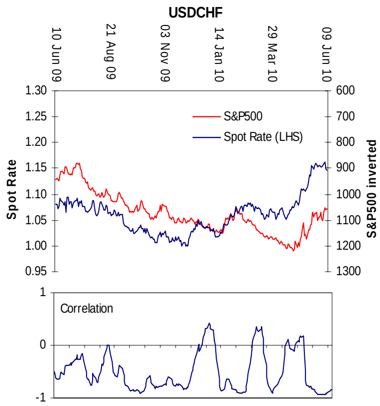


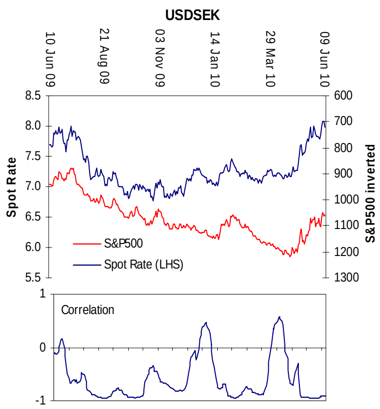



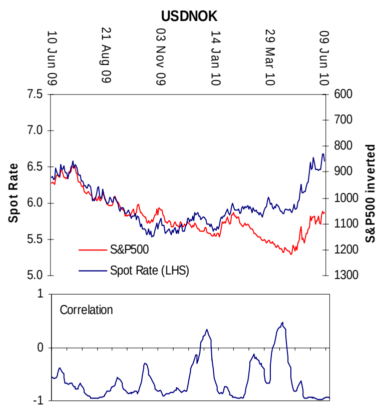



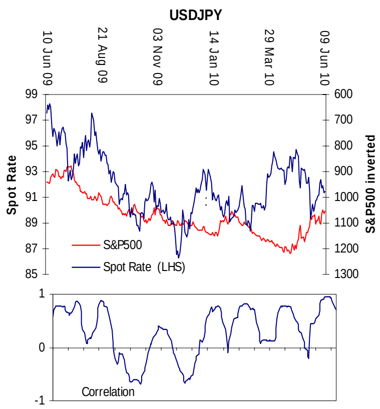



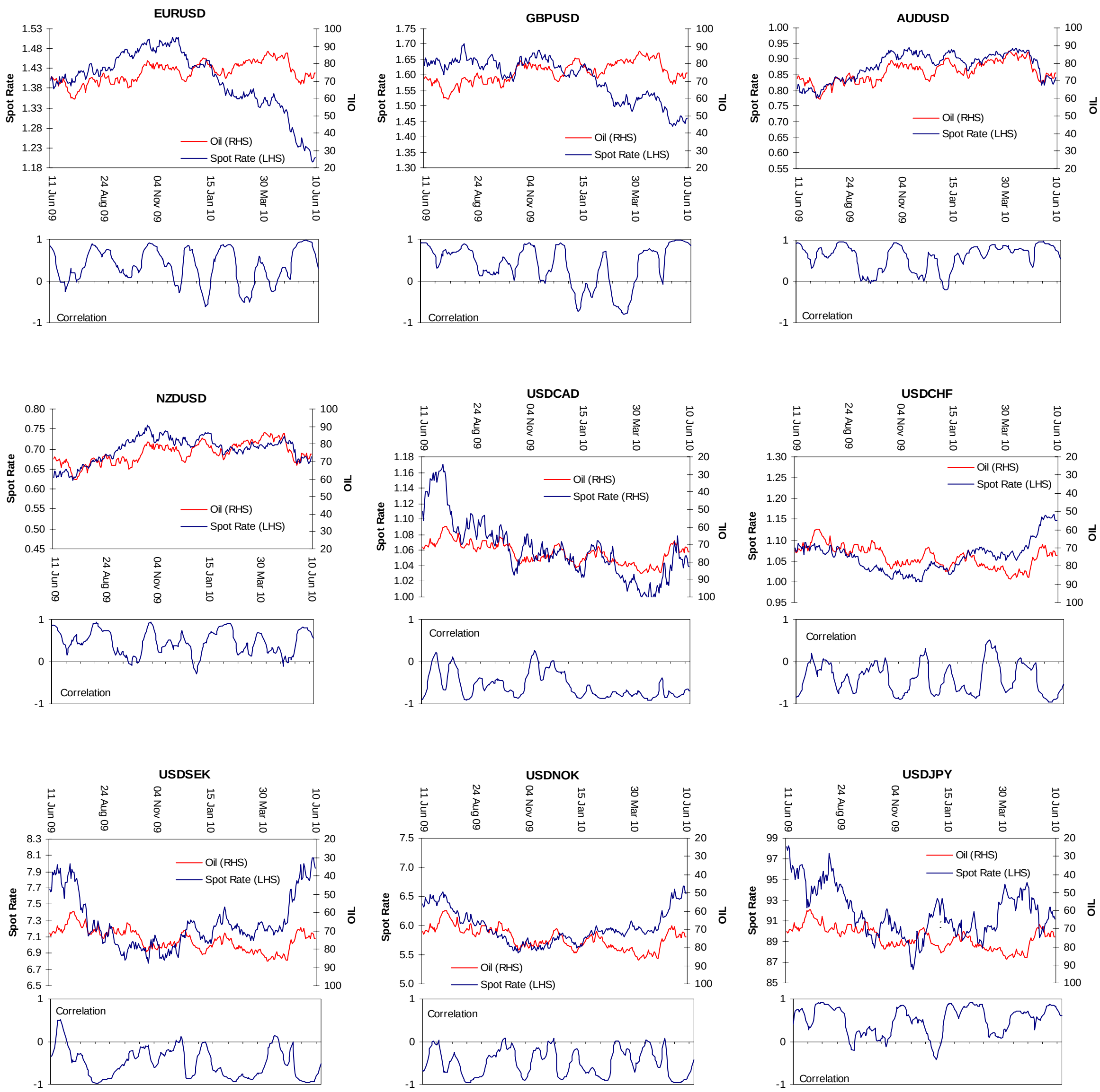



# Commodities vs. FX

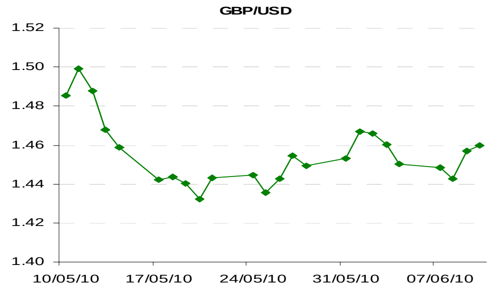
The charts below show oil prices plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

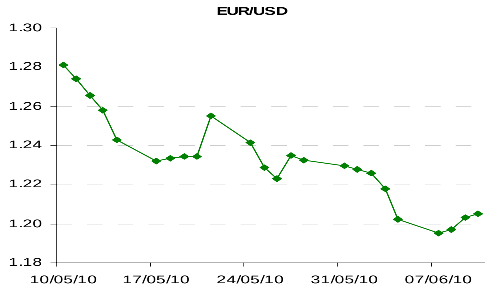


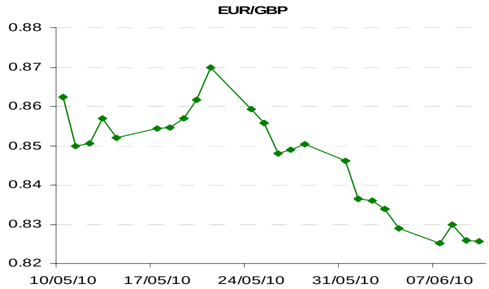

*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

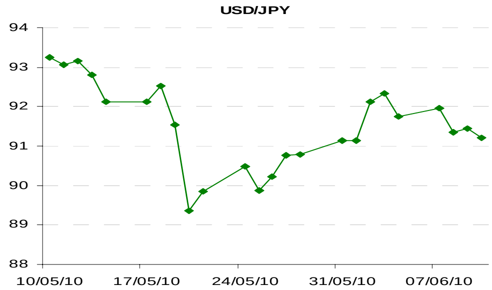
# Market Review

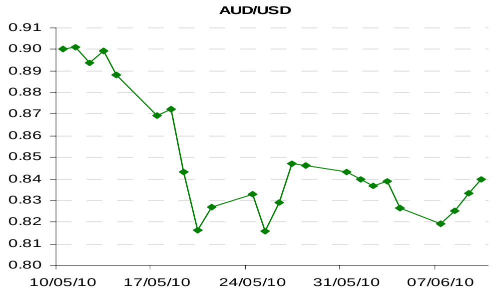
## Short-term G-10 FX Charts

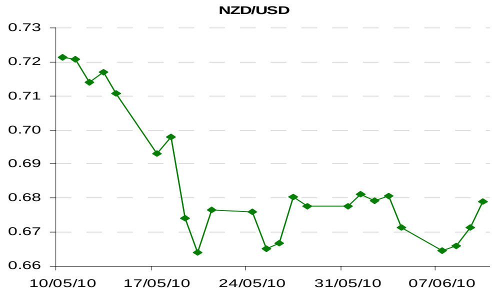


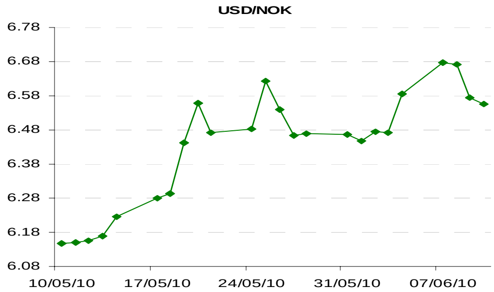



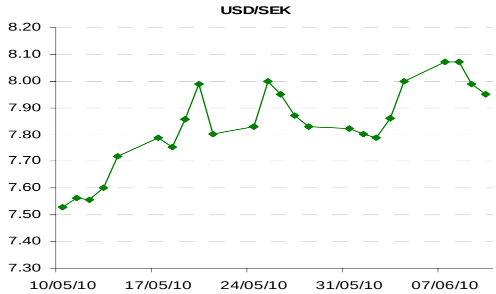



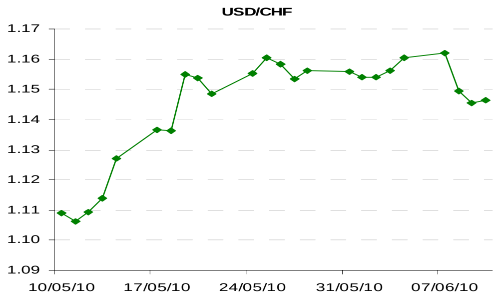



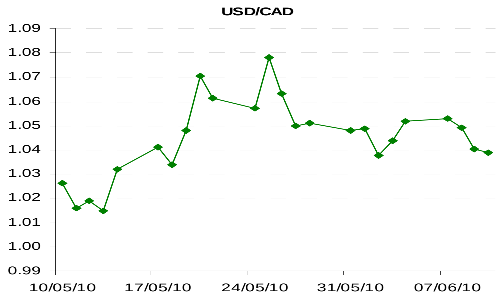



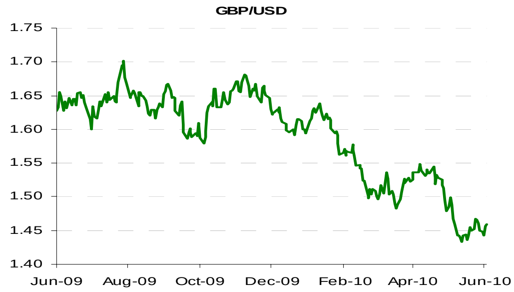



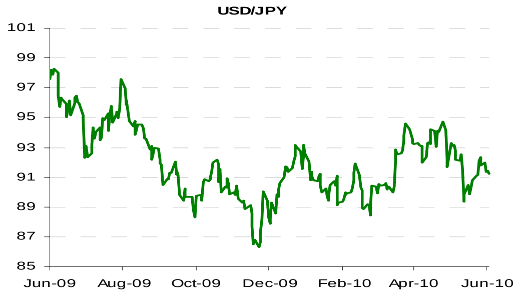



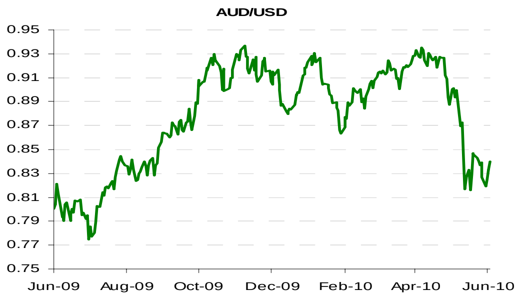



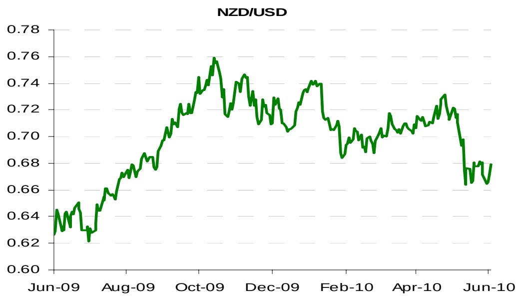
# Medium-term G-10 FX Charts





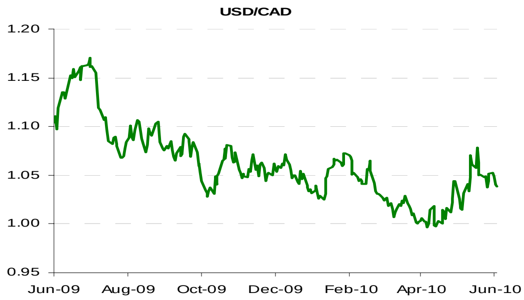



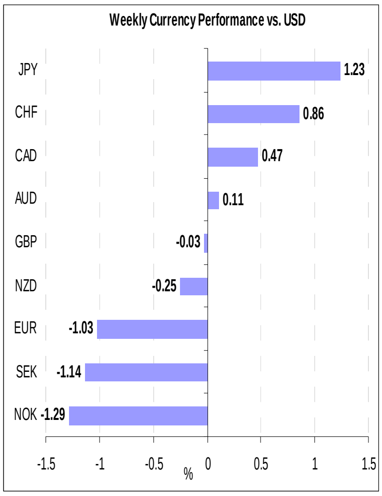


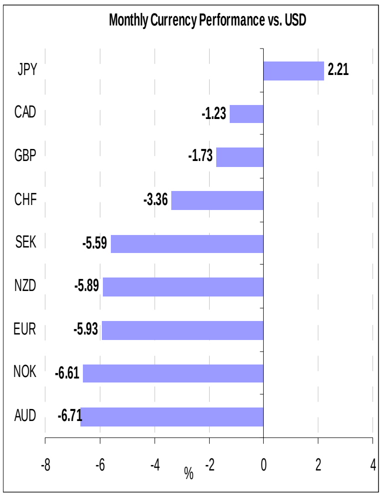


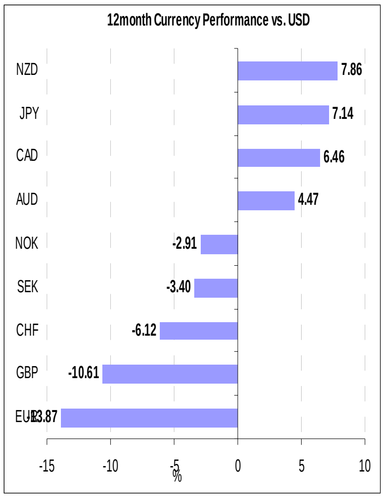


# FX Snapshot

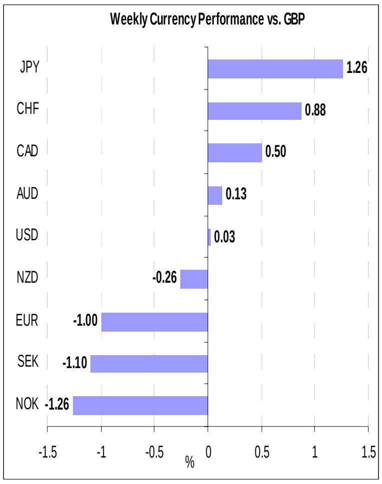
## Currency performance vs. USD

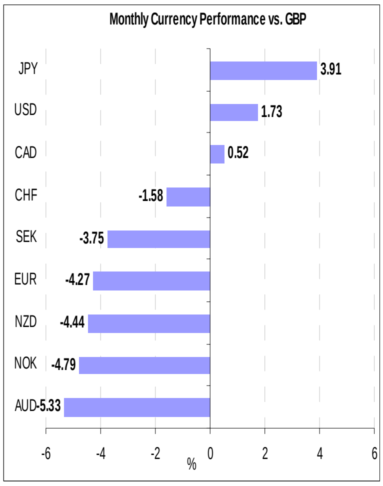


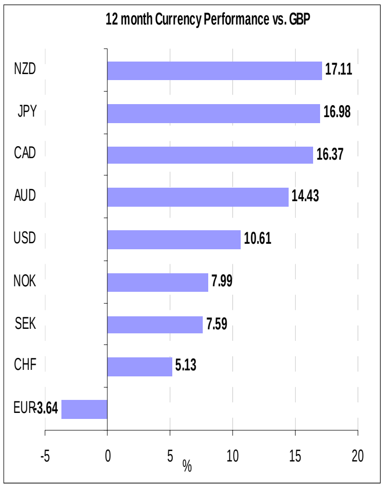



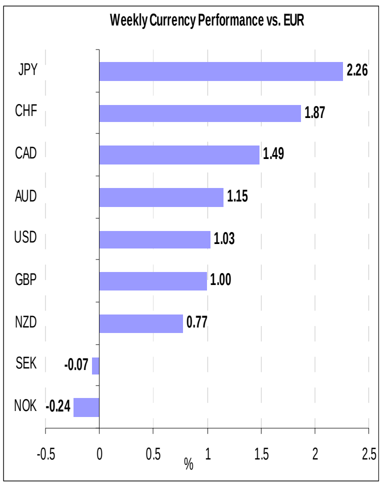

## Currency performance vs. GBP

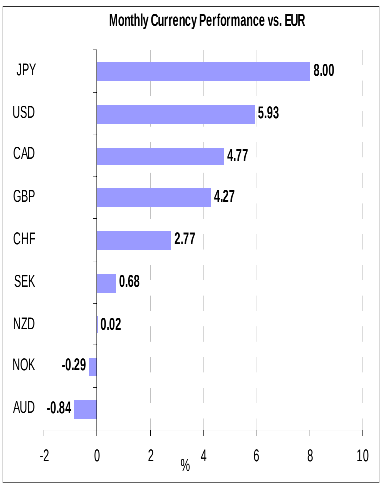


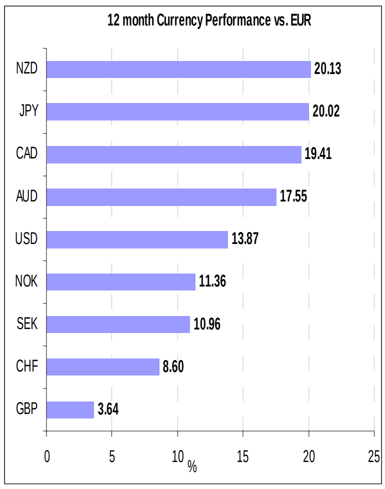




## Currency performance vs. EUR



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