Friday, 18th June 2010

FX Strategy Weekly

Market Strategy

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Market Outlook

Tactical view:

= buy CHF dips vs EUR, GBP

US dollar weakness and Swiss Franc strength translate into an interesting setup heading into the UK Budget, the FOMC and G20 summit next week, and is manifested in USD/G10 crosses approaching potential breakout territory and a rebound in volatility. GBP, NOK, SEK and the CHF all look set to test recent highs as equities negotiate one-month highs Underlying trading themes have not changed and should primarily continue to revolve around sovereign debt risk and the timing of a yuan reval, with US Q2 company results moving onto our radar. We stick to our longer-term bullish USD view but are pragmatic in a context where gold is hitting new highs and deteriorating US macro data and pressure from the G20 to curb public deficits have taken some wind out of the dollar's sails.

Recap

- Gold rose to a new high above $1,260 and platinum also rallied as US dollar weakness returned, but unconfirmed sources report that China was behind the strategic purchases of the precious metals. However, the decoupling with copper is striking and tells us of potential divergence in view over the path for risk assets, also characterised by the sideways price action in major equity benchmarks. GBP experienced a mixed week, gaining ground vs the USD, but posted substantial losses vs the CHF (sharing the pain with the rest of the G10). GBP/CAD rose 0.9% and GBP/JPY firmed 0.7%. The CHF was the star performer after the SNB changed its position on deflationary risks and the strength of the Franc. The CHF gained 3.4% vs the USD, 1.9% vs GBP, and 1.4% vs the EUR.

- UK CPI inflation slowed to 3.4% y/y in May from 3.7% y/y in April. RPI inflation eased to 5.1% y/y from 5.3% y/y. The core CPI rate dropped back below 3% to 2.9% y/y. Stronger than expected labour market stats for May reported a fall in total jobless claims back below the 1.5mln threshold, though the employment rate slipped and inactivity rate ticked higher. The RICS reported a bounce in its May house prices index to 22% from 19%, a 4-month high. In his annual Mansion House speech, BoE governor King said that a hike in Bank Rate would precede asset sales. The governor reiterated that inflation should ease back in the months ahead, but shared his concern and said is closely monitoring the rise in inflation expectations.

- UK 5y swaps closed near the highs of the week at 2.61% after touching the upper limit of the 4-week range (2.63%). 3-mth Libor held steady at 0.73% for a 2nd successive week, causing the 3mth Libor/5y swaps curve to steepen up to 189bp. The 3mth Libor/Ois spread ended the week flat at 24bp. The 2y/10y swaps curve steepened to 204bp (+10bp), approaching resistance at 206bp. Strong auctions took place for the 2014 gilt (b/c 2.28). The 2017 IL mini-tender was covered 2.53 times. America Movil sold £650mln in 2030 paper (165bp over).

FX	Close	Weekly Change %
GBP/EUR	1.1964	-0.42%
GBP/USD	1.4794	1.66%
GBP/JPY	134.24	0.66%
GBP/CHF	1.6420	-1.81%
GBP/AUD	1.7013	-0.57%
GBP/NZD	2.0988	-0.47%
GBP/CAD	1.5151	0.87%
GBP/NOK	9.4366	0.25%
GBP/SEK	11.41	-0.91%
EUR/USD	1.2365	2.09%
USD/JPY	90.75	-0.98%
AUD/USD	0.8696	2.27%
NZD/USD	0.7049	2.14%
USD/CAD	1.0242	-0.78%
USD/SEK	7.7133	-2.53%
USD/NOK	6.3782	-1.24%
USD/CHF	1.1100	-3.43%
Swaps %		**bp**
2yr	1.515	4.5
5yr	2.615	12.3
10yr	3.554	14.1
Equities		**%**
FTSE100	5250.84	1.69%

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G10 FX - GBP/USD at a crossroads

GBP/USD has recently been flirting with a return to the 1.4784-1.55 trading range observed between February and May. An improved technical picture and a rebound in correlations with equities and broader commodities from the early June lows suggest further upside may lie ahead in the short-term (1.54 topside) if the rally in risk asset remains intact and recent gains forces participants to cover short GBP positions. However, the downtrend in place since last November (see chart p2) still dominates and dictates a bearish profile for the medium-term, regardless of the Budget on June 22. A retracement below the 1.45 area cannot be ruled out if the cross fails to break through the 1.4900-50 resistance zone.

GBP/USD has been at a similar crossroads in mid to late April, only for the rally to fizzle out and reverse to the post-election May lows of 1.4231. The danger is that this scenario repeats itself if the rally up to the 1.4886 high on June 18 is not extended beyond trend line resistance situated in the 1.4950 area. The descending trendline in place since January 19 (1.6558 high) runs down to the April 24 high (1.5498). The trendline has not been tested since then and should dampen enthusiasm among those speculating that the cross can drift unchecked to 1.50-1.55, adding to the 1.9% gain in June. Though GBP is currently undervalued vs all its G10 peers (see table), PPP valuations have a very low predictive value when it comes to signalling short-term trend reversals. Speculative short GBP positioning vs the USD is still above historical norms and equally argues for a cautious set-up with tight stops.

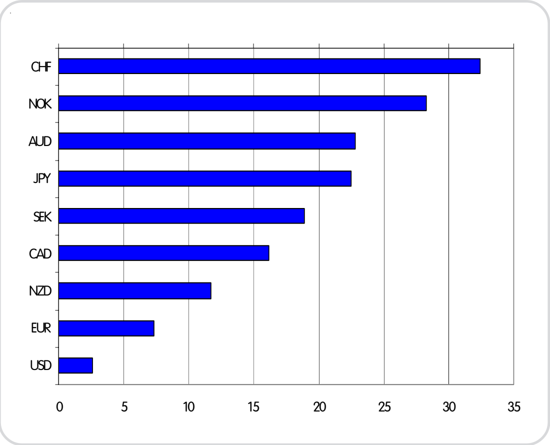
The GBP/USD outlook depends on the following:

1/ Commodities, equities: the two asset classes have rallied off the Q2 lows and lifted GBP/USD to a one-month high due to a pickup in correlation (see chart). Short covering, equity buybacks and good EU peripheral auctions (at concessionary rates) may have contributed to a modest buying of risk, but equity benchmarks like the S&P remain 50% below the April high. US Q2 company earnings and guidance for the second half will be key in July for the direction in GBP/USD, provided that correlation with risk remains elevated. Also keep an eye on the CRB index. The index has to test and preferably break the May high (267) to confirm the rally from below 250 and underpin GBP/USD.

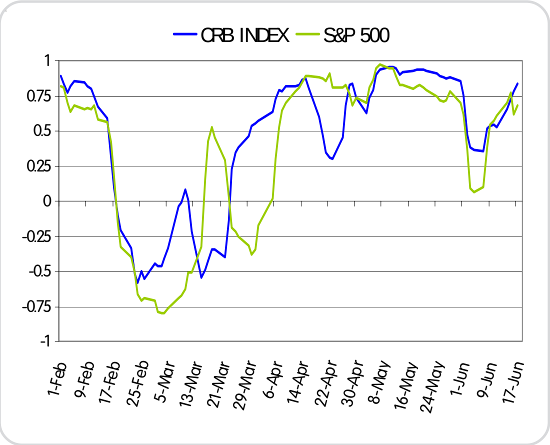
2/ Markets have been fairly agnostic to macro economic data recently. Is this about to change? A levelling off in US indicators could bring a second successive disappointing non-farm payrolls report on July 2. This would not go down well with risk assets (USD safe haven) and would add weight to talk that the Fed is discreetly discussing measures to counter a stagnating/faltering recovery.

3/ Overseas investors have already been reassured that the Con/LD government is determined to cut the public deficit, so the upside for GBP/USD from an endorsement by the credit ratings agencies we think is likely to be minimal. By 2013/14, the OBR projects a reduction in the public deficit from £155bln in 2010/11 to below £100bln, and a fall in public debt from 10.5% in 2010/11 to 5% of GDP. Can the US administration and the USD continue to dodge market fixation with public deficits ahead of the November mid-term elections?

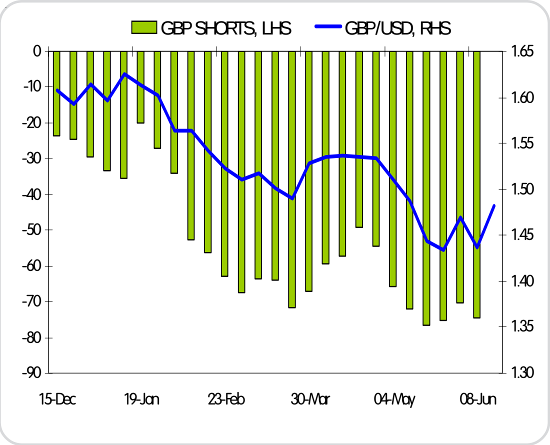
GBP under-valued vs the G10 (%)



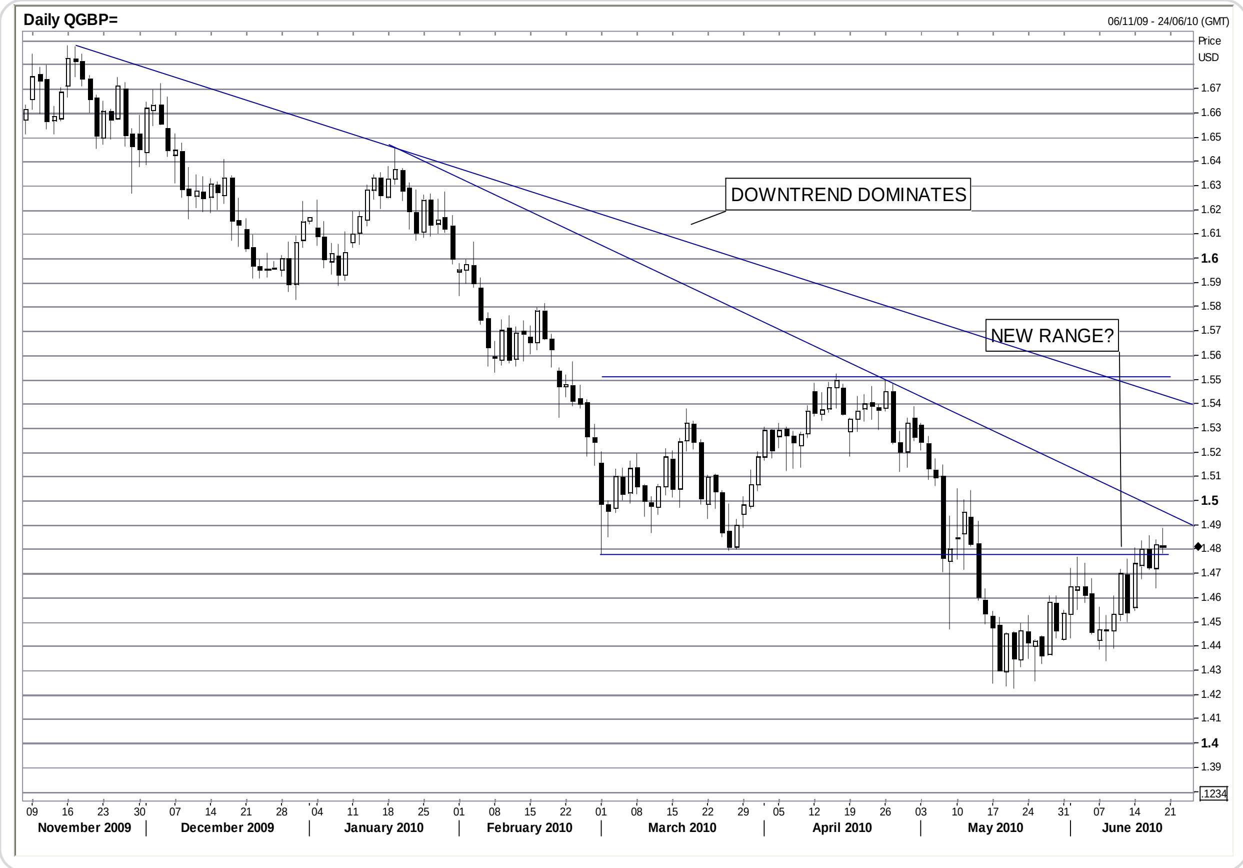
Correlation with S&P, CRB off early June lows



Speculative GBP shorts still above recent norm



GBP/USD: trying to establish new range, but downtrend dominates



Quantitative Market Analysis

- **GBP/USD correlation with stocks slips**
- **CHF positioning shifts on SNB verdict**

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 were added for a 2nd successive week, putting the total number of short contracts at a new high of 97,200. This was entirely a function of reported positions which now stand at -74,700 (+4,000). Non-reported positions marginally to -23,500 contracts. Reported EUR short contracts hit a 4-week high of 111,900. Overall EUR short positions also rose, to 111,400 contracts, but stayed below the record of 124,500. As a result, the EUR/GBP contract spread widened back to 14,000 in GBP's favour. This has not been reflected in spot prices, as EUR/GBP found support above 0.83.

The most interesting developments have taken place in the CHF. Though the SNB only decided on Wednesday to drop its ultra-dovish stance, speculative short CHF positions were scaled back well in advance. Since the SNB verdict, CHF has rallied strongly and outperformed the G10 over the past week, firming four big figures vs the EUR. We would expect short CHF positions to be trimmed further in the week ahead, adding potential downside for EUR/CHF to 1.35 medium-term target. The same path applies for GBP/CHF. The cross collapsed through 1.6628 support and has to hold 1.64 to stop from sliding towards the May low of 1.6265.

Long AUD and CAD positions showed minor variations and the fact that participants have stopped cutting back exposure in both currencies suggest that positioning may have reached a state of equilibrium. This has allowed both AUD and CAD to recoup some losses vs the AUD, backed by progress in equities and commodities. Long CAD positions rose 1,500 contracts to 43,500. Long AUD contracts dropped from 13,300 to 12,800. This has not prevented CAD/AUD from drifting to 1.1173, the lowest since May 31. GBP/AUD continues to trade heavy in the 1.070 area and could see momentum mount for a test of 1.6979 support.

The US DXY has dropped three big figures since June 7, falling through trendline support at 85.76. The index has to hold 85.131 support to stop a decline from accelerating to the 84.0 area. The FOMC statement and equity market reaction will obviously be key next week.

A sharp swing in CHF risk reversals was observed, dragging the skew to the lower end of the percentile rank. We don't think this necessarily signals the threat of a contra-trend move as market participants let the market settle after the SNB. We also take note of the diversion in skew late in the week

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	0.64	**0.82**	0.22	0.37	0.10	0.74	0.61
10 YR SPD	-0.10	0.17	0.49	-0.38	0.27	0.49	0.66
S&P500	**0.82**	-0.60	0.57	0.50	0.22	0.74	**0.79**
Gold	0.47	-0.66	-0.47	0.63	0.51	0.56	-0.12
Oil	0.66	**-0.80**	-0.07	**0.89**	0.30	0.64	0.15
Relative Yield Curve	**0.81**	0.71	-0.42	0.65	-0.27	**0.76**	-0.58
CRB	**0.88**	**-0.79**	0.34	**0.85**	0.14	**0.76**	0.49

between EUR/USD (higher) and GBP/USD (lower). Skews in USD/CAD, AUD/USD and NZD/AUD were steady. The 1mth/1y vol curve steepened further for EUR/GBP to 1.16, the highest since April 30, as short dated vol continues to ease off. For GBP/USD, 1mth vol fell below 12.0. A similar chart pattern can be observed for the VIX index which fell below 25 to a 4-week low of 23.30.

FX correlations

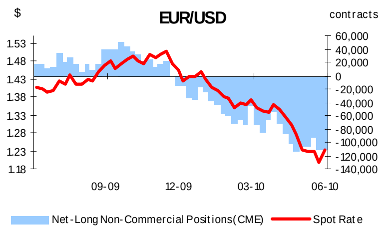
Market correlations are shown on pages 10-12. 1-month rolling correlations are plotted for G-10 FX against interest rate spreads, S&P 500 and commodities (represented through the CRB index).

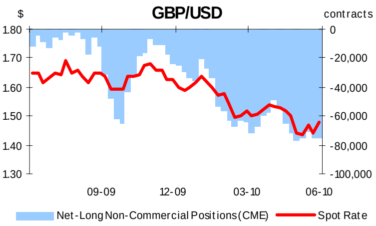
G10 correlations with 2y interest rate differentials fell from lofty to insignificant levels for EUR/JPY and AUD/JPY but interestingly have moved up for USD/CAD to statistically important territory (0.82). Equally remarkable is that the correlation of majors with the S&P has fallen back considerably for GBP/USD (0.50), though still remains significant for AUD/USD and less so for EUR/JPY. The correlation with the CRB index remains a powerful driver as can be derived from the table above. GBP/USD and AUD/USD continue to correlate quite closely we will be tracking progress of the CRB closely vs resistance in the 268 area.

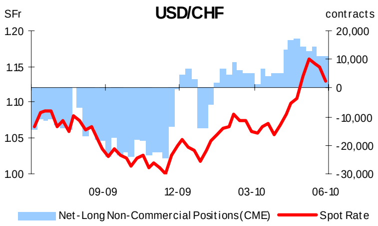
Macro data still only plays a peripheral influence although one cannot ignore that the USD has weakened in the face of softer US data. The bounce in weekly claims and the lower Philly Fed survey spring to mind, though the resilience of equities/credit to the weak data continues to be pivotal for G10 fx. Eyes on the FOMC statement next Wednesday.

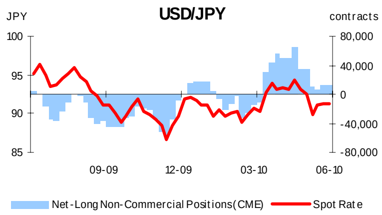
FX & Commodity Futures Positioning

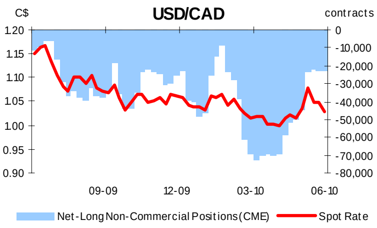
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

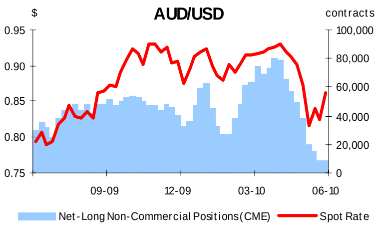


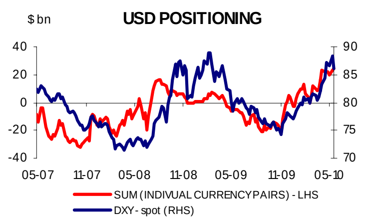


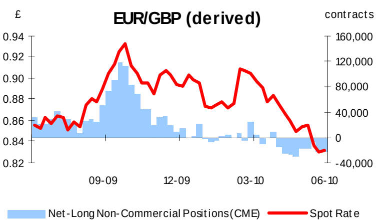


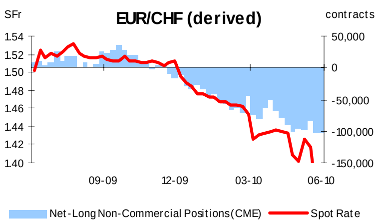


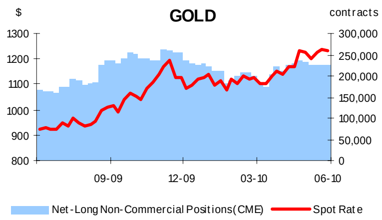


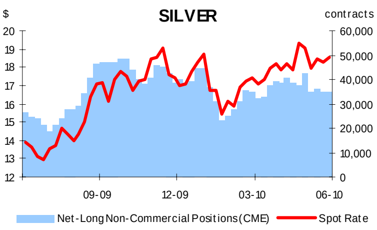


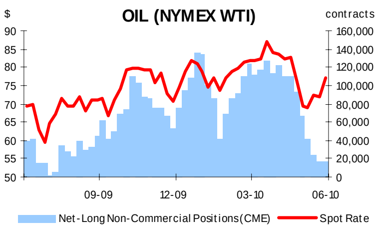


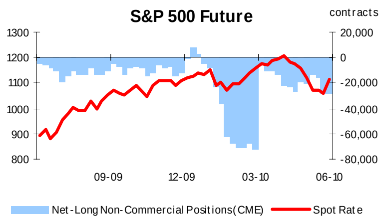


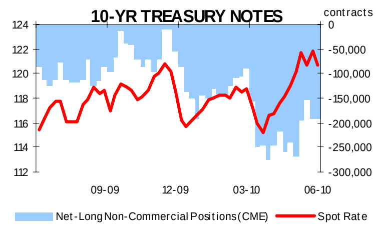


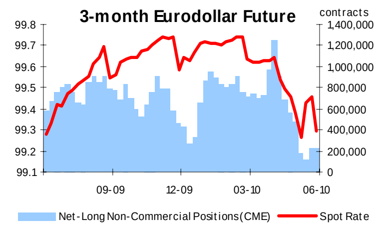






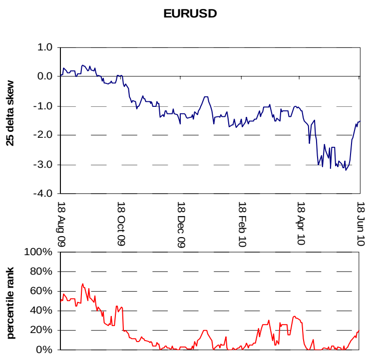


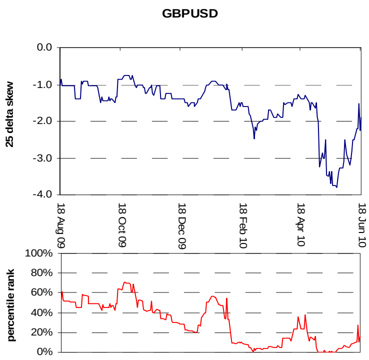


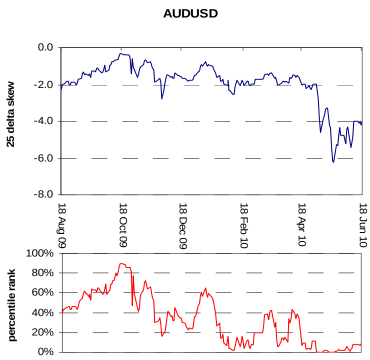


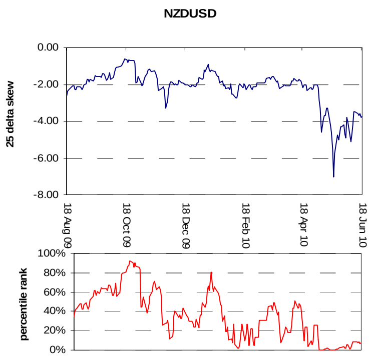
FX Options: Risk Reversal Skews

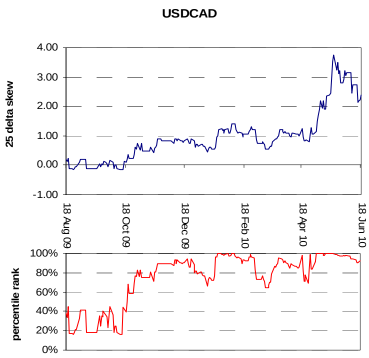
The risk reversal skew is the difference in volatility between similar out-of-the-money call and out-of-the-money put options. A positive risk reversal means that the implied volatility (used for pricing) of the call is greater than that of the put. In this section, the skew is based on 1-month 25 delta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

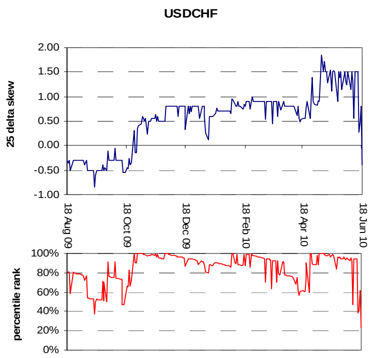


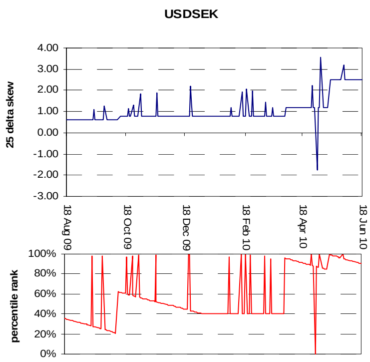


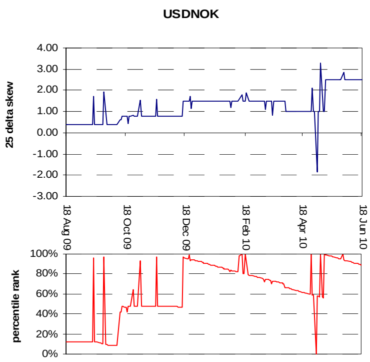


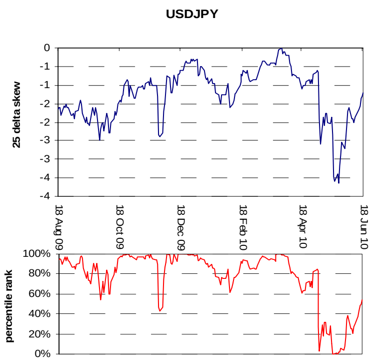






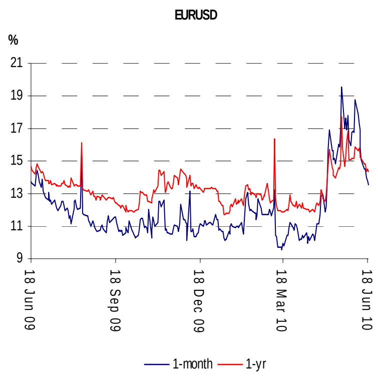


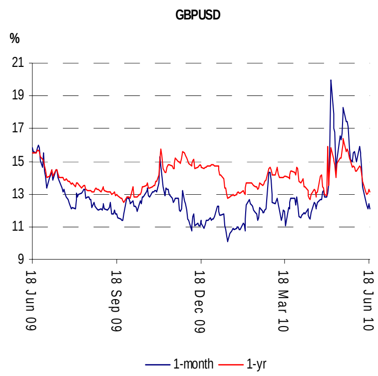


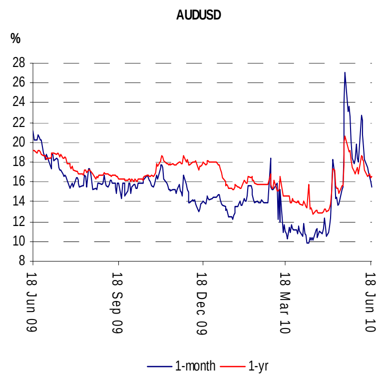


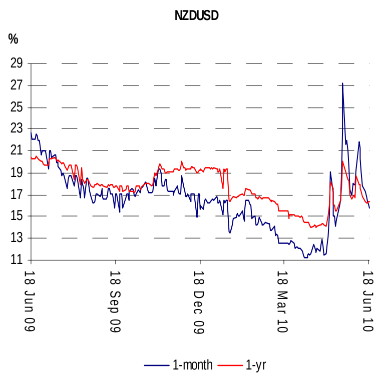
FX Options: Implied volatility

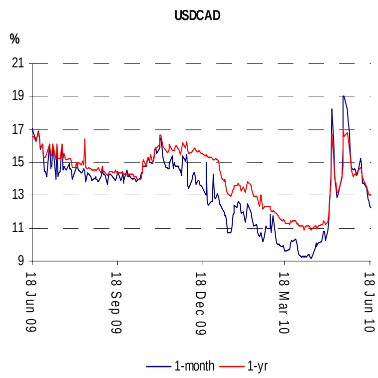
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

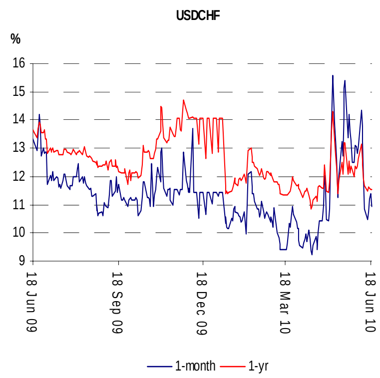


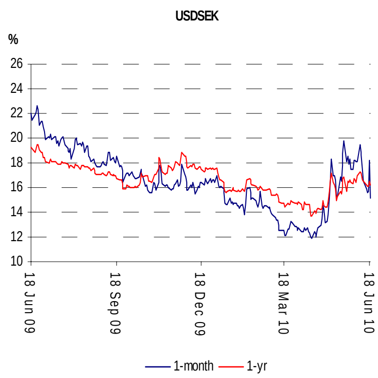


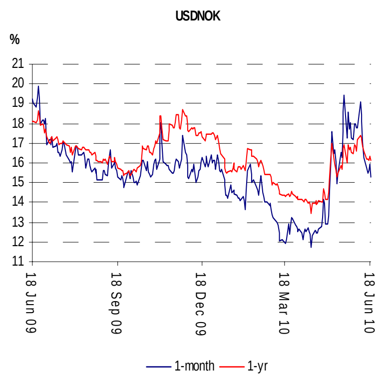


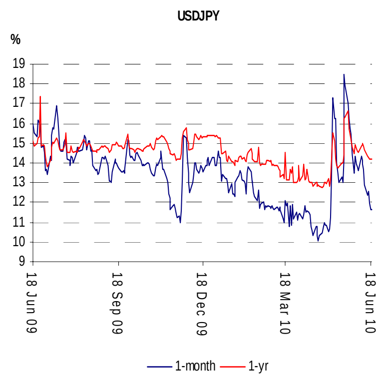






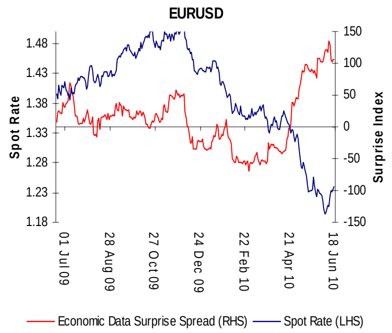


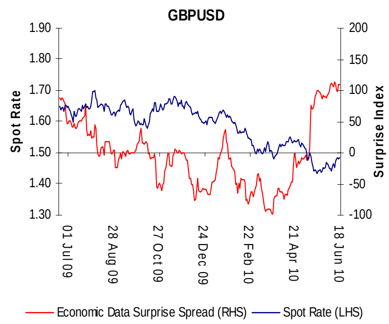


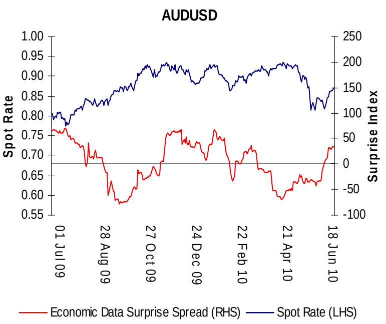


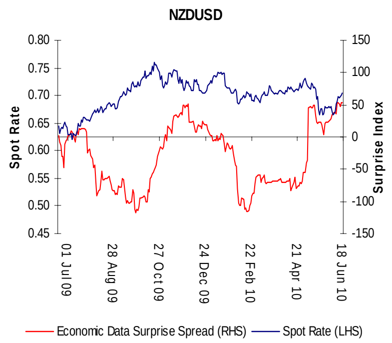
Economic Data Surprises

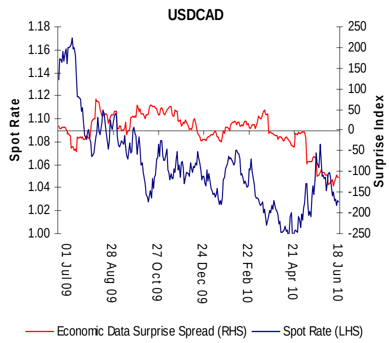
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

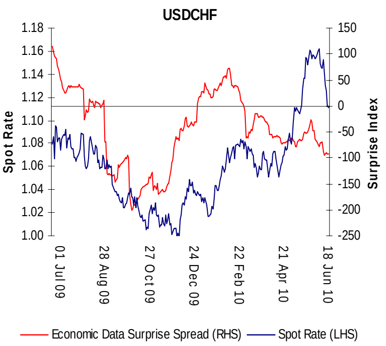


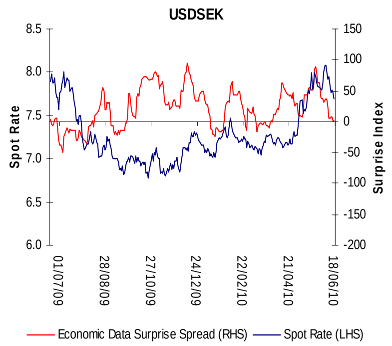


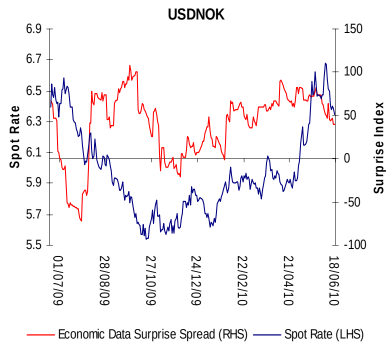


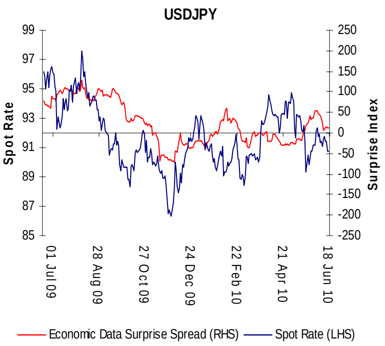






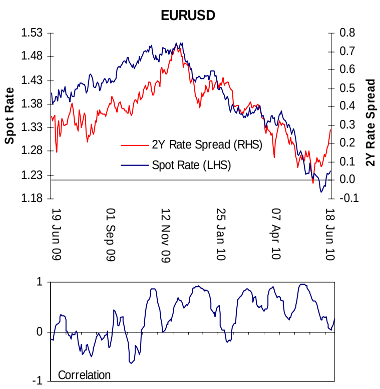


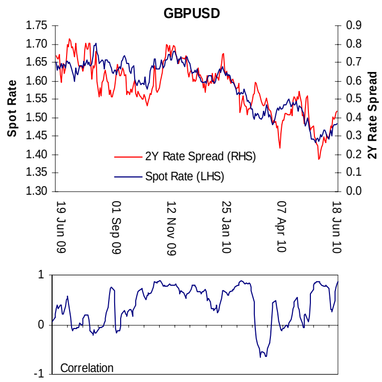


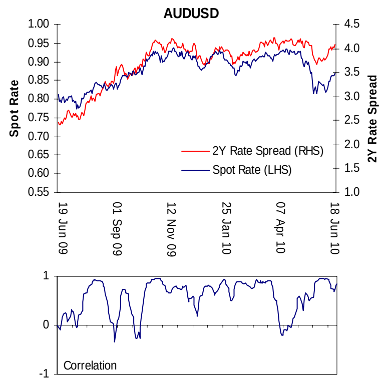


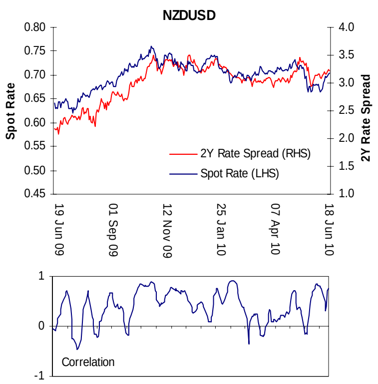
Interest Rate Spreads vs. FX

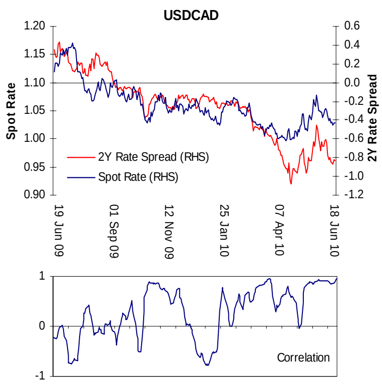
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

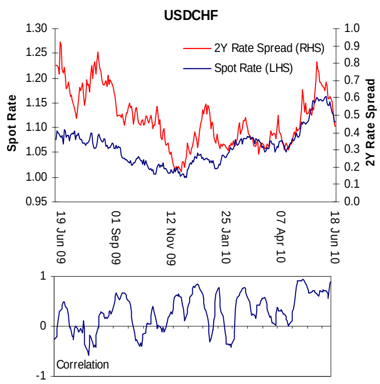


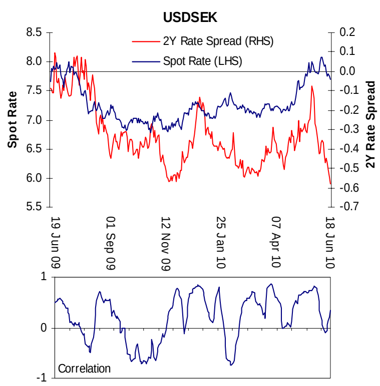


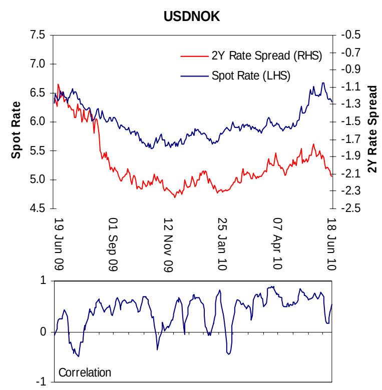


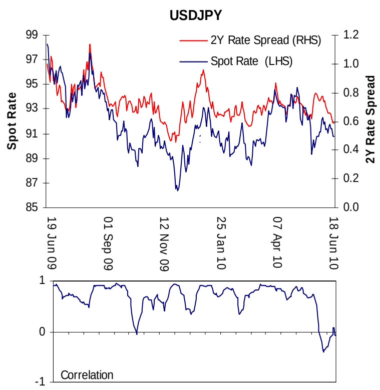






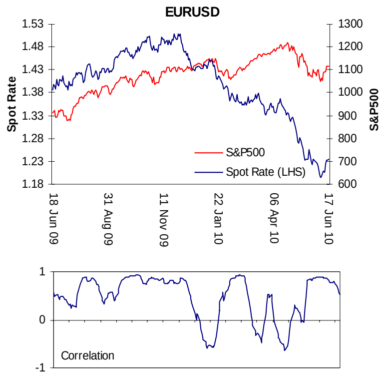


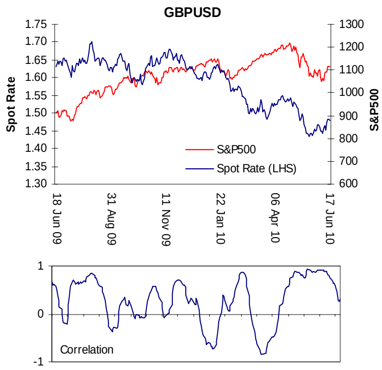


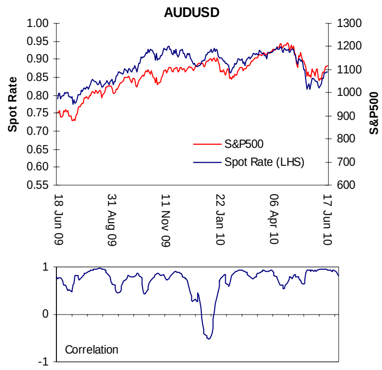


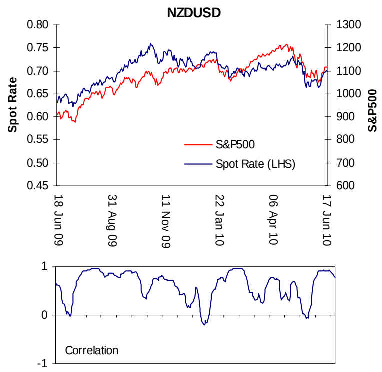
S&P500 vs. FX

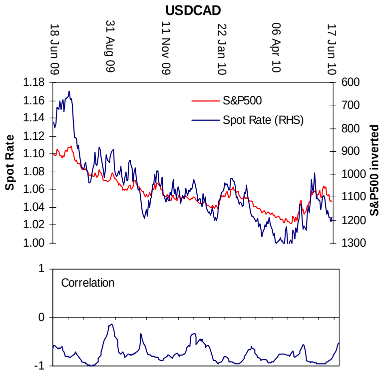
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

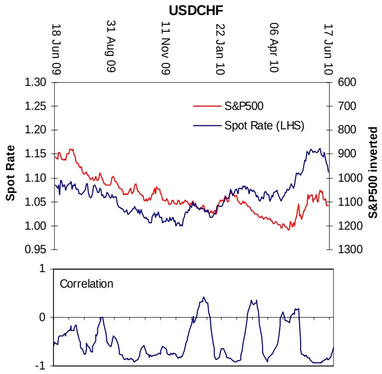


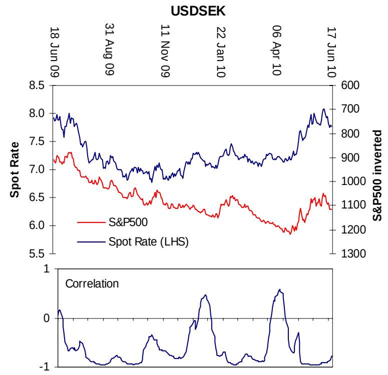


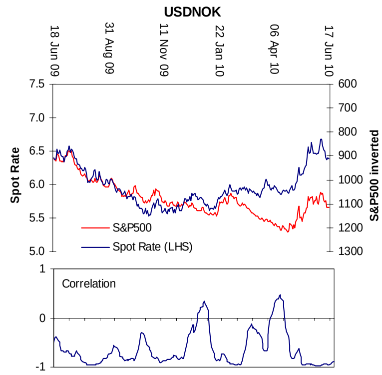


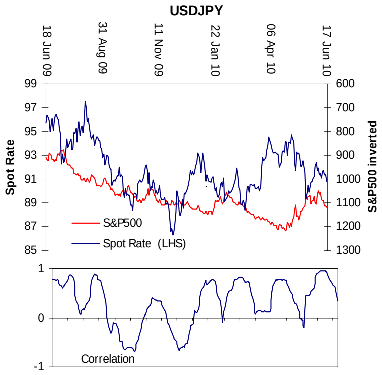






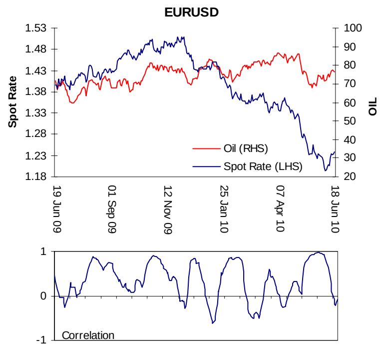


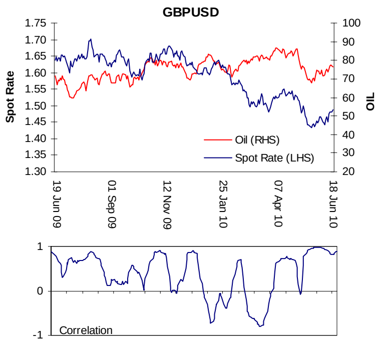


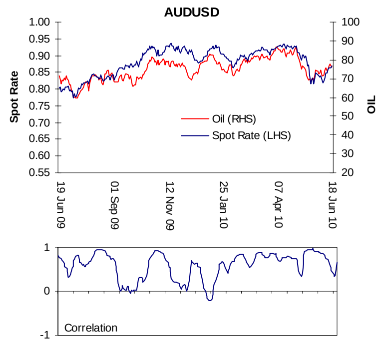


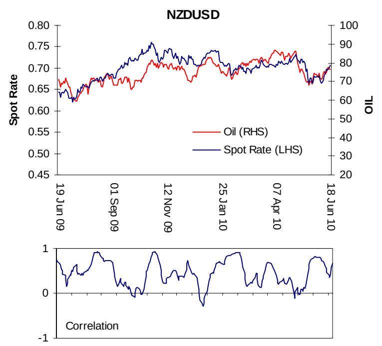
Commodities vs. FX

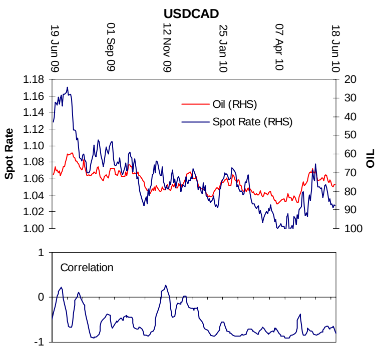
The charts below show oil prices plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

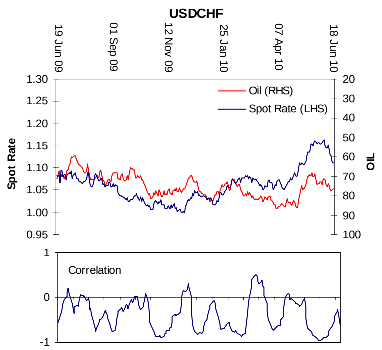


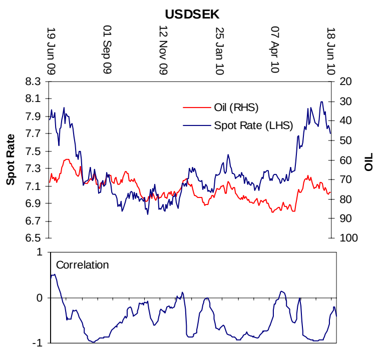


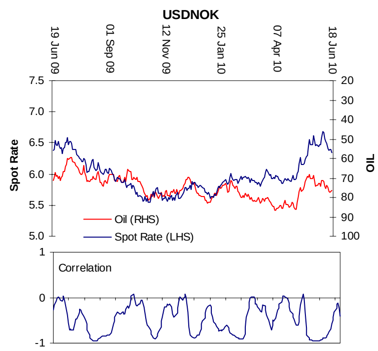


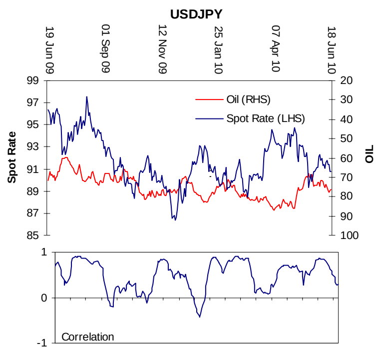








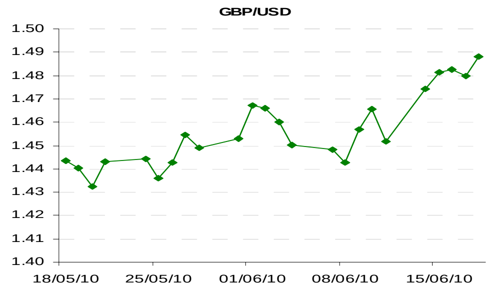


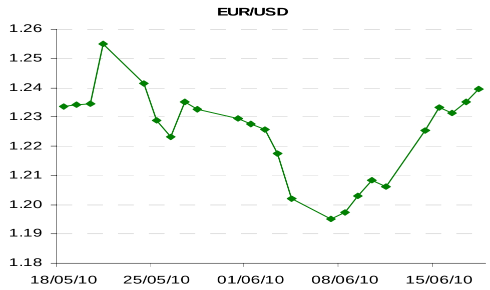


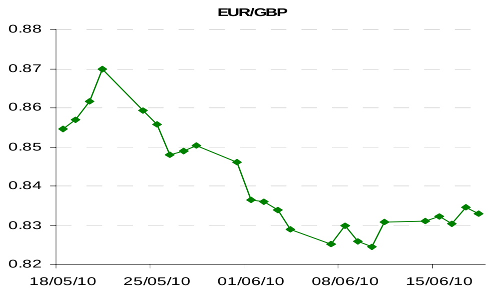
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

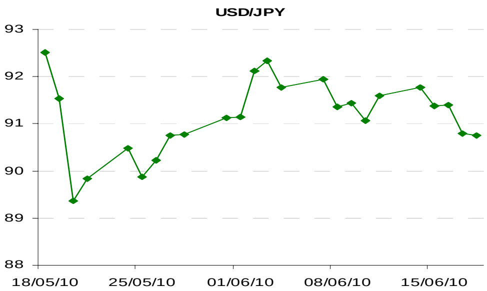
Market Review

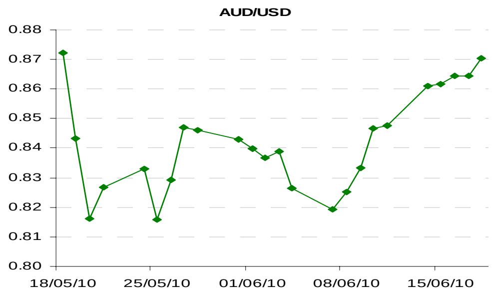
Short-term G-10 FX Charts

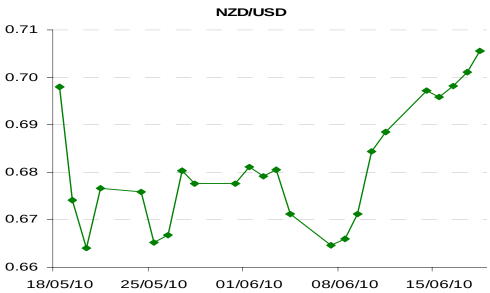


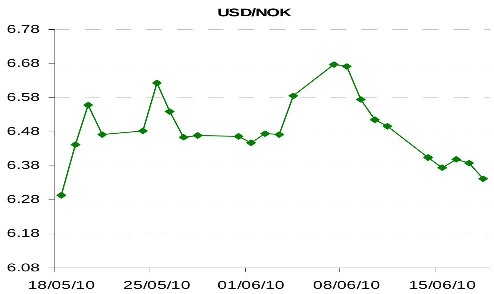


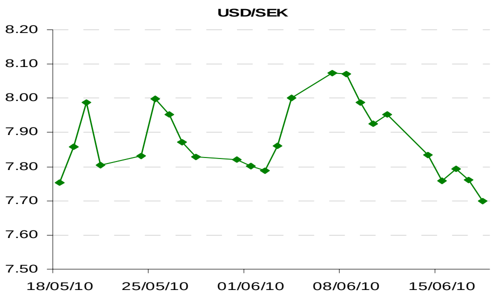


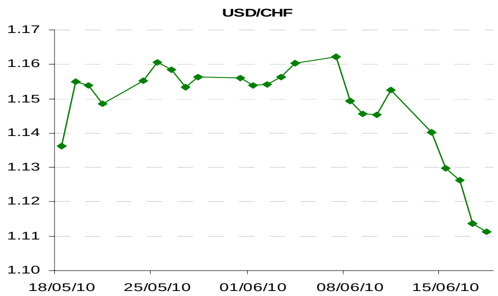


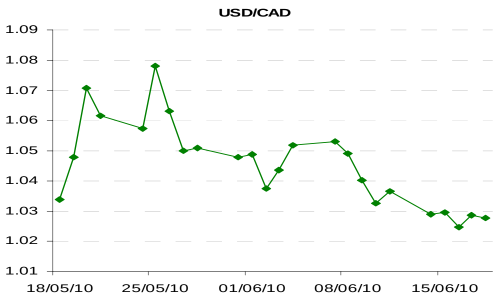




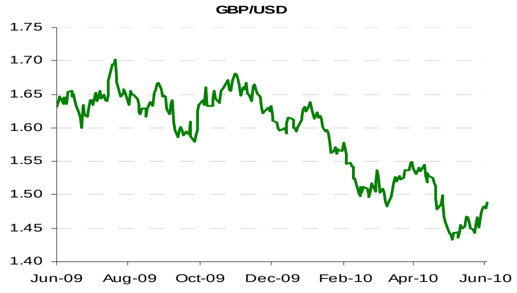


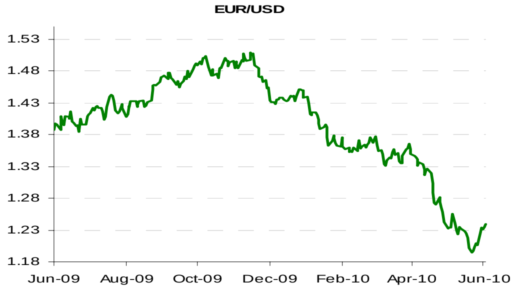


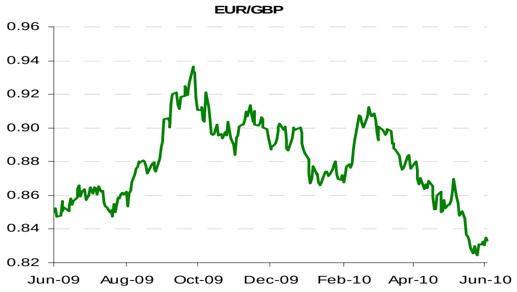


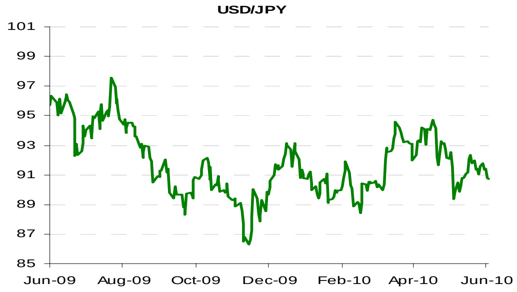


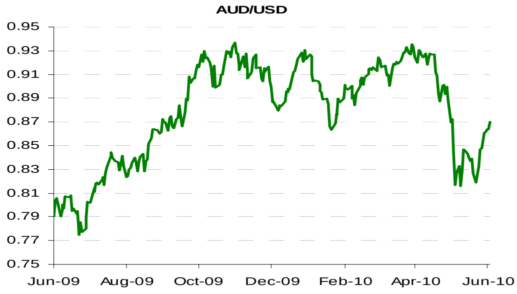
Medium-term G-10 FX Charts

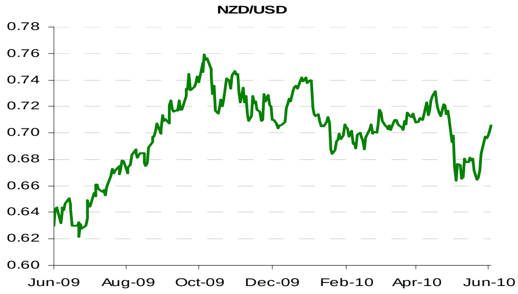


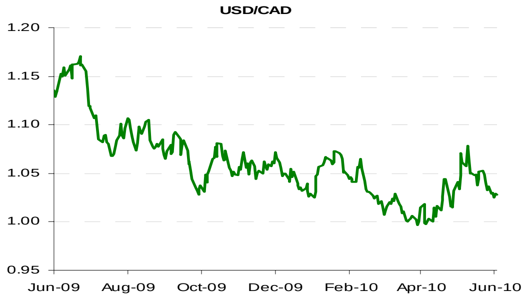






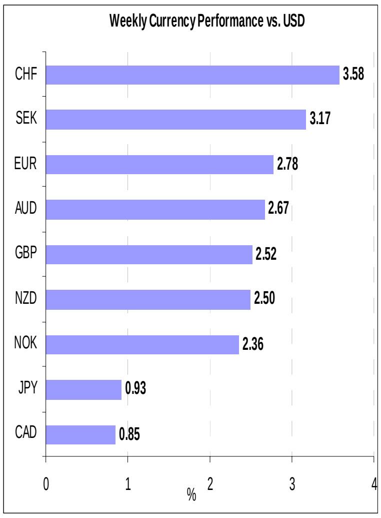


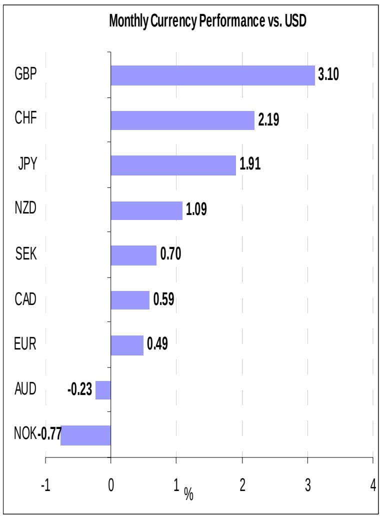


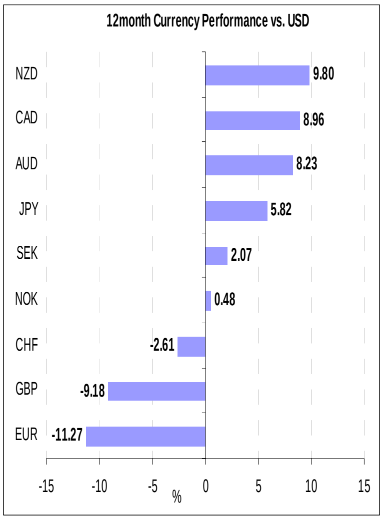


FX Snapshot

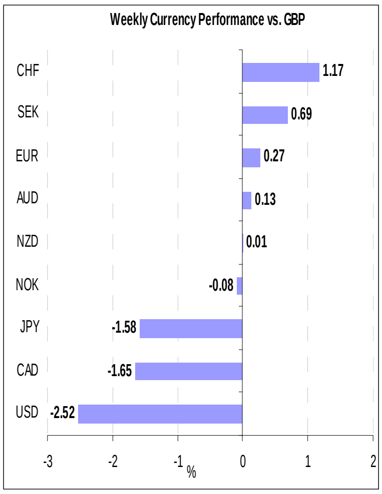
Currency performance vs. USD

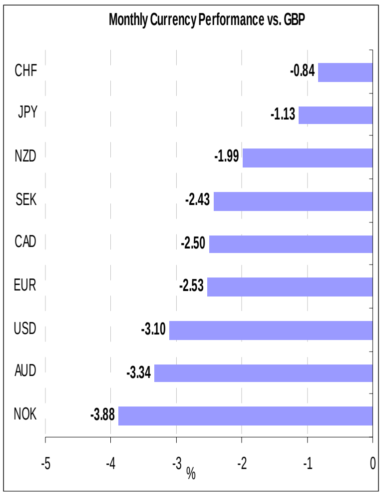


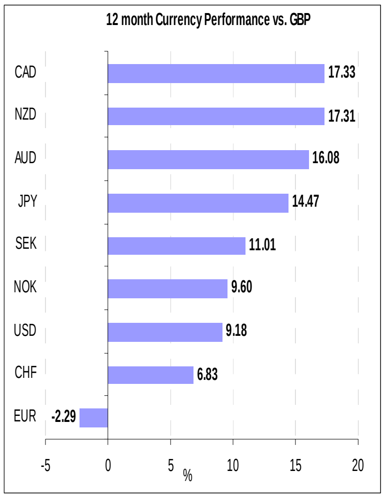




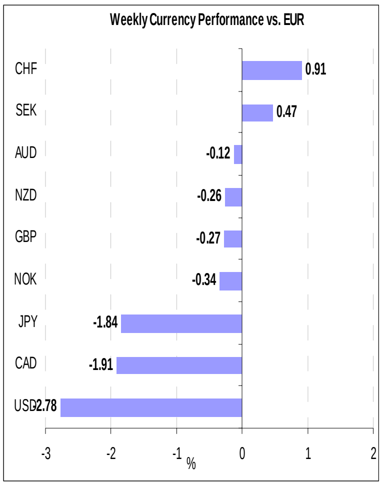
Currency performance vs. GBP

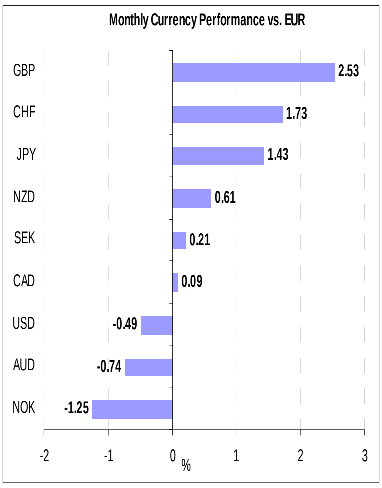


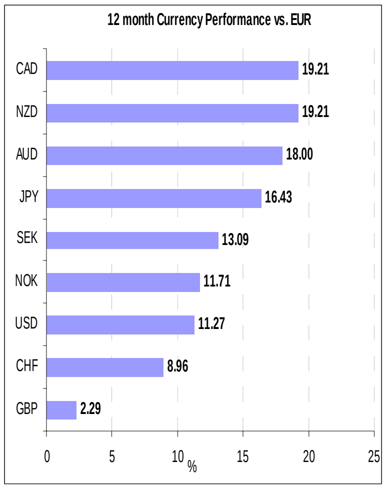




Currency performance vs. EUR







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