Friday, 30th April 2010

FX Strategy Weekly

Market Strategy

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Market Outlook

Tactical view:

= buy GBP vs G10 on Conservative or Conservative/Lib Dem election victory

= fade AUD on RBA 25bp hike/neutral statement

= sell EUR/USD rally on EU/IMF loan deal

Short speculative GBP positions have been cut back over the last four weeks, but overall are still well above historical norms. This leaves scope for an (extensive) short squeeze if the Labour party is defeated next week Thursday, with the biggest move potentially earmarked for GBP/JPY depending on equity market reaction to US non-farm payrolls. The dollar index hit our 82.24 target this week, cruising to a 82.71 high on flight-to-quality and outflows from the EUR. We look for the index to stay supported near-term, but within ranges unless the EU/IMF loan deal falls through (unlikely) and Chancellor Merkel loses the regional election in the state of NRW on May 9 (possible). We now target the 18 May-09 high, though admit that progress could stall if risk assets make it through next week unscathed. We look for the RBA to raise rates to 4.50%, but favour fading (stretched) long AUD positions if the accompanying statement takes on a neutral tone.

FX	Close	Weekly Change %
GBP/EUR	1.1505	0.13%
GBP/USD	1.5293	-0.55%
GBP/JPY	144.08	-0.28%
GBP/CHF	1.6484	-0.05%
GBP/AUD	1.6456	-0.71%
GBP/NZD	2.0924	-2.39%
GBP/CAD	1.5499	0.89%
GBP/NOK	9.0332	-0.28%
GBP/SEK	11.08	0.49%
EUR/USD	1.3292	-0.69%
USD/JPY	94.22	0.27%
AUD/USD	0.9294	0.17%
NZD/USD	0.7309	1.90%
USD/CAD	1.0135	1.44%
USD/SEK	7.2450	1.09%
USD/NOK	5.9064	0.28%
USD/CHF	1.0779	0.45%
Swaps %		**bp**
2yr	1.722	-4.0
5yr	2.981	-8.2
10yr	3.842	-7.0
Equities		**%**
FTSE100	5553.29	-2.98%

Recap

- GBP surrendered gains this week vs a handful of currencies but finished the month of April across its G10 peers except vs the NZD. GBP logged a gain of 2.9% this month vs the JPY and a 2.5% gain vs the EUR and Swiss franc. Light trading conditions ahead of the general election next week Thursday could result in erratic price swings, with market moving US macro data and risk appetite set to dictate trends. The EUR experienced another tormenting week, sliding 2.8% vs the NZD (top weekly performer), 1% vs the AUD and 0.8% vs the USD. An EU/IMF bailout is reportedly a matter of hours and should help the EUR to stage a relief bounce.

- UK data was very thin on the ground in the past week. Nationwide house prices rose 1% in April, inflating the annual rate to 10.5%, the highest level since June-07. The CBI distributive trades survey reported steady sales in April vs March. The level of expected sales rose for a 4th successive month, reaching a 5-month high. Consumer confidence fell back for a second straight month in April. The FTSE-100 closed below 5,600 for the first time since March 5, hit by soverign debt jitters and a retreat in US stocks.

- UK 5y swaps were rangebound and closed the week at 2.98%. The long-end of the curve outperformed the front-end, compressing the 2y/10y swap spread to 212bp. Gilts outperformed Treasuries and bunds. UK 10y swaps spreads to tighten 10bp to -1bp. Dec-10 short sterling rebounded off last week's low, rallying to 98.85.

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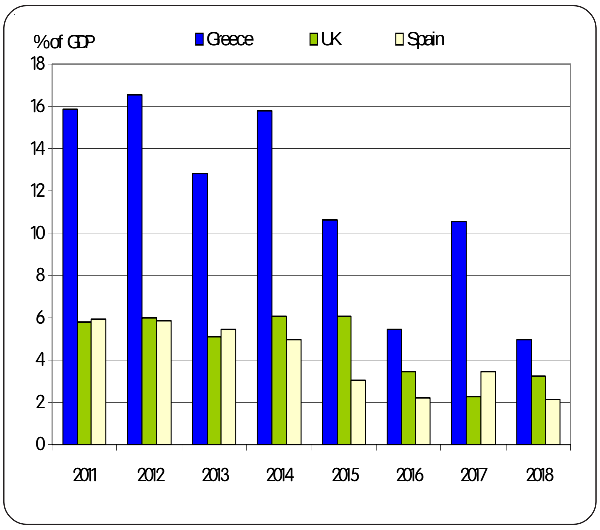
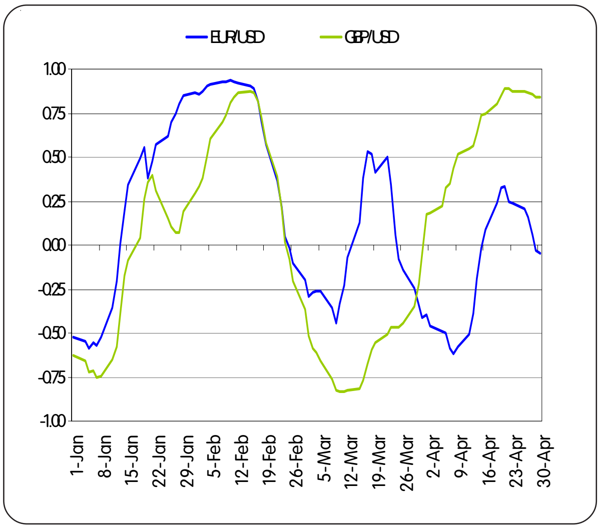
Government debt redemptions: the UK is not Greece



If equities hold up, GBP/USD will outperform EUR/USD



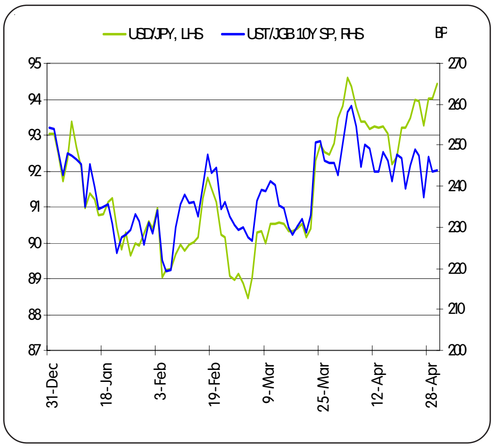
USD

• The dollar index hit our 82.24 target this week, cruising to a 82.71 high on flight-to-quality and outflows from the EUR. We look for the index to stay supported near-term but within ranges unless the EU/IMF loan deal falls through and Chancellor Merkel loses the regional election in the state of NRW on May 9. The 18 May-09 high (83.22) is our next target, though progress could stall if risk assets make it through next week unscathed.

• With the Fed happy to stay sidelined on interest rates and asset sales, we turn our attention to the April ISM surveys and the April employment report on Friday May 7. An outcome for NFP ahead of the 176,000 consensus forecast should help long-term Treasury yields to reverse, causing G10/US yield spreads to tighten. In itself this may not be enough to support the dollar if equities respond positively, though a narrowing in UST/JGB 10y yields is required to sustain the move up in USD/JPY through 94.0. US/JAP 12-mth libor trades over 34bp, the highest since December 7. A break of 94.79, the April 5 high puts the cross in 95.0-98.0 territory. This would be accompanied by rise in 1mth USD/JPY risk reversals towards -0.50.

• A big week in terms of US data serves up the two ISM surveys, personal income and spending, Q1 productivity and April non-farm payrolls. The US economic surprise index has dropped for three weeks in succession, hitting a near two-month low on Friday. A reversal of that pattern would reinforce the outlook for sustained GDP growth at the start of Q2, but may dissuade the Fed from changing tack on asset sales for a few more months. Overall IMM positioning favours USD shorts but the aggregate level has been reduced to -18,500 (ex NZD) vs the March 30 low (-49,900 contracts).

USD/JPY is running ahead of 10y UST/JGB spread



EUR

• Germany has been urged to close ranks and throw its weight behind the aid programme for Greece and though we understand that a comprehensive deal may be near, the broader question is what happens to sentiment elsewhere in the EU periphery if Chancellor Merkel loses the (regional) election on May 9? Does that weaken Germany's resolve and leave other PIIGS more exposed to a surge in bond yields and need for EU assistance? The next Greek 10y bond matures on May 19 (8.1bln eur).

• In the light of persisting near-term political uncertainty, we reiterate our bearish medium-term EUR view and preference to sell EUR/G10 rallies. This strategy has worked for most of this year, marked by the absence of follow-through buying of rallies, especially in EUR/USD. Though the EU-16 macro data surprise index hit a 7-mth high at 63.5 and in doing so outpace the US (see chart), gains have not been converted into a stronger EUR/G10, with the exception of EUR/SEK.

• The inferior correlation of EUR crosses with risk assets vs other G10 currencies like GBP, AUD and CAD gives the single currency limited upside beyond a post EU/IMF relief bounce. Though near-term losses in EUR/GBP may be contained by profit taking in long GBP positions prior to the UK election (support at 0.8603), we look for upside to be capped in the 0.8850 area (100d MA) barring a surprise election victory for Labour.

• For EUR/AUD, the inverse correlation with risk assets is offset by the RBA outlook. A 25bp rate hike to 4.50% next Tuesday by the RBA is priced in, but risks coming with a neutral statement and profit taking in stretched long AUD IMM positions. In tandem with a relief bounce in EUR/USD, we look for EUR/AUD to rally up to 1.45 where sellers could emerge, targeting a retreat to 1.40.

• For EUR/JPY, a narrowing of the trading range to 122.37-126.30 suggests a breakout may be imminent. Trendline resistance is situated at 126.56, with support resting at 122.51.

GBP

• We look for trading volumes in GBP to be light and short-term volatility to stay bid of the general election on Thursday, potentially resulting in erratic and violent price swings before the results impact the market on Friday. Election polls over the weekend will set the tone early on Tuesday along with the manufacturing PMI.

• Short IMM speculative GBP positions have been cut back over the last four weeks, but overall are still well above historical norms. This leaves scope for an (extensive) short squeeze if the Labour party is defeated, with the biggest move potentially earmarked for GBP/JPY with a break of 145.0 clearing the path for 150 should the FTSE resume its upward trend.

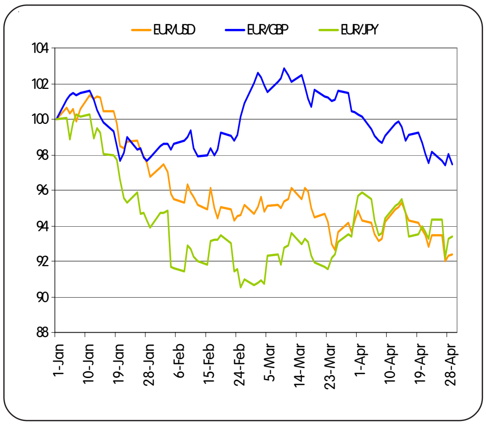
• The correlation of GBP/USD with equities improved markedly through the second half of April. This means that, should equities and commodities rally on a EU/IMF aid deal and positive US payrolls data, pro-risk sentiment may cushion the liquidation of GBP/USD on the election of a Labour (coalition) government. EUR/GBP faces a return to 0.8850-0.90 range if Labour win a 4th successive term.

• With the exception of the NZD, GBP is up against all G10 currencies in April, logging a 2.9% gain vs the JPY, 2.2% vs the CHF and 2% vs the EU. GBP/NZD is down 1.5%, with Friday's break below 2.10 setting the pair up for a test of trendline support at 2.0809. Buy a bounce above 2.10 with a 2.15 short-term target.

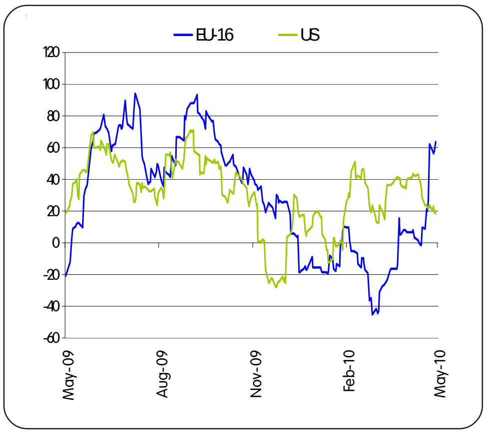
• The release of the manufacturing and services PMI surveys for April will command some attention on Tuesday and Thursday. Though Q1 GDP data disappointed two weeks ago, good numbers could reinforce speculation of an upward revision to the 0.2% q/q preliminary GDP estimate on May 25. Confirmation of the Q1 improvement in the PMIs would support my view that the BoE will revise up its inflation projections on May 12. The two-day MPC meeting starts exceptionally on Friday, May 7 and concludes on Monday, May 10. The Q2 QIR is due on Wednesday May 12.

• For GBP/AUD, we are mindful of negative pressures associated with a widening in UK/AU 2y and 10y rate differentials to the upper end of the 6-week range, but favour fading the RBA rate hike for a move to 1.6750.

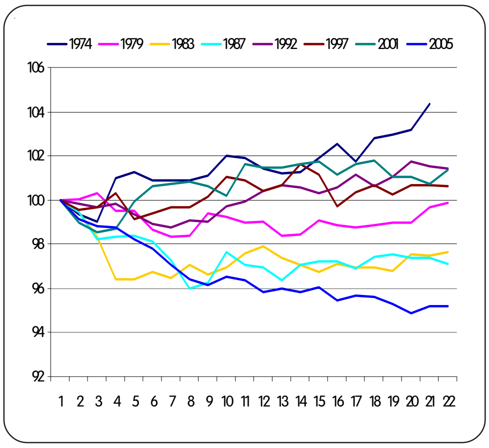
EUR/JPY and EUR/USD underperformance



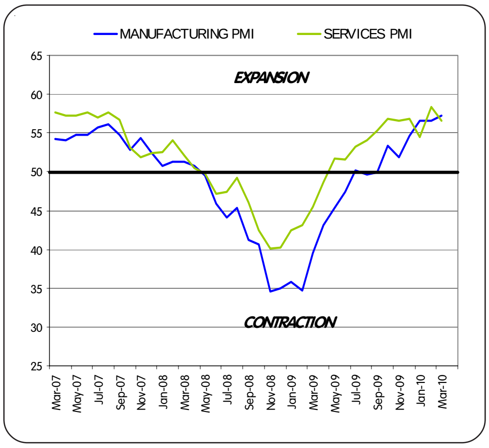
EU macro surprise index outpaces US



GBP/USD to repeat post Feb-74 election rally?



UK/EU 2y spread: targeting 40bp



Quantitative Market Analysis

- **Commodities underpinned by long positioning**
- **GBP/USD correlation with equities holds**

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.

A 4th successive drop in short GBP positioning reduced the overall shorts pulled the number of short contracts to -61,000. Reported short positions fell below 50,000 contracts. Non-reported positions rose a fraction to -11,600, marking the first rise since April 6. Short EUR positions rose for the first time in three weeks, climbing to -76,000. The move was led by a jump in reported short positions to 71,000 contracts vs 55,500, the highest since March 30. This comes despite (or because of) EU/IMF negotiations of a bigger than originally planned rescue package for Greece (120-120bln eur?). We hope to finally get some clarity next week, though our patience has been tested before and negotiations in German Parliament and the regional election on May could further delay the process. Short JPY positioning stabilised at -78,200 contracts.

For the commodity and high yield currencies, we observed a marginal increase in long CAD positions and a small drop in long AUD positions. However, the changes are relatively minor in the bigger IMM positioning context and reveal no meaningful rebalancing from what are still stretched long CAD and AUD positions. With the RBA set to raise rates next week to 4.50% and chances of a neutral statement rising, we ask the question whether the AUD is not vulnerable to a cutback in speculative longs. A surprise from the EU/IMF and the election of a Cons/Lib Dem government could turn EUR/AUD and GBP/AUD into preferred sell targets. The US DXY index extended last week's gains and hit an 82.71 high on EUR and JPY selling, the two biggest constituents of the DXY. We remain medium-term dollar bulls, but as indicated in the section above, progress could stall in the event equities make it through next week unscathed. Our next target level is 83.22. The April employment report will be key next week for risk sentiment and demand for carry trade strategies. Long oil, silver and gold positioning is stuck near the highs of the year, supporting the bullish price action of late.

Risk reversals turned bearishly for EUR/USD, GBP/USD and remained soft for AUD/USD (favouring USD calls). GBP/USD RR are likely to stay choppy over the week ahead considering heightened event risk and may prove inconclusive for short-term market bias, with the unwinding of 1-week options set to have a significant impact. UK macro data will be totally dominated by the general election (May 6), and subsequent BoE MPC rate decision (May 10) and Q2 Inflation Report (May 12).

Table 1: 1-month rolling correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	AUDJPY	EURJPY
2 YR SPD	0.28	0.19	0.72	0.29	0.67	0.33	0.73
10 YR SPD	0.28	0.14	0.16	0.49	0.60	0.18	0.33
S&P500	0.72	-0.68	-0.05	**0.81**	0.10	0.54	0.02
Gold	0.66	-0.50	-0.32	0.66	0.17	0.55	-0.18
Oil	0.48	-0.70	0.19	0.32	0.58	0.75	0.58
Relative Yield Curve	-0.15	0.30	0.61	-0.53	0.10	0.16	0.57
CRB	0.62	**-0.81**	0.31	0.64	0.39	0.70	0.56

Short-dated implied volatility in EUR/USD and USD/CHF surged then subsequently plummeted, but remains higher on the week. Short-dated vol also rose for USD/SEK and USD/NOK. The 1mth/1y vol curve for EUR/GBP flattened to 0.67, the lowest since last November.

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).

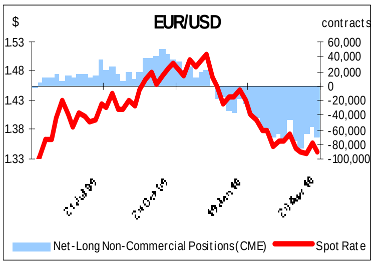
Except for USD/JPY, the correlations of G10 crosses with 2y interest rate differentials are statistically irrelevant for a 2nd successive week. The correlation with 10y spreads offers no guidance either for near-term performance.

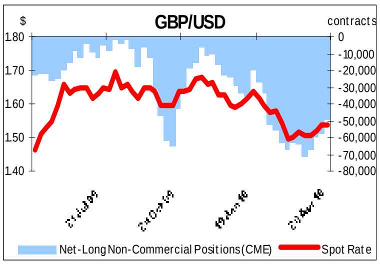
In terms of risk assets (S&P 500), the correlation in GBP/USD dipped slightly to 0.81 but still offers good guidance for short-term performance, though the outlook for next week is obviously clouded by the election outcome. Correlations in USD/NOK and USD/SEK improved for a 2nd week.

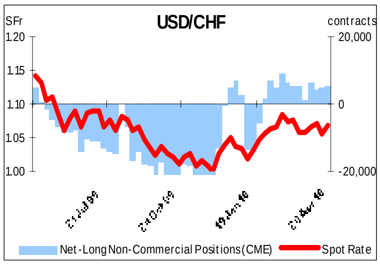
The decoupling of EUR/USD from the EU/US economic surprise index has been observed for most of April (see chart) and underlines how problems in Greece are overshadowing the firmer EU economic backdrop. We believe this inverse correlation may continue to exist for some time. A narrowing of the EU/US spread is possibly on the cards next week.

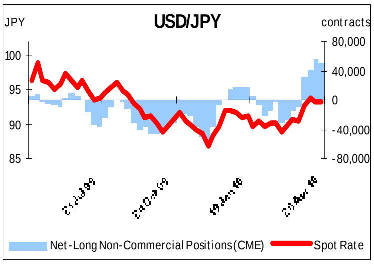
FX & Commodity Futures Positioning

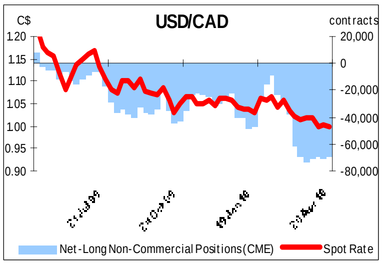
Data from the major US futures & options exchanges are released each Friday evening and report positions up to the close of business on the previous Tuesday. Traders are classified as either commercial or non-commercial. The positioning of the non-commercial traders can be used as a proxy for the speculative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

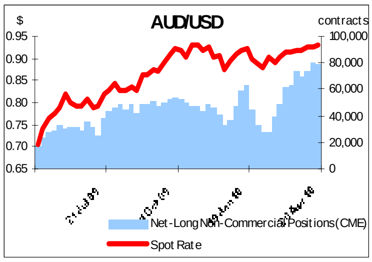


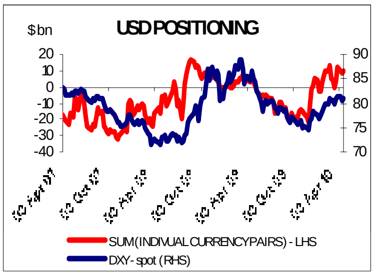


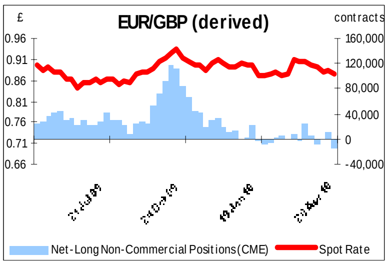


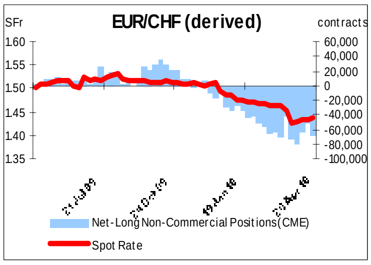


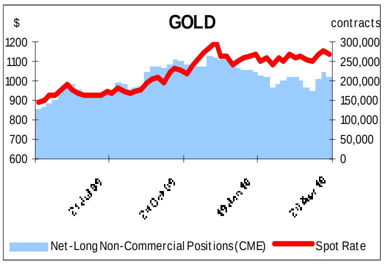


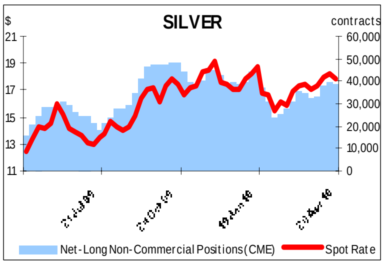


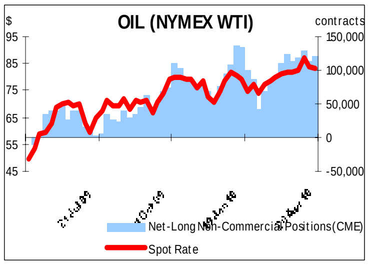


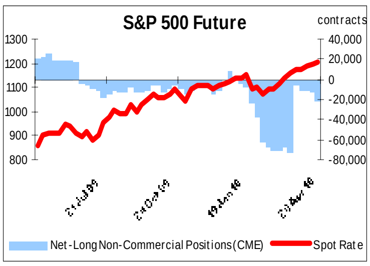


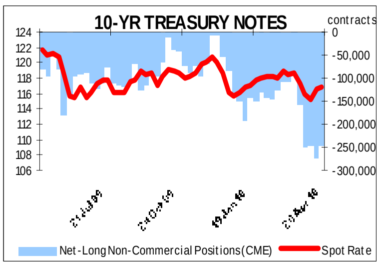


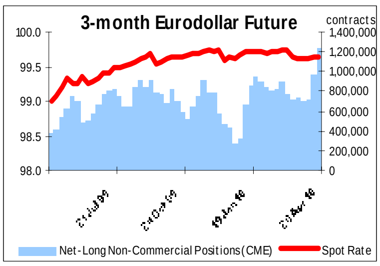








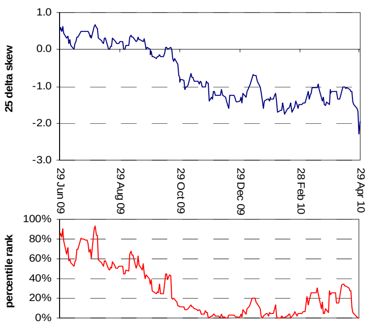




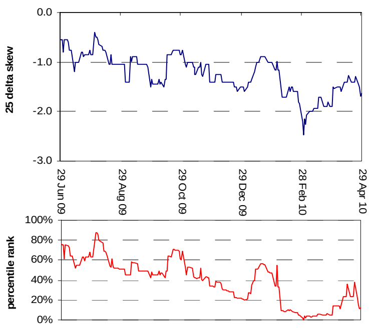
FX Options: Risk Reversal Skews

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.

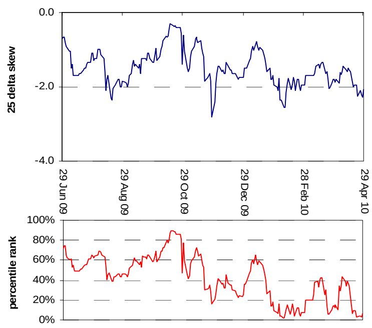
EURUSD



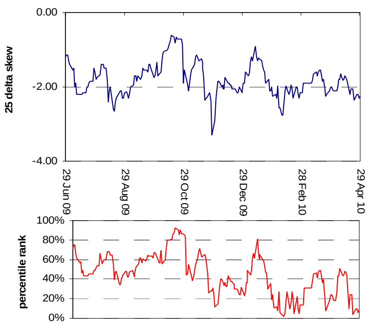
GBPUSD



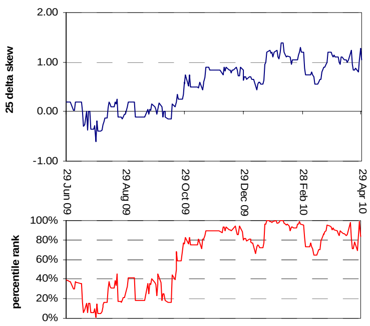
AUDUSD



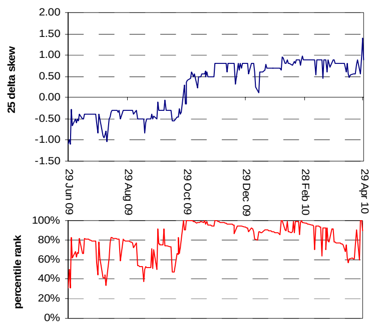
NZDUSD



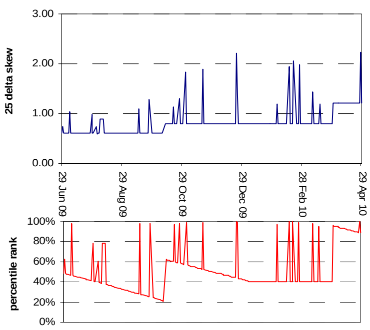
USDCAD



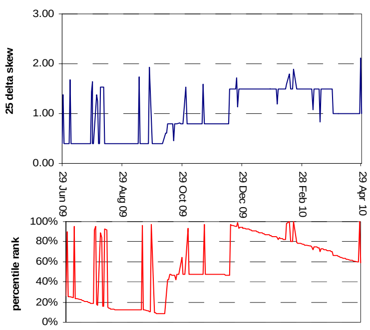
USDCHF



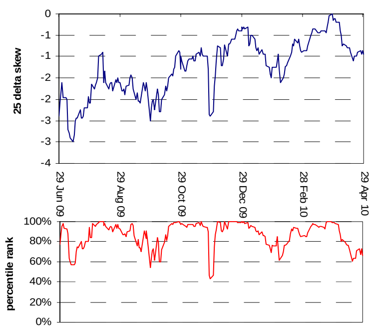
USDSEK



USDNOK

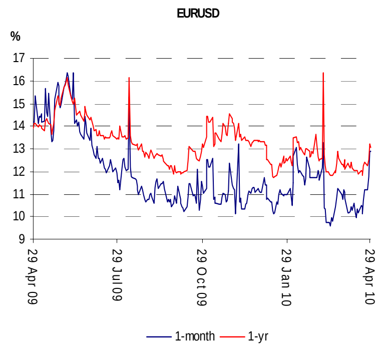


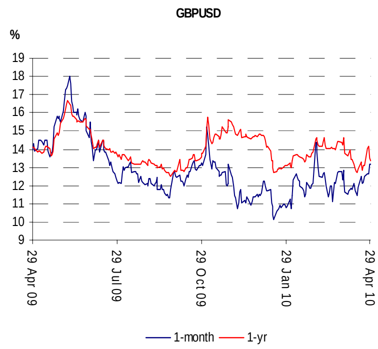
USDJPY

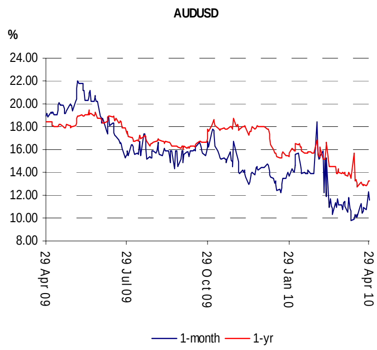


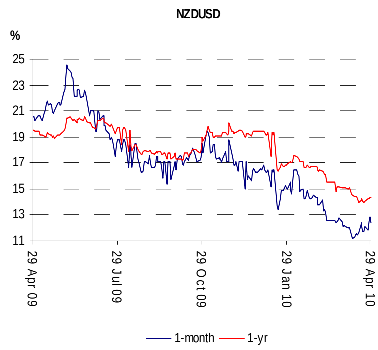
FX Options: Implied volatility

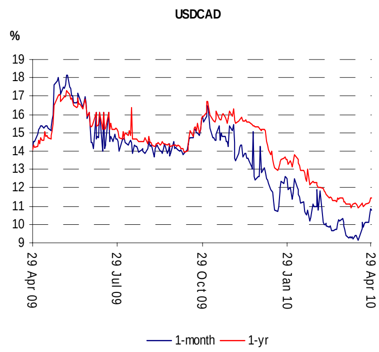
Implied volatility is an input that is required when an option has to be priced. A higher implied volatility would result in a higher option price, if other factors were unchanged. Implied volatility is traded in the markets and is therefore also dependent upon supply and demand for options. In periods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

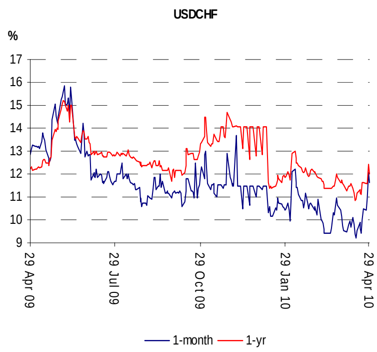


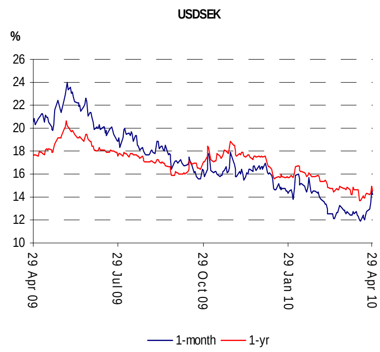


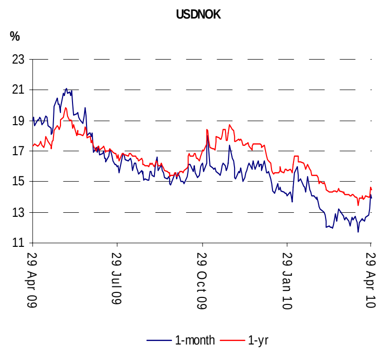


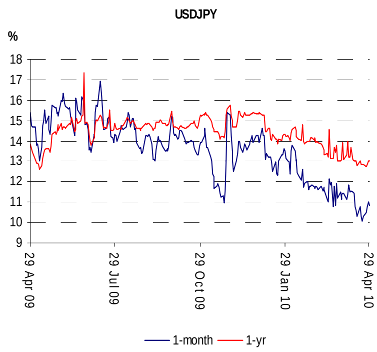






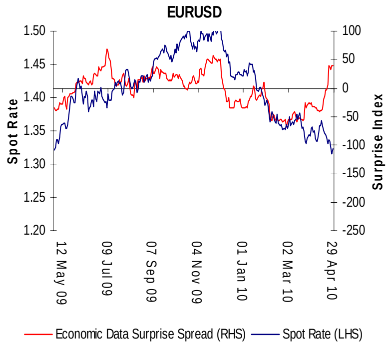


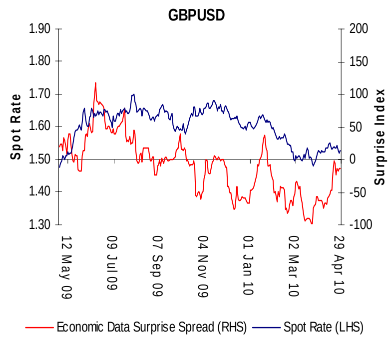


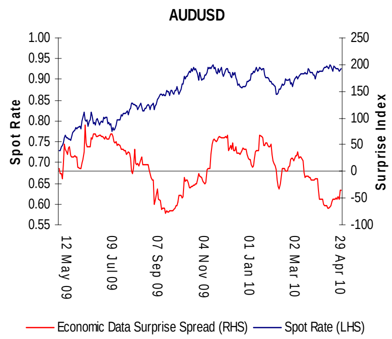


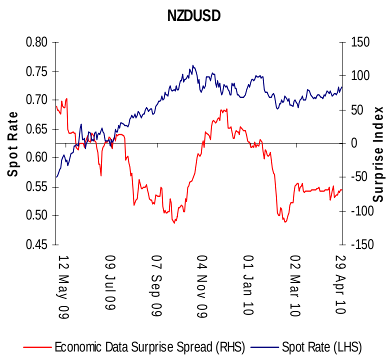
Economic Data Surprises

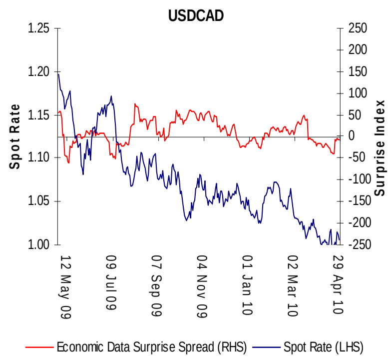
The charts below show relative economic data surprises against historical FX spot rates. The economic data surprises indice are provided by Citigroup. They are defined as weighted standard deviations of data surprises – actual releases vs. Bloomberg survey median. Relative data surprises between two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

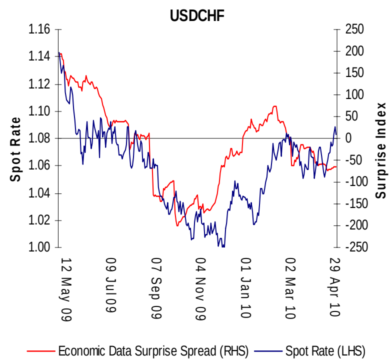


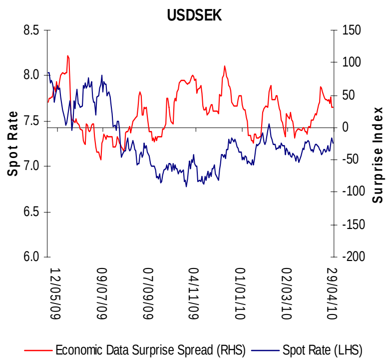


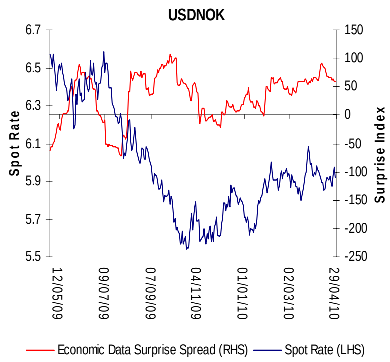


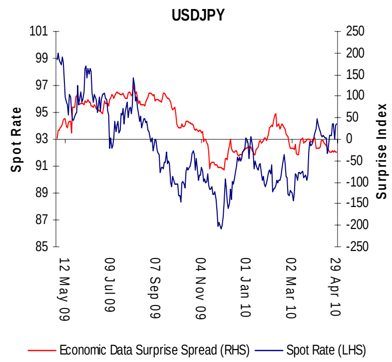






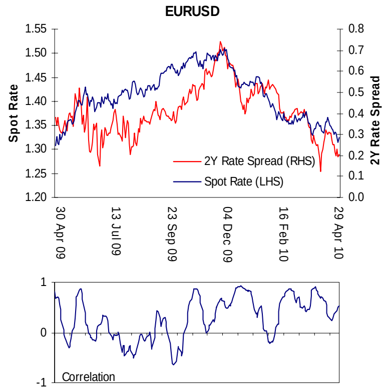


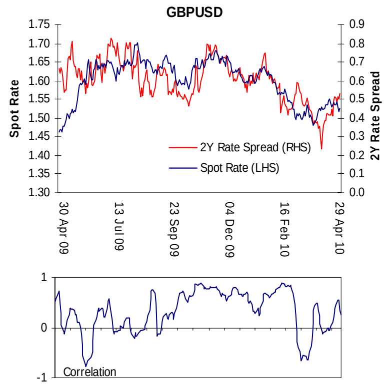


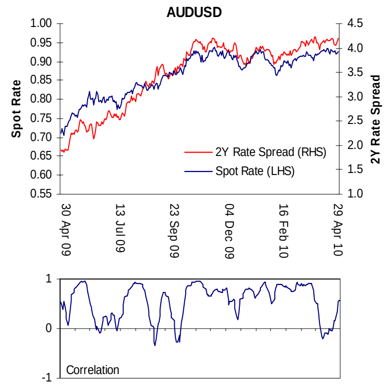


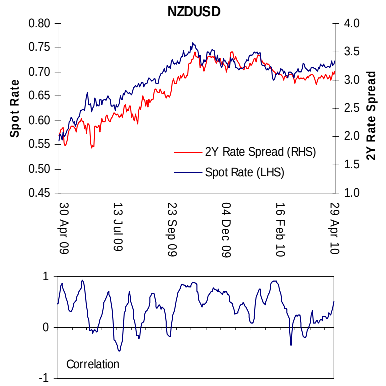
Interest Rate Spreads vs. FX

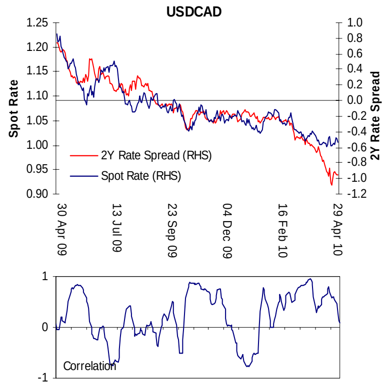
The charts below show interest rate spreads plotted against historical FX spot rates. The spreads are calculated using two-year interest rate swaps. A one-month rolling correlation (between the spot rate and the interest rate spread) is shown to identify time periods when interest rate spreads are driving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

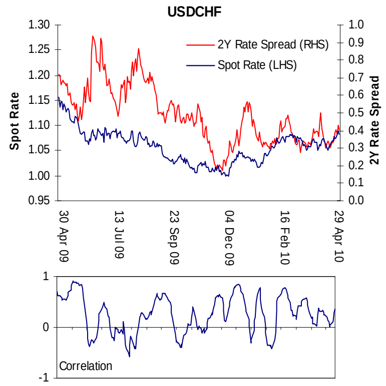


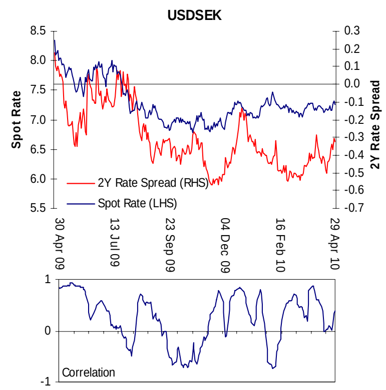


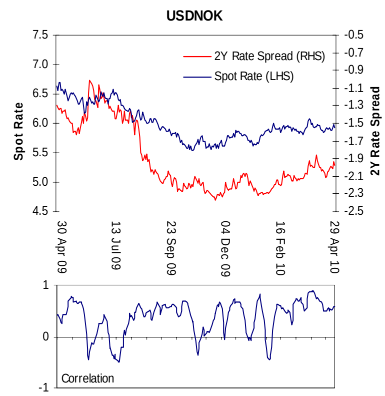


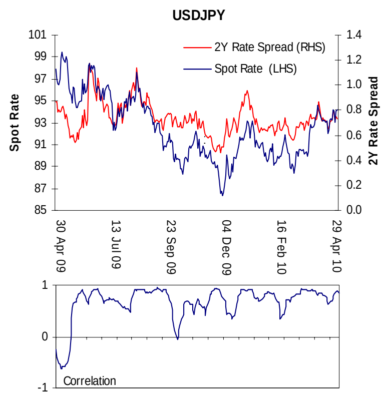






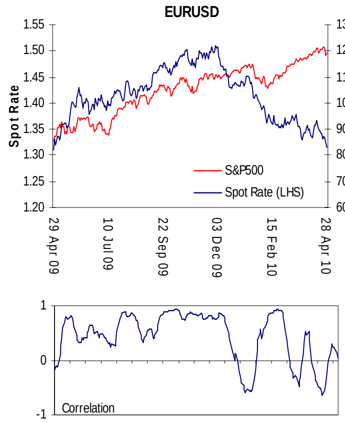


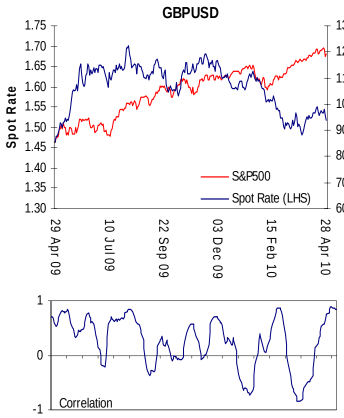


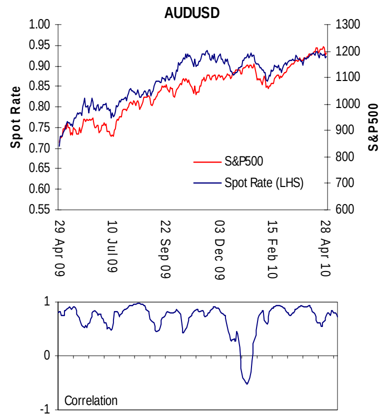


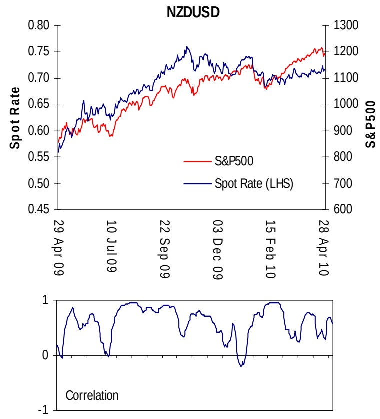
S&P500 vs. FX

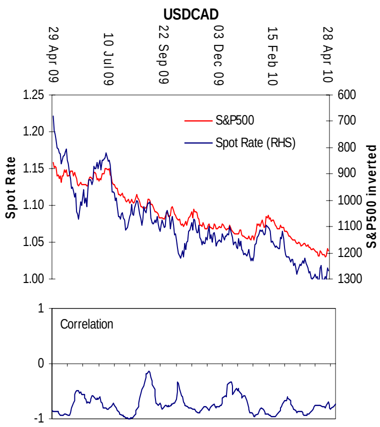
The charts below show the S&P500 plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and equity index) is shown to identify time periods when the two series are moving in tandem.

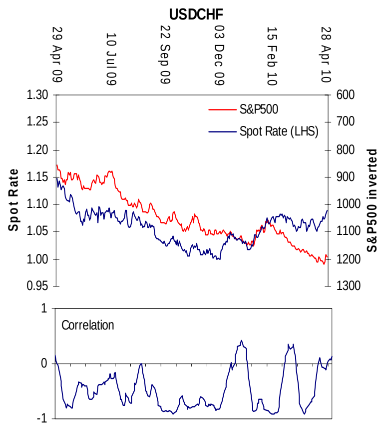


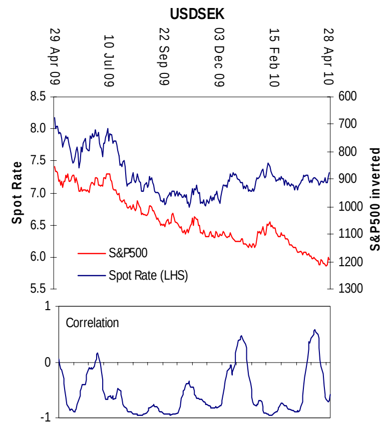


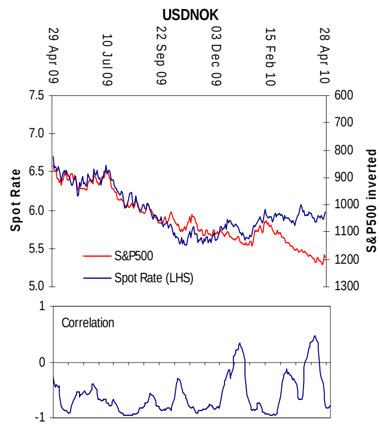


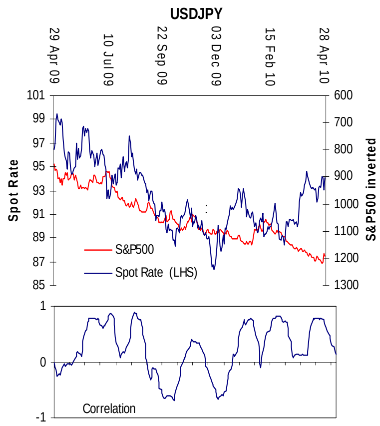






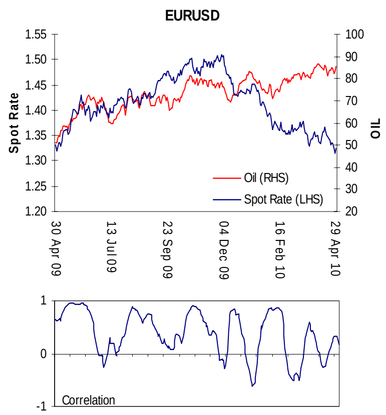


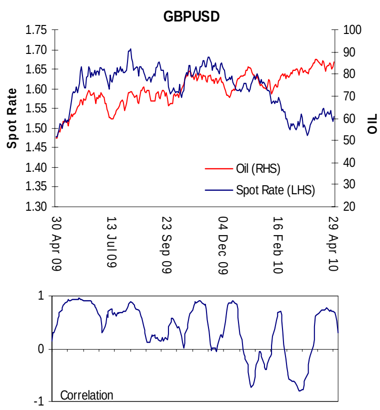


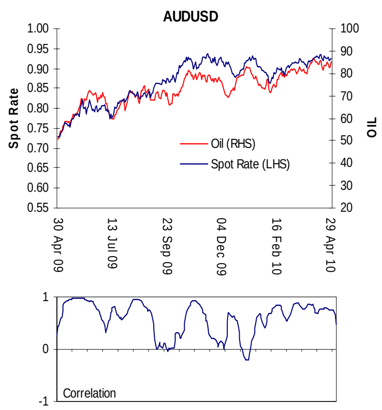


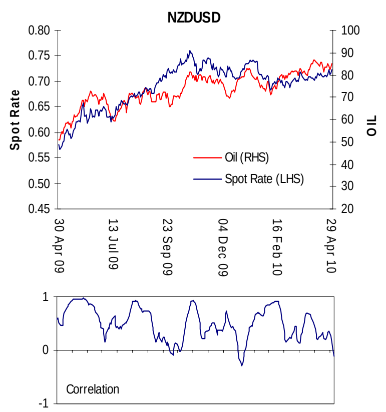
Commodities vs. FX

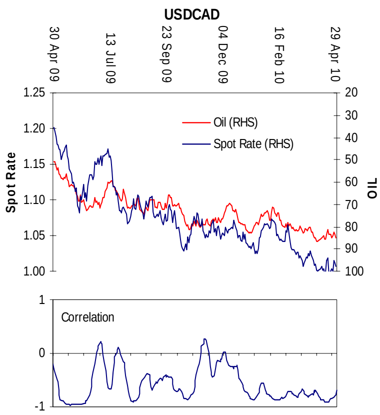
The charts below show oil prices plotted against historical FX spot rates. A one-month rolling correlation (between the spot rate and the commodity series) is shown to identify time periods when the two series are moving in tandem.

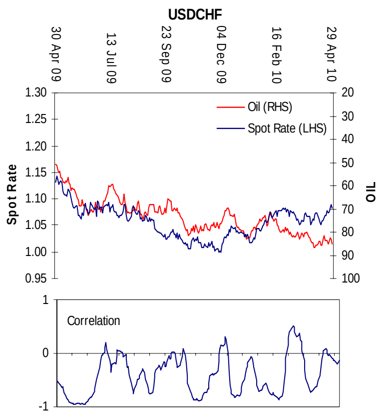


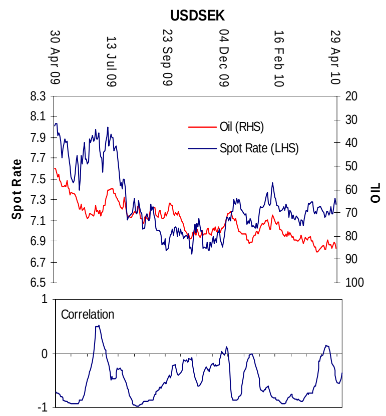


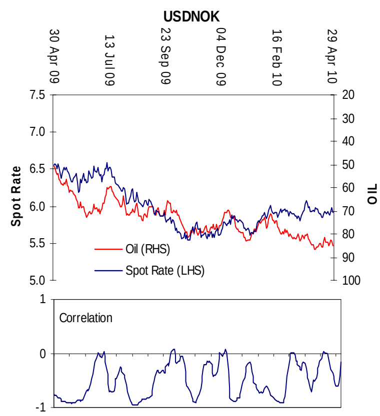


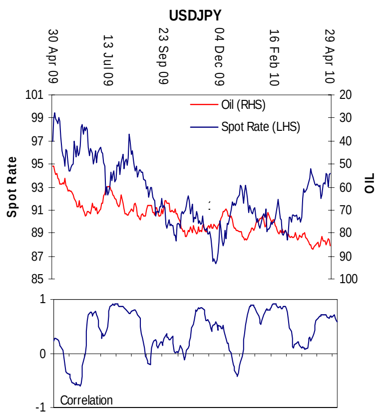








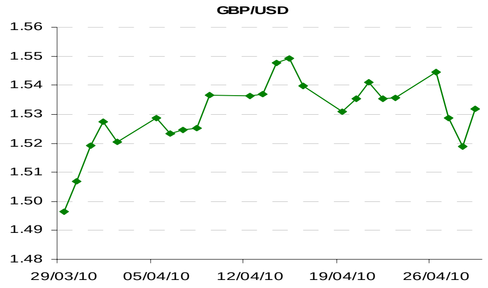


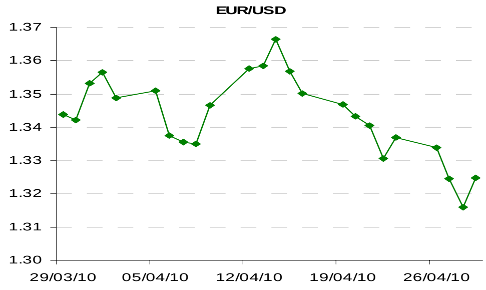


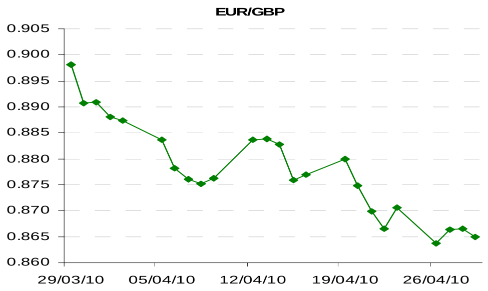
*All charts are sourced to Lloyds TSB Corporate Markets Research, Bloomberg, Datastream and Citigroup.

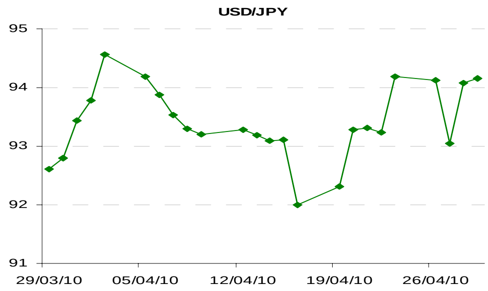
Market Review

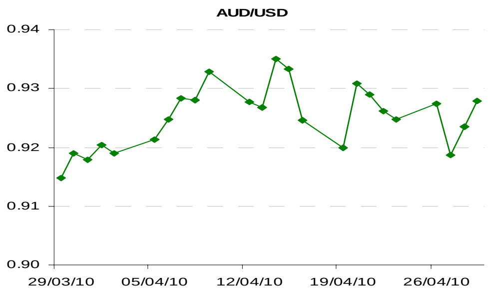
Short-term G-10 FX Charts

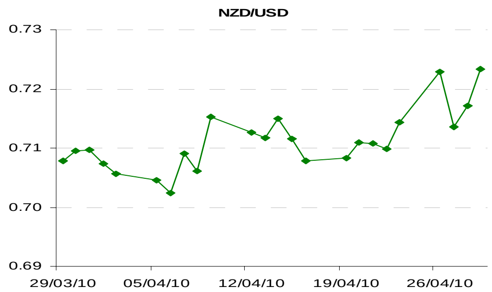


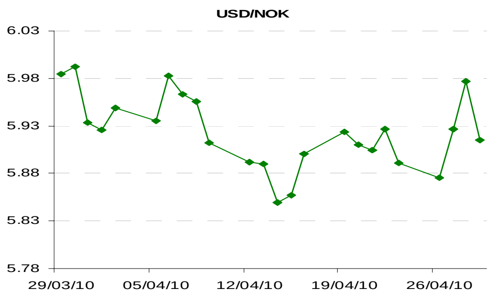


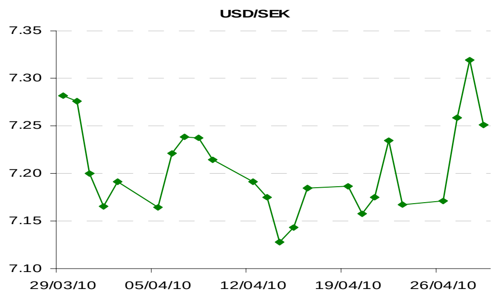


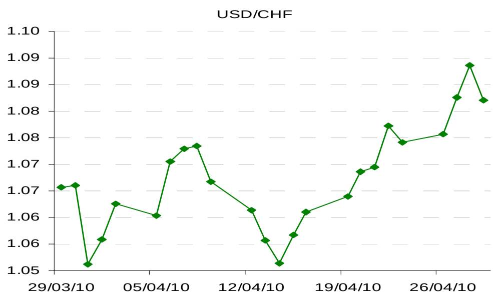


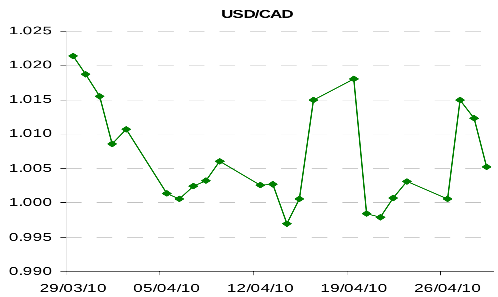












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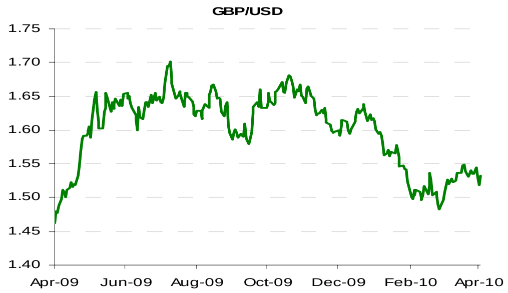
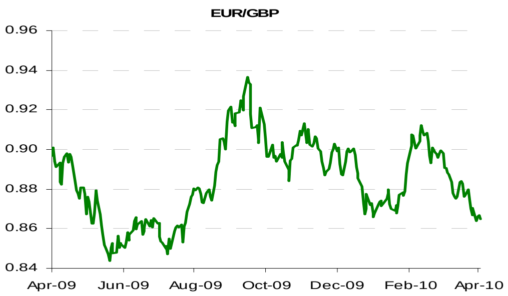
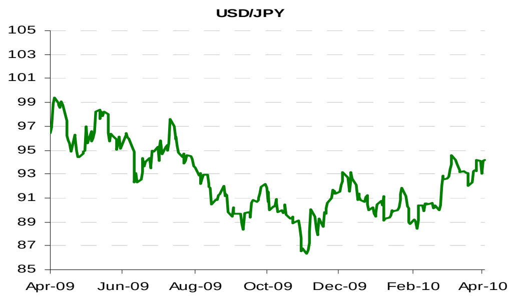
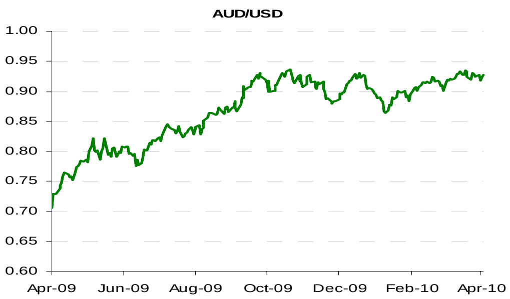
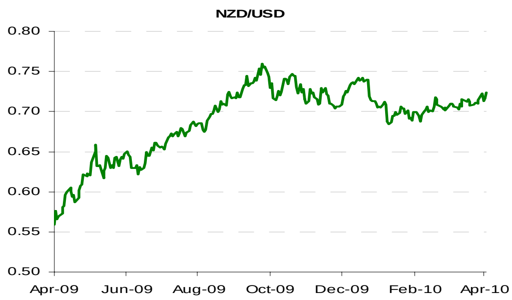
Medium-term G-10 FX Charts

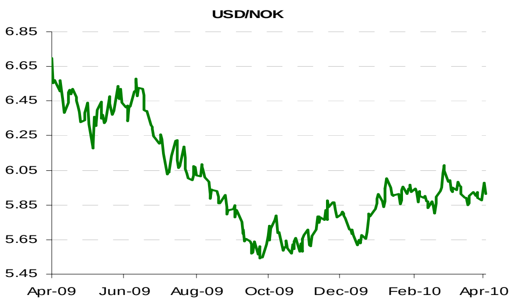


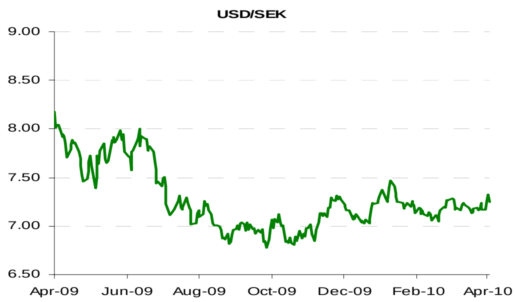


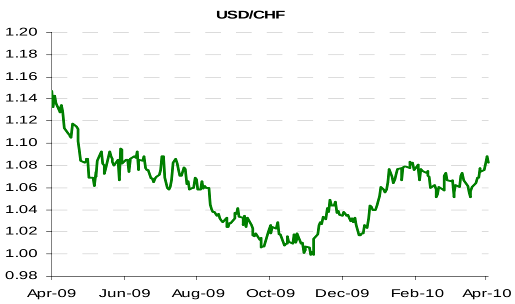


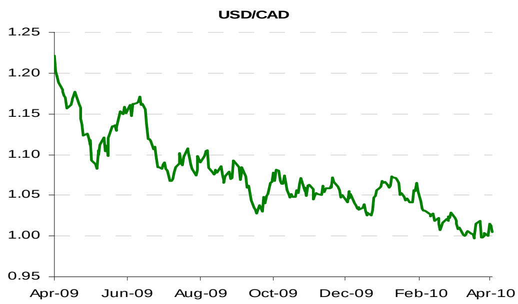






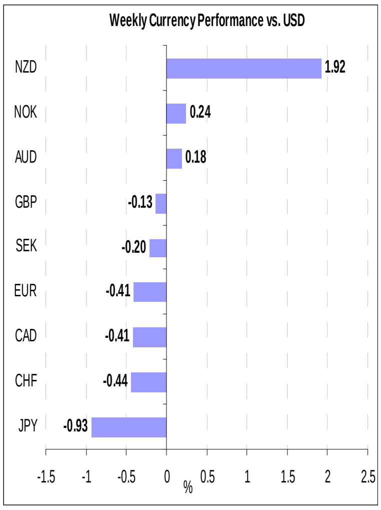


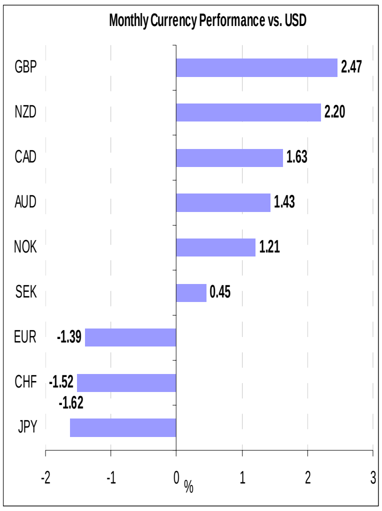


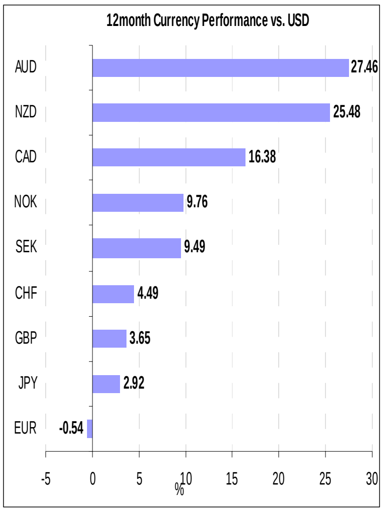


FX Snapshot

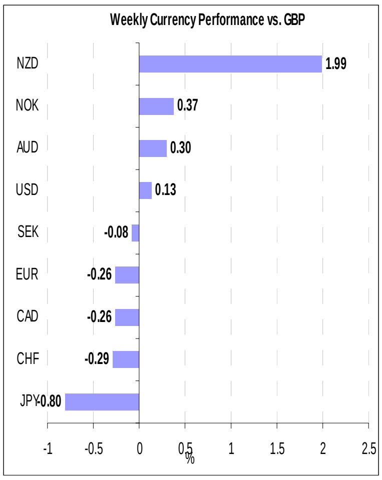
Currency performance vs. USD

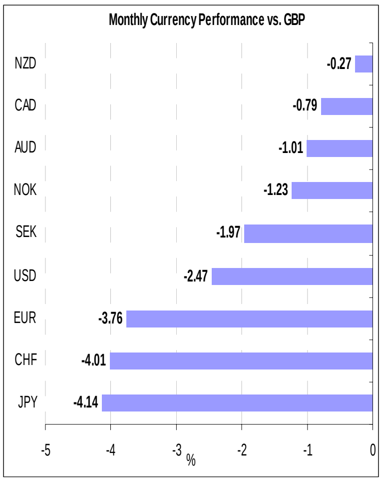


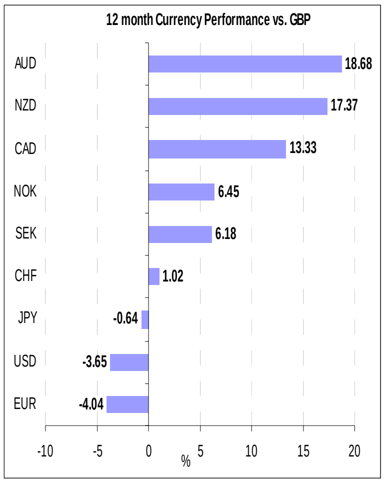




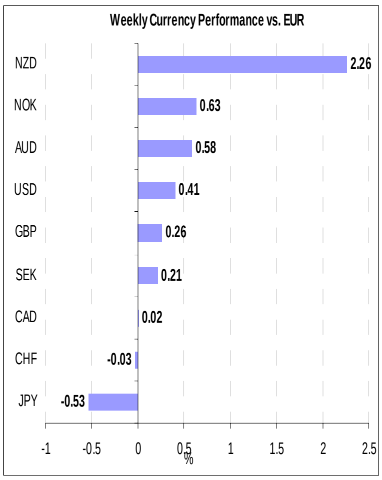
Currency performance vs. GBP

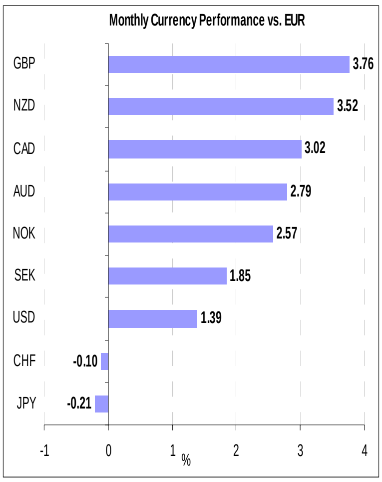


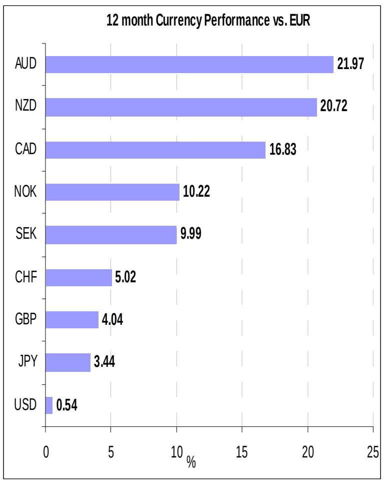




Currency performance vs. EUR







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