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# FX Strategy Weekly

## Market Strategy

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FX	Close	Weekly Change %
GBP/EUR	1.1614	1.11%
GBP/USD	1.4774	-3.27%
GBP/JPY	135.45	-5.48%
GBP/CHF	1.6389	-0.40%
GBP/AUD	1.6608	0.52%
GBP/NZD	2.0681	-1.56%
GBP/CAD	1.5388	-1.00%
GBP/NOK	9.2529	2.61%
GBP/SEK	11.34	2.42%
EUR/USD	1.2722	-4.30%
USD/JPY	91.68	-2.31%
AUD/USD	0.8895	-3.77%
NZD/USD	0.7145	-1.72%
USD/CAD	1.0416	2.33%
USD/SEK	7.6765	5.86%
USD/NOK	6.2628	6.06%
USD/CHF	1.1094	2.95%
<b>Swaps %</b>		<b>bp</b>
2yr	1.663	-5.5
5yr	2.860	-11.8
10yr	3.715	-12.3
<b>Equities</b>		<b>%</b>
FTSE100	5123.02	-8.81%

### Market Outlook

Tactical view:

= Buy GBP dip on relief bounce in stocks, BoE QIR

= New trading range for EUR crosses

A total breakdown in equities played out negatively for GBP considering the big jump in volatility with stocks in April. With no clear indication on what political Parties will form the next government, we adopt a cautious stance and are reluctant to buy GBP on dips. The dark clouds hovering over equities add to the uncertain outlook and may keep GBP on the defensive near-term vs the G10 until risk appetite returns. The sovereign debt crisis should not have a major impact on the way the BoE delivers its rate decision on Monday and Q2 Inflation Report on Wednesday. The sharp fall in equities and rise in labor rates are a bearish signal and will force the BoE to navigate the sovereign headwinds carefully, with upward revision to inflation projections likely to spark only a minor reaction.

### Recap

- GBP came under attack following a dramatic sell-off in global equity markets and a much closer election result than hoped, losing 5.5% vs the JPY and 3.3% vs the USD. GBP did rally however vs other G10 currencies including the AUD, EUR, NOK and SEK. We remain cautious on buying GBP dips at this stage considering the political uncertainty, but a subsiding of risk aversion in equities offers attractive entry points for a short-term rally. The EUR suffered a heavy blow vs the USD, diving to a 1.2529 low on Thursday, before clawing back ground to end the week at 1.2722. Key support in the 1.4320 area finally gave way in EUR/CHF and dragged the cross to a 1.4006 low.

- Solid PMI data underscored that the UK economic recovery remains intact as we move towards the middle part of Q2. We look for confirmation in the labour market stats next week that companies are stepping up hiring, though this may be offset by reduced public sector employment. The Halifax reported a 0.1% m/m drop in house prices in April. The US economy added 290,000 jobs in April, the biggest gain since Mar-06. The ECB kept interest rates on hold at 1%, and could be tempted to deploy new measures to restore confidence in the EUR and peripheral debt markets.

- UK 5y swaps eased back from a 2.90% high to close the week at 2.85%. The long-end of the curve outperformed the front-end for a 2nd week running, compressing the 2y/10y swap spread to 206bp. Gilts underperformed Treasuries and bunds, whilst UK 5y CDS rose over 100. 10y swaps spreads widened to -12bp, bouncing off -20bp. Dec-10 short sterling sold off to a 98.64 low before closing at 98.78.

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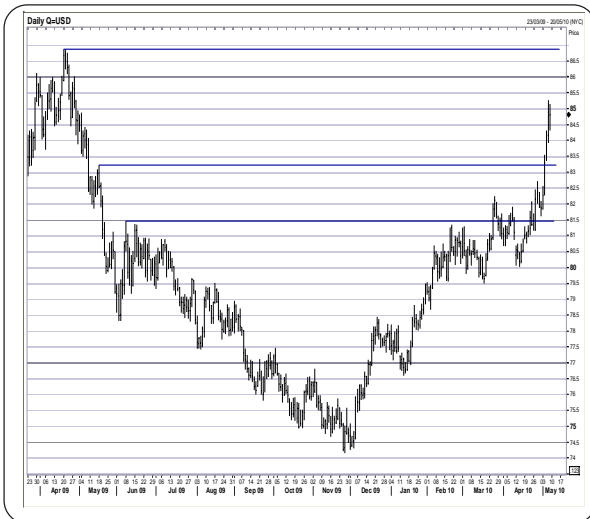
## Market Outlook

Tactical view:

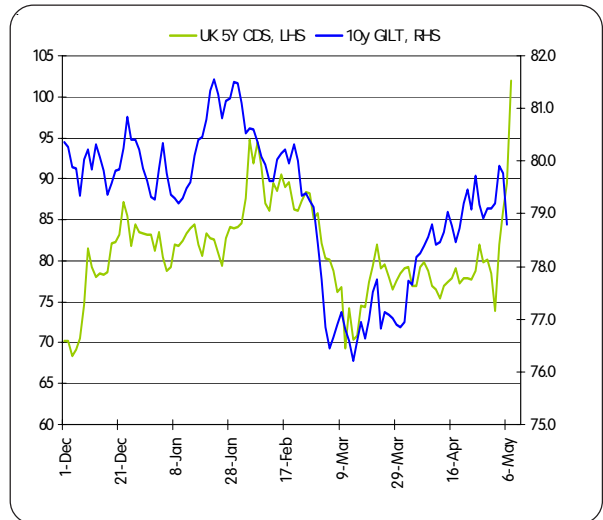
- = Buy GBP dip on relief bounce in stocks, BoE QIR
- = New trading range for EUR crosses

A breakdown in equities played out negatively for GBP considering the elevated correlation with stocks. With no clear indication on what political Parties will form the next government, we adopt a cautious stance and are reluctant to buy GBP on dips. The dark clouds hovering over equities add to the uncertain outlook and may keep GBP on the defensive near-term vs the G10 until risk appetite returns. The sovereign debt crisis should not have a major impact on the way the BoE delivers its rate decision on Monday and Q2 Inflation Report on Wednesday. The sharp fall in equities and rise in libor rates are a bearish signal and will force the BoE to navigate the sovereign headwinds carefully, with upward revision to inflation projections likely to spark only a minor reaction.

### Dollar index: progress has accelerated, not stalled



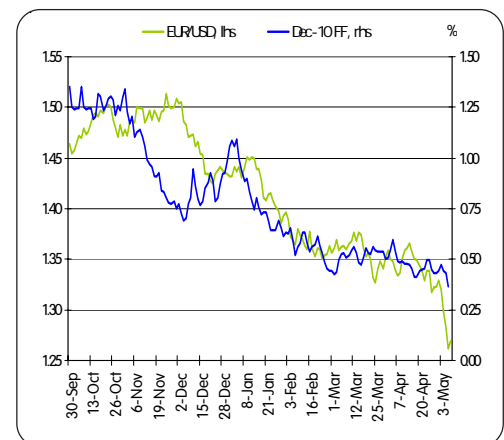
### UK 5y CDS tops 100 on hung Parliament



## USD

- We haven't learnt anything fundamentally new on the economy and the labour market over the past that we didn't know, and this gives us few reasons to change our near-term outlook for US rates as a driver for the USD. The labour market added 290,000 jobs in April, and an upward revision to March will bolster confidence at the Fed that policy is on the right track. However, with a minority of Fed officials favouring possible asset sales before a rate hike, FOMC policy could turn over the summer if job gains are sustained and the unemployment rate starts falling back.
- The Treasury announced a reduction in quarterly coupon sales for the first time since 2007, featuring lower sales of 2y-5y paper. We look for the rush out of the EUR and the direction of risk assets to dictate sentiment, potentially adding impetus to the dollar index.
- The rapid descent in EUR/USD below 1.30 has been closely tracked in Fed fund futures, with Dec-10 contract sliding below 0.50% and implicitly reducing the probability of a Fed 25bp rate hike by year-end to just 38% following the latest episode of equity market selling. With the dollar strengthening, equities tumbling and unit labour costs in retreat, the outlook is intact for US interest rates to stay low for an extended period.
- The quick succession at which key topside levels have been taken out suggests the dollar index is venturing into overbought territory. This is not equal to saying that the currency is overvalued, but we expect the rate of appreciation to ease off. Based on demand for a safe harbour, further gains are anticipated.
- Technical indicators like Bollinger bands (two standard deviations above/below the 20d MA) suggest we could see profit taking in the dollar index over the coming week, if equities stabilise. The trouble with this view is that we see no grounds for a reversal in the EUR as money managers trim single currency holdings and appetite for GBP longs is curbed by a hung Parliament.

### US rate hike probability pared back on EUR/USD





## EUR

• No time to relax on Monday as the market takes in the regional election results in the German state of NRW. Chancellor Merkel's coalition is in danger of paying a price for compromising on the EU/IMF aid package and a hefty contribution of 20bn eur, though it bargained for attached conditionality and allows for 'orderly default' by a member state. A wounded CDU/FPD coalition could raise doubts over the success of future bailouts or interventions on behalf of the EU, and could persuade markets to rev up for another test of the credibility and flaws of EU and ECB policies.

• The protracted sell-off in EUR crosses over the past week was concentrated vs the JPY (-7%) and the USD (-5%) as flight-to-quality from the peripheral bond markets stepped up a gear. 10y Greece over bunds topped 900bp, with Portugal following at 350bp. We think this story is not over and stick to our bearish EUR strategy for the short and medium term. The move through 1.30 to a 1.2529 low argues for a defensive set-up and selling of rallies, with 1.2330 an obvious target (Oct-08 low) once 1.25 gives way. EUR/USD risk reversals point to an overwhelming bias for EUR puts (-2.87).

• We remain fundamental EUR bears. Though one has to recognise that macro data for Germany is keeping good pace with the US since the start of May (watch Q1 GDP next week, see chart), the market is clearly conditioned by contagion fears in the peripheral bond markets, the exposure of euro zone financial institutions, and the longer term plight of Greece. A 5% surge in German industry orders was matched by a 290,000 gain in US April employment, but failed to spur a relief rally in EUR/USD, though a return to calmer was observed on Friday.

• For EUR/JPY, we are mindful of the long-term downtrend in place since January. The dramatic sell-off on Thursday to a 110.70 low puts the pair in a new trading range. We favour selling a bounce in the 120.0-122.70 area.

## GBP

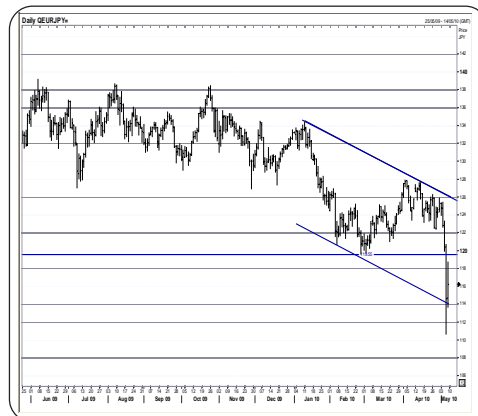
• What a week. A total breakdown in equities played out extremely bearishly for GBP/USD considering the big jump in volatility with stocks in April. With no clear indication on what Parties will form the next government, we adopt a cautious strategy and are reluctant to buy GBP on dips. The dark clouds hovering over equities add to the uncertain outlook and may keep GBP on the defensive near-term vs the G10 until risk appetite returns.

• The sovereign debt crisis should not have a major impact on the way the BoE delivers its rate decision on Monday and Q2 Inflation Report on Wednesday. The sharp fall in equities and rise in libor rates are a bad sign and will force the BoE to navigate carefully for what it communicates on the inflation and growth outlook for this and next year. Revisions to February CPI and GDP forecasts should not be that material. Inflation may be slightly revised up for this year (weak GBP, import prices), but in today's risk averse context and flight-to-quality to bonds, asset purchases will not be ruled out. I think gilts/short sterling will comfortably absorb the higher CPI projections without necessarily pushing up the front end of the yield curve which I must admit marks some back pedalling from my view over the last few weeks. As long as equities fall, bond yields should stay capped and may test further downside, led by the long end of the curve (bull flattening).

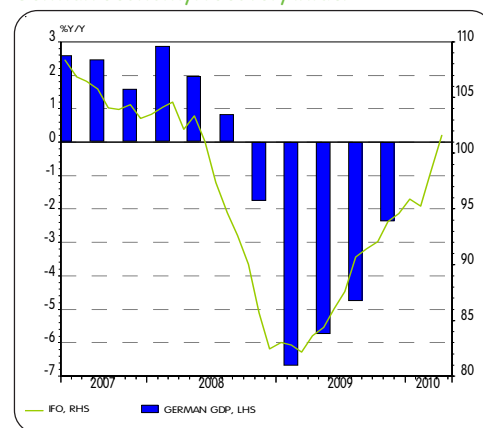
• Government negotiations also argue for caution on behalf of the BoE. We know that if the Tories get in (with the Lib Dems), a fiscal squeeze will be agreed sooner rather than later, and this will bear down on the short-term outlook for GDP growth. In every sense, this gives the Bank every reason to play a safe strategy and not over-commit with regard to future looking statements as pans for fiscal policy are eagerly awaited. GBP could rally of this week's lows if the hawkish views held by some MPC members are upheld. For GBP/USD, we target a rally up from 1.4784 trendline support, initially stretching up to 1.50.

• For EUR/GBP, a sharp retracement late on Friday below trendline resistance at 0.8699 bodes well for a return to the 0.85 area if the German election does not go Chancellor Merkel's way and the EUR is met with fresh bout of selling on Monday. A UK/EU 2y spread of 55bp, arguably below the 68bp high, should add support.

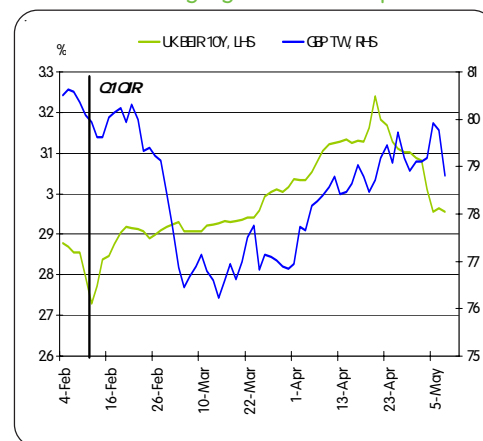
## New trading range for EUR/JPY



## German economy: recovery intact



## BoE QIR: balancing higher inflation expectations



## Gilts: safe haven compromised?

