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G10

USD: Stronger despite more soft housing data

The US dollar rallied across the board overnight, while equity markets held on to their gains. EURUSD traded down to a low of 1.4139 from a European session high of 1.4226. The pending home sales index (PHSI) fell 6.5% m/m in August, worse than consensus of a -2.1% decline, and follows on from a revised 10.7% m/m drop in July. The fact that banking stocks have managed to rally this week despite more bad disclosures on the subprime front and poor housing data suggests that investors think the worst is past on this issue. Other data this week is inconsistent with earlier episodes of the Fed cutting rates, with the manufacturing ISM on Monday holding above the 50 level, and today's non-manufacturing ISM expected to do the same. A G7 source suggested overnight that the UK and Canada will likely join the Eurozone in voicing concern over pronounced USD weakness. More important for the US dollar at this juncture is positioning risk given how short the speculative market is of USD presently. If payrolls on Friday were to significantly exceed expectations, a short squeeze in the USD could help push EURUSD lower. Likewise, a consensus or softer-than-expected payrolls this Friday would probably help the dollar consolidate at current lows for now. Ahead today, the ADP report and the non-manufacturing ISM report could influence expectations. Our economists note that both the ADP private payrolls series and the employment index in the nonmanufacturing ISM survey correctly signalled the tone of the employment report in August. The key focus with the September data will be whether and how much the data bounce back. The consensus is looking for an ADP reading of 58k private payroll jobs in September after 38k in August.

EUR: Weaker PPI, firm employment numbers

PPI inflation for the Eurozone for August came in at 0.1%m/m, 1.7% y/y, a touch lower than consensus. Our economists note that underlying PPI inflation is now below the 3.4%-3.6% range held between July 2006 and April 2007, further pointing to more dovish ECB prospects ahead. Unemployment was flat at 6.9% though there are questions being asked over the rate of decline. On Monday, a string of European PMI numbers were released across the Eurozone and most nations registered falls, in line with expectations. Italian and Spanish PMIs came in at 23 and 27-month lows respectively, French PMI fell to just above the key 50 level, while Germany's index also fell. The overall Eurozone PMI fell to 53.2 as expected, with new orders down to a two-year low of 52.2. The numbers continue to indicate weaker economic conditions and are consistent with our economists' view that the ECB will leave rates unchanged for the remainder of the year. However, the rhetoric of the ECB with regard to price pressures has strengthened recently, and the EUR may yet benefit if a surprisingly hawkish signal is sent at Thursday's interest rate meeting. The euro is likely to hold well on the crosses in the short term as improving growth sentiment is driving regional asset markets higher. Nevertheless, we advise against chasing EURUSD moves higher at this stage as excessive currency strength will both ease inflationary concerns and caution policymakers against further hikes which may potentially be damaging to growth.

CHF: Inflation still not a problem

Swiss inflation rose by 0.1% m/m, 0.7% y/y for September. The numbers yet again confirm that the buoyancy of the economy is not being undermined by inflation, and that the SNB may further move towards a neutral or dovish stance. On Monday, Swiss PMI for September slowed from 65.1 to 57.6 the previous month and against expectations of a mild drop to 63. Our economists note that at 50.6, the weakness in the production sub-component was rather pronounced and stood barely above the critical expansion-contraction threshold of 50. From a forward-looking perspective, the backlog of orders and lower stock of finished goods suggest that the business remains in solid health but the effects of this summer's events have been clearly felt in the domestic economy. The numbers should not be of great concern to the SNB, though markets would appreciate further clarity on interest rate prospects after the conflicting messages of September. Newfound stability in equity markets has allowed EURCHF to regain traction, especially if the ECB continues to show a proclivity towards further hikes up ahead. We still see upside risk on the cross as long as risk aversion continues to retreat.

GBP: Concerns linger over financials

The GBP continues to be vulnerable to news reports voicing concern over the health of UK financials exposed to the recent credit squeeze. An article in a UK newspaper suggested today that British banks have accounted for a substantial portion of last week's EUR 190bn ECB tender. The reluctance of the BoE to provide liquidity in money markets until events moved beyond their control may have been the catalyst for banks to approach the ECB. However, the scale of the borrowing will lead to questions over the extent of liquidity problems UK lenders are currently facing. Recent credit-related events will dominate the agenda of this week's BoE rates decision. The market expects no change to interest rates, but the central bank may also choose to release another uncustomary accompanying statement to ally concerns that money market conditions are not showing significant signs of improvement. A sharp decline in interest rate expectations against its high-yielding peers has put sterling on the defensive. The GBP's gains against the EUR will likely be capped around current levels. We target EURGBP at 0.70 in both 1- and 3-months.

AUD: RBA leaves rates unchanged

The RBA left rates unchanged this morning at 6.5%, in line with market expectations. The RBA does not communicate to the market following board meeting where the decision was to keep rates on hold. Retail sales for August is due at 0130 GMT and the market expects a rise of 0.3% m/m, while the trade balance for August is also due, and the market expects a widening in the deficit to A$1.4 bn up from A$0.76 bn in July. However, for domestic rate expectations, the next key event is not really until Oct 24 when CPI for Q3 is released. Beyond that is the Australian Federal Election, likely to take place on the last Saturday of November.

Emerging FX

IDR, INR: Where strong domestic stories help

Most Asian bourses recorded net foreign buying in the last two weeks, signalling an improved overall appetite for EM stocks. Barring the Kospi and the PSE, all the reporting Asian bourses which include the TWSE, SET, BSE and JKSE, announced positive prints in net foreign buying in the past fortnight, helping these stock indices back to around their historic highs. But to-date since the onset of the credit turmoil in August, theses purchases have been unconvincing at best. According to our data the total net of foreign buying into these stock markets remains in the negative since the onset of the credit market woes in the middle of August. Summing up all the foreign fund flows into these six markets shows that foreigner investors are still net sellers to the tune of US$6.6bn of Asian stocks since the credit market turmoil began. Only Indonesia and India have seen a complete turnaround in foreign outflows since the onset of the credit turmoil, with the total net foreign buying of US$674mn and US$3.3bn respectively in the seven week to the end of September. Meanwhile foreigner investors sold a net US$9bn worth of Korea stocks and US$1bn of Taiwan stocks over the same period. The PSE meanwhile saw a small net foreign selling of US$121mn in the said seven-week period. This we think is a good reflection of investors favouring a strong domestic growth story given the current environment of uncertainties. We have noted in past comments that we favour growth over carry and have preferred the IDR, INR, PHP, MYR and the SGD for their respective strong domestic growth stories and these foreign equity flows data have vindicated our views. We remain long the PHP and IDR as part of our EM FX portfolio.

TRY: Are we there yet?

We continue to see positioning in Turkey as high and valuations stretched. TRY at these levels looks vulnerable, and we note that its beta to risk appetite (as proxied by MSCI global) remains elevated. The current account deficit is at risk of being further compromised by stronger FX; yesterday the finance minister announced that a 10% appreciation in the lira raises imports by 5%. The situation with the current account deficit requires structural economic adjustments that make the export sector more competitive. The CBRT is not commenting about intervention, though anecdotally it is thought that perhaps increasing the amount of daily USD actions would be the way to go. The pros in this case would be easing pressure on the current account deficit, but the cons would be fewer dampers against inflation. It is noted that the bank’s mandate is inflation, and that perhaps the wider economy requires a comprehensive macro-management plan that removes the CBRT from the limelight on issues other than inflation management. But at these levels the balance of risks appears in favour of a weakening rather than strengthening of the TRY. We retain a fundamentally bearish bias on this currency for now.

BRL: Central bank continue to refrain from USD purchases

The BRL had another very strong session on Monday gaining around 1.4%. The benign external environment with the US equities hitting record levels has given the green light for the appreciation of the BRL. We think the Real’s appreciation is firmly rooted on the good fundamentals of the Brazilian balance of payments. This was again apparent in the September trade balance released on Monday which showed a surplus of US$ 3.5 bn – beating the market consensus of US$2.9 bn. The discussion now in Brazil is if, and when, would the central bank resume its USD purchases which has been absent since the beginning of the credit market turmoil. The absence of the central bank might be explained by recent inflationary pressure since a stronger real would help curb inflation by its direct effect on tradable goods. As the BRL moves south, the return of central bank is becoming increasingly likely in our opinion. In our view, if the current positive sentiment in global markets persists, the BRL should continue to move towards the 1.80 level. In this context, the next important number for the BRL will be the upcoming US labour market statistics on Friday.

MXN: Still lagging other EM currencies

On Monday, the MXN gained around 0.4% on the back of a very positive day for US equities. The MXN has been lagging other currencies in EM space, and rightly so given that the US is the most important market for Mexican exports, but we think a milder slowdown of the US economy could give a positive impulse to the Peso. The trigger for a MXN catch up could the US labour market statistics to be released this Friday. If the numbers showed a more stable labour market, the perspectives to Mexican economy and the MXN will improve. In this environment, the MXN could move towards the 10.70-10.80 range in our opinion.

CLP: Breaking important supports

The USDCLP has broken the important 510-509 support level on Monday, gaining around 0.66% on the day. The positive sentiment on external markets lead by strong performance of US equities and higher domestic rates in Chile due to recent inflationary pressures is supporting the CLP. These conditions should persist in the short term, helping to push the Peso towards the 500-505 level.

Technical FX – USDCAD bear taking a breather

CURRENCY PAIR:	* TREND:	KEY TECHNICAL THEME:
EURUSD	**BULLISH**	**Momentum waning but S/T up-trend intact above 1.4043**
USDJPY	**BEARISH**	**Break of 117.13 needed to offset bear threat**
GBPUSD	**BULLISH**	**Break of 2.0495 would open 2.0654**
USDCHF	**BEARISH**	**Downward momentum waning, but heavy below 1.1923**
AUDUSD	**BULLISH**	**Bull trend eyes 0.8970 and then 0.9000**
USDCAD	**BEARISH**	**Bear eyes 0.9890 – resistance at 1.0096**
EURCHF	**BULLISH**	**Focus is on the 1.6688 key resistance**
EURGBP	**BULLISH**	**Likely to extend gains into the 0.7022-0.7107 resistance zone**
EURJPY	**BULLISH**	**Edges higher towards 165.39 and 167.36 resistance zone**

***NOTE:** The trend for each currency pair as defined in the table is determined by our proprietary model and is independent of our discretionary interpretation of price action.

Key Events

3 October 2007				Source: UBS Global Economics		
Country	**GMT**	**Release/Event**	**Frequency**	**UBS**	**Previous**	**Consensus**
United Kingdom	23:01	Nationwide Consumer Confidence (Sept)	index	n/a	94	90
Australia	*23:30*	*RBA Rate Announcement*	*%*	*6.50%*	*6.50%*	*6.50%*
Australia	*1:30*	*Retail Sales (Aug)*	*m-o-m*	*0.5%*	*0.9%*	*0.3%*
Australia	1:30	Trade Balance (Aug)	AUD mn	-1300	-756	-1400
France	7:50	PMI Services (Sept)	index	57.0	58.4	55.2
Germany	7:55	PMI Services (Sept)	index	58.0	59.8	56.1
Eurozone	8:00	PMI Services (Sept)	index	54.0	58.0	54.0
Eurozone	8:00	PMI Composite (Sept)	index	54.5	57.4	54.5
United Kingdom	8:30	PMI Services (Sept)	index	57.0	57.6	56.8
United Kingdom	8:30	BRC Sep Shop Price Index				
Eurozone	9:00	Retail Sales (Aug)	m-o-m	0.4%	0.1%	0.4%
Sweden	*10:15*	*Riksbank Dep Gov Wickman-Parak speaks*				
United States	11:00	MBA Mortgage Applications (Sept 28)	w-o-w	n/a	-2.8%	n/a
United States	12:15	ADP Employment Report (Sept)	lvl	n/a	38k	58k
United States	*14:00*	*Non-Manufacturing ISM (Sept)*	*index*	*54.5*	*55.8*	*54.6*
Australia	1:30	Building Approvals (Aug)	m-o-m	-0.5%	0.4%	-0.5%

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