UBS

Global FX Strategy Research

Global

Research Note

Foreign Exchange

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G10

USD: Stocks and dollar seesaw

The US dollar fell against all currencies bar the yen overnight, while the commodity currencies were the strongest performers as risk aversion eased. The Vix index dipped to 20.41 from 21.64 on Tuesday, while the S&P500 rose by 0.9% on the session, while US 2-year Treasury yields declined by 4bp. US Treasury Secretary Paulson said China needs faster currency appreciation to reduce imbalances and more flexible CNY will help China keep inflation in control. It was reported in the press yesterday that the Federal Reserve does actually support the initiative of major US banks to create a super SIV, however, the Fed official endorsing the fund was not prepared to be identified. However, Former Fed Chair Greenspan said credit markets are still operating in a "state of fear" and was sceptical on the role that SIV fund will play and warned that it may actually prolong market adjustments. Today's session will provide further updates on the state of the US housing market with pending home sales due at 1100 GMT and existing home sales due at 1400 GMT. The data will likely maintain concerns about the state of the housing market and as such we think the US dollar should remain weak in the near-term, with our 1-month forecast for EURUSD at 1.43. However, over 3-months we look for significant dollar gains and target EURUSD at 1.35.

JPY: Slowing exports and imports

The trade balance for September was released this morning and showed a surplus of Y1.64 tn, higher than market expectations of Y1.47 tn. Exports grew by 6.5% y/y, down from 14.5% y/y in August, while imports declined by 3.2% y/y. By region, exports to the US turned negative, declining by 9.2% y/y from 4.7% y/y in August. Exports to Asia and Europe slowed further but were still relatively firm, with exports to Asia up 8.3% y/y versus 16.4% y/y last, and exports to Europe rose by just 13.2% y/y versus 15.5% y/y in August. Overall exports to China stayed solid at 16.5% y/y vs. 23.7% y/y in August. We maintain a positive stance on the yen on a 3-month basis as we expect a slowing global economy to contribute to higher risk aversion and volatility and hence a stronger yen.

EUR: Industrial orders slip

Eurozone industrial orders increased 0.3% m/m, well below the expected 0.9% (UBSe 1.6%). The data points to weaker industrial production ahead and will add to ECB concerns of slowing growth in the months ahead. This week's business confidence surveys and PMI reports may also foreshadow weakness in the key manufacturing sector of the Eurozone economy and we expect the ECB to begin toning down its rhetoric in due course. Our economists continue to forecast interest rates on hold at 4.0% for the remainder of the year. The euro will likely continue to weaken versus the dollar as tightening expectations are gradually priced out. With risk appetite ebbing and funding currencies looking to consolidate recent gains, we do not see much potential for a stronger EURGBP or EURCHF in the near term.

CHF: Further hawkish warnings from SNB

SNB Vice-President Hildebrand warned Monday that the SNB sees a number of risks on the inflation front and that the Swiss economy would not fully escape the fallout from the credit crisis, but that the economy is in a good position to absorb some of the risks. Fundamental data do not seem to support any of his concerns but his comments are a clear indication that the SNB remains worried about inflationary effects arising from a weak franc, firm activity and a tight labour market. Other board members have also sharpened their rhetoric over the past two week but data in the coming months may not warrant a hike at the next meeting, especially if worries in the European banking sector—a key contributor to the Swiss economy—fail to subside. The CHF will probably remain weak in the short term but will benefit from a general rally in funding currencies if market sentiment is tempered by risk aversion. We target EURCHF at 1.66 in one month and 1.63 in three months.

GBP: Pound buying is back

The equity rebound in Europe has prompted investors to add back to positions in higher-yielding currencies like sterling. We believe the pound will likely continue to trade at current levels in the near term. As a result, we forecast cable at 2.03 in one month. We think GBP remains in the overshoot territory against the dollar. The CBI industrial trends survey showed a weaker than expected result pointing to deteriorating manufacturing sector. This is consistent with our view that activity has peaked in the UK in Q3. Looking ahead, slower global growth, in particular in the Eurozone, and country's higher borrowing costs will transpire in other sectors of the economy. Our economists do not think, however, that the MPC will be looking for more evidence of a slowdown in the economy, most notably from the PMI surveys, before it decides to ease policy rates. In addition, the lingering effects of this summer's financial market turmoil and tightening of credit conditions continue to arise. An SIV managed by a London hedge fund is said to be arranging a bailout with a UK bank.

CAD: Retail sales rebound

Retail sales increased 0.7% m/m in August following two consecutive monthly declines with sales gains reported in each of the eight major categories. The headline figure exceeded expectations (consensus 0.5%, UBSe 0.3%). Excluding autos, sales increased 0.3% m/m, in line with expectations. Headline sales have increased 3.6% year-to-date but are still 1.2% below the May peak. Our economists continue to expect the Bank of Canada to leave the overnight rate target unchanged at 4.50% while markets are currently pricing in a 32% chance of a 25bp rate cut at the next meeting on December 4. The BoC has indicated that it is comfortable with the current level of interest rates in achieving the inflation target. Our 1- and 3-month USDCAD forecasts are 0.96 and 1.00, respectively.

AUD: CPI in focus

Australian Q3 CPI data, due today at 130 GMT, is expected to post a 0.9% q/q increase. The OIS market is pricing 14bp of tightening at the upcoming RBA meeting in November, despite the Federal Election falling due on November 24. Australian 2-year yields have shifted higher by 13bp over the past month, compared with no change in NZ yields and a 19bp shift lower in US 2-year yields. With both the incumbent government and opposition offering tax cuts over the next two years, we think the RBA will remain trigger happy, helping to keep the AUD supported for now. As such, we target AUDUSD at 0.8900 over one month. Over three months, however, we see prospects of a stronger USD and a weaker global economy. As such, our three-month AUDUSD forecast stands at 0.8400. The RBNZ meet Thursday; we expect the central bank to make no change to the OCR at 8.25%, and only look for the bank to begin easing policy in the New Year. We maintain an upside bias to AUDNZD over the next 1-3 months and a downside bias to AUDCAD.

Emerging FX

HKD: HKMA defends the peg

The HKMA's website indicates it intervened to buy US$100 mn at the 7.7500 convertibility barrier on Tuesday as the market continued to speculate on a potential change to the Hong Kong dollar's currency board regime. We reiterate our belief that the HKD peg is here to stay and will endure this period of strong inflows led by China's move to broaden the QDII scheme to allow mainland institutional investors to invest in HK-listed firms. There were additional pressures earlier this month when the China Securities Regulatory Commission hinted at pushing ahead with allowing retail investors to buy HK-listed China-related shares via accounts opened with a local bank in Tianjin and talk, since denied, that the CSRC would allow unrestricted swapping of shares with dual listings in the Shanghai and HK markets. In our view, these should not translate into any imminent move to reconsider the HKD peg. We believe the pressure on the HKD to weaken during and immediately after the Asian financial crisis in 1997/98, which saw domestic asset prices going into a protracted period of deflation, was probably a tougher test of the Authority's resolve to maintain the peg. Then, property prices fell by two-thirds while broader CPI was in negative territory for almost 6 years and the jobless rate rose to 9% from a pre-crisis average of around 2%. Despite pain in the broader economy, the HKMA defended the peg by selling reserves. The pressure today pales in comparison. Given the economy's current strength, benign inflation and the relatively easier task of buying reserves to protect the peg, we do not think the HKMA is in any real danger of losing control of the USDHKD peg. Additionally, while Hong Kong's business cycle is increasingly coming in line with China's, we think the prospect of pegging the HKD to the CNY instead of the USD is a multi-year risk rather than an immediate one. China's less developed currency and money markets and ongoing currency reform make the CNY an inferior alternative to the USD as a base currency for any peg regime.

BRL: IPOs attract foreign investors

The BRL did well on Tuesday, gaining around 1.30%. The stabilization of US equities opened the way for the BRL to resume its appreciation trend, supported by strong domestic fundamentals and sizable flows from IPOs, which are picking up in the last quarter of the year. The total amount of IPOs reached US$23 bn year-to-date in October, of which around 75% is foreign money. This flow should persist for some time since the combination of rising profitability, falling interest rates and higher corporate governance standards are driving investors into equities, making the stock market an attractive source of capital for companies. Indeed, our equity strategists expect another US$10 bn of IPO issuance until the end of the year. This, together with the robust FDI flows, support our constructive view on the BRL. In our opinion, the risks to the BRL remain exogenous, coming mainly from the impact of the collapse of the US housing sector on credit markets and the US economy in general. We maintain a long BRL bias but trade opportunistically, with options more attractive in this environment.

Technical FX

EURUSD	**BULLISH**	**Loss of 1.4144 exposes 1.4094 ahead of 1.4115. Resistance at 1.4350**
USDJPY	**BEARISH**	**Sharp recovery from 113.26, but outlook heavy below 115.72**
GBPUSD	**NEUTRAL**	**Remains entrenched in the 2.0247 – 2.0574 range**
USDCHF	**BEARISH**	**Abrupt rebound from 1.1603, but vulnerable beneath 1.1801**
AUDUSD	**NEUTRAL**	**Near resistance at 0.8994. Bear trigger at 0.8749**
USDCAD	**BEARISH**	**0.9825 resistance fuels new trend low – support at 0.9604**
EURCHF	**BEARISH**	**Tests trend-line support at 1.6626. Initial resistance is at 1.6737/50**

EURGBP	**BULLISH**	**Break of 0.6935 or 0.7028 required for fresh direction**
EURJPY	**BEARISH**	**Bounces from 160.48 with room toward 164.95**

***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

24 October 2007					Source: UBS Global Economics	
Country	**GMT**	**Release/Event**	**Frequency**	**UBS**	**Previous**	**Consensus**
Japan	23:50	Trade balance	JPY bn	1332.5	735.3	1475.5
Australia	1:00	DEWR skilled vacancies (Oct)	m-o-m	n/a	-1.7%	n/a
Australia	*1:30*	*CPI (Q3)*	*q-o-q*	*1.0%*	*1.2%*	*0.9%*
Eurozone	7:00	ECB's Gonzalez-Paramo speaks				
Italy	*7:30*	*Business Confidence (Oct)*	*index*	*93.0*	*92.2*	*92.1*
Eurozone	8:00	Current Account sa (Aug)	EUR bn	n/a	1.7	2.0
Eurozone	8:00	PMI Manufacturing (Oct)	index	52.5	53.2	52.9
Eurozone	8:00	PMI Services (Oct)	index	53.5	54.2	54.5
Eurozone	8:00	PMI Composite (Oct)	index	53.25	54.7	54.6
United States	*14:00*	*Existing Home Sales (Sep)*	*lvl*	*5.10 mn*	*5.50 mn*	*5.25 mn*
Euro area	16:00	ECB's Trichet, Garganas speak				
United States	16:30	Treasury's Paulson Talks About India's Economy in Washington				
Argentina	19:00	Trade Balance (Sept)	USD mn	n/a	416	496
New Zealand	*20:00*	*RBNZ OCR Review*	*%*	*8.25%*	*8.25%*	*8.25%*
United States	20:15	Fed Governor Mishkin speaks on financial instability				

G10 Strategy

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