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Global FX Strategy Research

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Research Note

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G10

USD: Dollar is no carry currency

The US dollar weakened on Friday, partly due to soft consumer sentiment, and has continued to weaken in Asian trading this morning. EURUSD gapped higher on the Asian open and has traded to a high of 1.4426, while USDJPY has hovered around the 114.20 levels, not much changed from Friday. Stock markets rallied hard on Friday, with the S&P500 up by 1.4% as broader risk appetite improved, reflected in the Vix index declining to 19.56 from 21.2 on Thursday. The final reading on the Uni of Michigan consumer sentiment index for October fell to 80.9, less than market expectations of 82 and down from 83.4 in September and was the lowest reading in more than a year. While the data is second-tier it did play to market concerns that the US economy is gradually slipping into a recession. It is interesting to note, the market is now pricing in higher rates in the Eurozone than in the US by June 2008 according to the Euribor-Eurodollar third contract spread. This is the first time since 2003 and means the US dollar will have the third lowest yields among the major currencies with only CHF and JPY with lower rates. However, we should be wary of concluding that this should automatically translate to a weaker US dollar or that the US dollar will be used as a funding currency. Unlike the JPY of the CHF, the US dollar is not backed by a country with a large current account surplus or a large stock of savings ready to be deployed abroad. Also, volatility in global markets appears to have structurally risen following the subprime crisis this year and will likely continue to rise as we head into next year. The US dollar has been weakening in trend terms due less to carry outflows and more due to diversification activity, perhaps as the Chinese manage the CNY against the US dollar effectively via transactions in EUR. At some point, the Chinese, will desire a stronger currency in trade-weighted terms and when that happens, official buying of EUR will dry up and the relentless downward pressure on the US dollar will cease. This week we have the FOMC meeting and payrolls. The market is pricing in 27 bp of a hike for the FOMC meeting (i.e. some chance of a 50bp move) and expects payrolls for October to rise by 80k, less than the 110k in September.

JPY: Soft CPI on Friday

Japan CPI, released on Friday, declined 0.1% y/y, in line with expectations. Nationwide core CPI declined 0.3% y/y, in line with expectations and down from-0.2% in August. Industrial production came out softer than expected, declining by

1.4% m/m in September, weaker than the expected 1.2% decline. The soft industrial production follows on from softer exports earlier this week, although our economists expect a rebound in industrial production in the next month. Our economists forecast no change to rates until January 2008, at which time they expect the Bank of Japan to hike 25bp to 0.75%. We think global growth is slowing and that risk aversion is likely to remain elevated. This should translate to sustained higher volatility and ultimately a stronger yen. As such, while we target USDJPY at 115 over 1 month, our 3-month target is 112.

EUR: Softer consumer sentiment

The German GfK consumer sentiment survey fell to 4.9 in November, against expectations of 6.5 and much lower than the 6.8 release in the previous month. The number suggests further deterioration in German consumer sentiment is likely as concerns over a US slowdown affecting global growth continue to weigh on expectations. However, strong fears over higher inflation ahead will be of concern to the ECB and may provide the hawkish Governing Council with ammunition to attack complacency over price pressures, despite clear signs of slowing growth. To further support their position, the first German CPI for October today came in higher than expected at 0.2%m/m, while money supply showed an 11.3% growth, weaker than expected but quite high compared to the ECB's "reference value" of 4.5%. Our economists continue to see upward inflation pressures to remain in the coming months but should not be severe enough to warrant another rate hike. In Switzerland, import and export prices both came in lower than expectations, countering recent SNB suggestions that inflation is still a key concern.

CAD: Don’t sell CAD based on royalty increase

The Canadian province of Alberta has increased the royalties that it collects from oil to a minimum of 56% of oil revenue, up from 46% of revenue. The new royalties take effect from January 1, 2009. The government's take of revenue can increase to a maximum of 66% depending on oil prices. This is not negative for CAD while oil prices remain so high, but if oil prices were to fall significantly then CAD would fall disproportionately more. This is because extracting oil from Canada's tar sands is a much more expensive proposition than from oil resources in other countries and hence elasticity of investing in Canada's energy resources relative to oil resources elsewhere is high. Oil is high at the moment in part due to geopolitical tensions. However, uncertainty over government taxation of oil revenue is probably also hindering future investment, with Kazakhstan, Ecuador and Nigeria looking to increase taxes on oil revenues. In a way then, the development in Alberta could paradoxically prove positive for the CAD to the extent that other energy exporters also raise their taxes on energy revenue, further deterring expansion of oil production globally. This in turn can drive a higher oil price and help benefit CAD via terms-of-trade effects. We maintain a relatively upbeat stance on CAD relative to AUD and NZD despite these developments. The royalty review was concluded on September 18 but investors were aware of the general direction of the report back in July.

Emerging FX

GCC: IMF endorses progress

The IMF's Rato gave a brief endorsement of the six-nation Gulf Cooperative Council's progress towards economic and currency unions on Saturday, following a meeting with members of the Council in Jeddah. This should provide some support for the region, which is seeing speculative pressure to dismantle its pegged currency regimes in the face of rising inflation. Rato commended the Council for maintaining stability amid recent market turmoil in the oil and financial markets and noted that the loose grouping remains committed to the aim of a common market by a delayed date of 2008, despite differences. The GCC nations had an original target of 2007 for the creation of a common market and 2010 for monetary union. The IMF expects progress towards the monetary union to accelerate with the convergence criteria likely to be formalized next year. Inflation is a concern but the IMF remains confident that structural reform and investment to alleviate tight capacity utilization will help ease the inflationary pressure. Inflation is the highest in Qatar at 12.8% in June but this is already easing from record highs earlier this year. Based on admittedly fragmented data, we do not believe the GCC economies are facing insurmountable pressure to dismantle their currency pegs. GCC countries have been actively recycling current account surpluses through private and public accumulation of foreign assets led by the sovereign wealth funds, while reserve accumulations have remained modest in recent years.

INR, MYR: Central banks to keep rates unchanged

The slowing WPI numbers and domestic absorption rate in recent months should mean the RBI will keep rates unchanged at this week's monetary policy meeting. The WPI has fallen from a high of 6.7% earlier this year to a low of 3.07% now as the effects of the central bank's earlier tightening kick in. However, we expect the RBI to retain a hawkish stance, which may see the INR staying supported given elevated oil and other commodity prices. Base effects will keep the WPI reading low for now but the RBI should be fully aware that this anchor for inflation data will end in the second quarter of next year. BNM is also expected to keep rates unchanged this week given still strong domestic demand amid tepid inflation. Broad money growth has eased to a year low of 11.8% in August after reaching a peak of 15% y/y in February from an average of 8% in 2006. Watch also for Indonesia's inflation numbers this week. This will have a direct effect on BI's rates decision on November 6. Inflation has been on the rise in recent months, with the m/m prints rising steadily to +0.8% in September. A further rise here will take the y/y rate back above the 7.0% mark and will scupper any hope of a near-term resumption of the easing cycle. BI had hoped to bring rates down to 8% by the end of this year to support the nascent recovery in consumption and investment, but may be hampered by an emerging trend of rising prices.

BRL: Support from IPO flows, external environment

The BRL gained around 1.50% on Friday on the back of positive US equities and IPO flows. On Friday, the central bank concluded the rollover of US$ 2.6 bn of USD reverse swaps that were about to expire and held its usual auction to buy USD. Despite the central bank's intervention, the BRL appreciated strongly. The environment of general USD weakness and resilient US equities has also contributed to BRL strength. In our view, the central bank intervention will only smooth the appreciation trend, not stop it. We remain constructive on the BRL, which we see moving towards 1.70, supported by the robust flows and USD weakness. We acknowledge that the BRL remains vulnerable to spikes in risk aversion given somewhat crowded positioning.

MXN: Banxico hikes rates against consensus

The MXN gained around 0.75% on Friday on the back of a favorable external environment and Banxico's rates decision. The central bank decided to hike policy rates by 25bp, citing higher than expected pressures from food prices. This was in line with our call but against the consensus forecast in a Bloomberg survey. Banxico also said that the same inflationary pressures from food would delay inflation reaching the center of its target of 3% until the end of 2009 instead of end-2008. In our view, the hike will restore some of the bank's credibility as a serious inflation targeter, which markets had been questioning following the deterioration of medium-term expected inflation. The MXN should gain some support from this hike, especially since it came while markets are attaching a high probability of more Fed easing. The divergent direction of Mexican and US monetary policies have increased yield spreads between the two curves, stimulating investments in MXN. The recent surge in oil prices, Mexico's most important export, is another factor contributing to MXN strength. In our view, a contained US slowdown, higher spreads, soaring oil prices and global USD weakness will continue to put appreciation pressure on the MXN, which we see moving towards 10.70 to the USD. The main risk to the MXN, for which the probability remains uncomfortably high at the moment, is a recession in the US, the destination of more than 80% of Mexican exports.

COP: Central bank on hold as expected

The COP gained around 0.8% on Friday on the back of general USD weakness and resilient global risk appetite. The Central Bank of Colombia decided to hold policy rates constant as expected by Bloomberg survey. The decrease in food prices combined with the effects of past hikes have reduced inflationary pressures, supporting the central bank's decision. However, the bank said strong domestic demand is still a risk for inflation. In our view, global risk appetite will remain a key determinant of the COP since the fundamentals of the balance of payments are not very positive given the sizable current account deficit.

Technical FX

EURUSD	**BULLISH**	**1.4350 break exposes 1.4469 en route to 1.4530. Key support remains 1.4125**
USDJPY	**BEARISH**	**Maintain a bearish bias below 115.72, with focus on 113.26**
GBPUSD	**BULLISH**	**Up-trend dominant above 2.0247, with focus on 2.0574, then 2.0654**
USDCHF	**BEARISH**	**Bearish below 1.1801, targeting 1.1603 en route to 1.1484**
AUDUSD	**BULLISH**	**Maintain a near-term bullish bias above 0.8937**
USDCAD	**BEARISH**	**Vulnerable beneath 0.9825, targeting 0.9577**
EURCHF	**BULLISH**	**Hold trend-line support at 1.6626 and pressures 1.6828 next**
EURGBP	**BULLISH**	**Bullish resolution to overcome 0.7035 resistance**
EURJPY	**NEUTRAL**	**Bounced from 160.48 to extend gains towards 166.47**

***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.

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