

Daily Market Strategy

Friday, 25th September 2009

Market Strategy

Market Strategy Team

Paul Rodriguez
Senior Technical Analyst
0207 158 1744

Kenneth Broux
Market Economist
0207 158 1750

Naeem Wahid
Quantitative Strategist
0207 158 1741
naeemwahid@bostreasury.com

Altaz Dagha
Analyst
0207 158 1747
altazdagha@bostreasury.com

- Sterling rout pushes GBP/USD below 1.60
- UK 5y swaps fall back below 3.30%, target 3.26%

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/\$: 1.6356, €/\$: 1.4733, \$/¥: 90.75

UK 5y sw: 3.32%, US 5y sw: 2.70%, EU 5y sw: 2.73%

Overnight

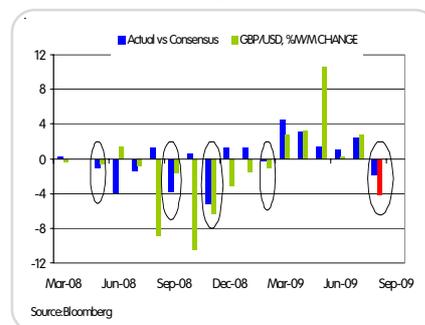
- Another solid US auction: \$29bn, 7y covered 2.79 times, indirects take 61.7%
- G20 to replace G8 as main economic forum
- French consumer confidence highest since Feb-08, Q2 GDP confirmed at +0.3% q/q

Sterling suffered more losses overnight in Asia, with follow-through selling in the wake of BoE King's comments pulling GBP/USD below 1.60 and EUR/GBP reaching 0.9193 (GBP/EUR 1.0877). With GBP/USD flirting with the lowest levels since May, the question is whether a further retracement to 1.55 lies ahead. We are looking for positives to support a GBP bounce vs the USD and commodity currencies (NOK, CAD, AUD), but alas, admit there isn't much on our radar beyond a technical bounce from oversold conditions. With regards to the USD, we are still wondering whether the Fed changed the (carry) game around after stating yesterday that it will start scaling back its liquidity facilities. The statement was not well received in equity markets and sparked a safe haven bid in government bonds and compressed swaps. The final G20 communique and next week's ISM and NFP releases will give us a better idea of correlations in FX and should help the dust settle for GBP. For illustration purposes only, we have re-inserted a chart below which we originally put together at the start of the month to illustrate the correlation of GBP/USD with the UK manufacturing PMI. So far this month, GBP/USD is down 1.9% (red bar). Ahead today, we will keep a close eye on US durable goods orders and new home sales.

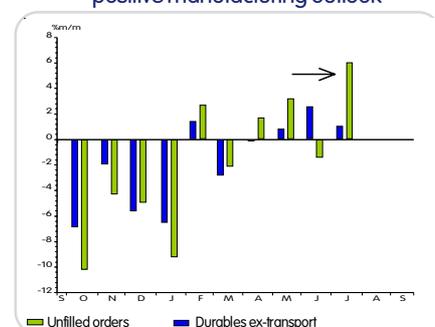
FX: There is no point fighting the BoE's verbal intervention, we suspect that high frequency (UK) economic data will be of very little influence (support) in the short term. GBP crosses look set to trade heavy on the final trading day of the week and this justifies near-term targets. For EUR/GBP, a move up to 0.9246 is on the cards if we can break 0.92 and for GBP/USD a test of 1.5803, the June 8 low, cannot be ruled out. A G20 statement favouring ongoing stimulus would be seen as pro-risk and could help to spur some bottom fishing in GBP crosses. We've also lowered our GBP/NOK target to 9.15.

Rates: UK 5y swaps fell below 3.32% support and believe momentum could squeeze rates back to 3.26% on the final trading day assisted by weaker stocks and the conclusion of US Treasury sales. The syndicated £5bn, 2050 IL auction was covered 1.80 times at a 0.54% yield. A further £8bn in syndicated gilt sales are scheduled for the remainder of 09/10. We favour being long bunds ahead of Sunday's Germany election (121.38 target for Dec future).

UK manufacturing PMI vs GBP/USD:



Strong gains in unfilled orders: supports positive manufacturing outlook



	Close	Daily Change %
FX		
EUR/GBP	0.9129	1.27%
GBP/USD	1.6059	-1.73%
EUR/USD	1.4666	-0.46%
USD/JPY	91.275	-0.01%
AUD/USD	0.8650	-0.54%
Bonds %		
US 10Yr	3.381	-3.7
EUR 10Yr	3.305	-6.8
UK10 Yr	3.751	-1.4
UK 5yr Swap	3.320	-9.0
Equities		
S&P500	1050.78	-0.95%
FTSE100	5079.27	-1.17%
Eurostoxx50	2838.22	-1.70%
Shanghai Composite	2849.50	-0.14%
Commodities		
Crude Oil \$/bl	65.89	-4.47%
Gold \$/oz	994.1	-1.42%
Copper	271.0	-3.51%
Baltic Dry	2163	-0.55%
Other		
VIX	24.95	6.22%
iTraxx XOVER	567.92	9.8

Today's Events

German Consumer Confidence, Oct 07:10 4.3 A 3.8 R
 French Consumer Confidence, Sep 07:45 -3.6 A -3.7 R
 French GDP, Q2 final q/q 07:45 +0.3% A +0.3%
 EU-16 M3 Money Supply, Aug 09:00 +2.7% +3.0%
 UK Business Investment, Q2 final 09:30 -10.4% -10.4%
 US Durable Goods Orders, Aug 13:30 +0.1% -0.3%
 University of Michigan Confidence, Sep final 15:00 70.5 70.2
 US New Home Sales, Aug 15:00 440K 433K
 ECB speakers: Mersch (08:15), Orphanides (16:15)
 Fed speakers: Bernanke (15:00), Warsh (18:15)
 G20 meeting in Pittsburgh (final day)
 BoJ releases minutes of 10/11 August policy meeting

Time	Consensus	Previous
07:10	4.3 A	3.8 R
07:45	-3.6 A	-3.7 R
07:45	+0.3% A	+0.3%
09:00	+2.7%	+3.0%
09:30	-10.4%	-10.4%
13:30	+0.1%	-0.3%
15:00	70.5	70.2
15:00	440K	433K

Technical Analysis

Paul Rodriguez, Senior Technical Analyst

- The cautious equity outlook remains. Key support levels have now been breached in the FTSE futures at 5,075 and 5,617 in the DAX index, although the sell-off has been limited. Despite this, a rally back up to 5,075 in FTSE futures would be used as a chance to sell from here and the bullish case is on hold until the high marked at 5,169 is breached (or there is some other compelling technical reason to reverse the outlook). The next key support is at 5,005.
- Sterling was clearly the main mover in the FX markets with key technical levels at 1.6110 and 0.9145/55 being breached. In contrast to the last major sell-off for the currency, the back drop has been against a pro-risk environment with falling FX volatility. Whilst the primary trades remain to buy the EM and commodity currencies against the dollar and sterling, broad weakness for the pound can not be ignored. The question of whether the market is getting bearish at the bottom of the range is valid, but for the moment Cable longs will wait for a low support marker and momentum to swing back through 1.6200. Unless this move is quickly reversed, the tailspin for the pound could become aggressive. Sterling was not the primary trade to reflect risk appetite, but despite this I have called this latest move wrong.
- UK bond yields remain compressed against the US and eurozone and for the moment the reversal levels at 0.50% in UK 1y yields, 1.00% in UK 2y yields and 4.00% in UK 10y yields look distant. Patience is clearly being tested here, but the relative firmness in US yields implies something has to give in the coming weeks. The pullback in oil and gold is encouraging long bond position holders to stay put and for now this looks to be a short term retracement in commodities. But the failure to take out highs one week from now would severely dent the bullish argument.

Chart of the day: UK 5 year swaps



Key Levels

	EUR	GBP	JPY	EUR/GBP	GBP/EUR
R2	1.4966	1.6746	95.15	0.9270	1.1404
R1	1.4865	1.6455	93.41	0.9198	1.1308
Current Spot	1.4684	1.5999	90.57	0.9178	1.0896
S1	1.4609	1.5802	90.30	0.8843	1.0872
S2	1.4177	1.5755	87.14	0.8769	1.0787

Spot prices as of: 07:09:28 Source: Bloomberg

Natural gas futures have been basing over the past few weeks. A break through \$5.00 and then 200 day m.a at \$5.13 would strengthen the bullish view. Given the current risk-averse environment, this may be a challenge.

	Spot	Bias	Entry	Target	Stop	Comment/Levels
EUR/USD	1.4684	Bullish	1.4675	1.4950	1.4630	Stop hit.
USD/JPY	90.57	Bullish	<u>89.90</u>	96.00	89.30	
USD/CHF	1.0284	Bearish	-	1.0000	-	
GBP/USD	1.5999	Neutral	1.6200	1.7000	1.6125	Stop hit.
EUR/GBP	0.9178	Neutral	<u>0.9190</u>	0.8500	0.9235	Final attempt to sell rally
GBP/JPY	144.92	Neutral	-	156.00	-	
EUR/JPY	133.01	Bullish	133.50	139.14	132.80	Stop hit.
CAD/JPY	83.28	Bullish	84.90	90.35	83.80	Stop hit.
AUD/USD	0.8690	Bullish	0.8305	0.9000	0.8637	Stop hit.
USD/CAD	1.0876	Bearish	1.0800	1.0000	1.0925	Stop hit.
NZD/USD	0.7196	Bullish	0.6860	0.7447	0.7035	
USD/BRL	1.8003	Bearish	1.8338	1.7000	1.8455	
USD/PLN	2.8494	Bearish	<u>2.9000</u>	2.7000	2.9110	
USD/HUF	184.37	Bearish	<u>188.00</u>	180.00	190.20	

Spot prices source: Bloomberg

ENTRY - Targetted

ENTRY - Active

Quantitative Market Analysis

Naeem Wahid, Quantitative Strategist

The trend following model has kept all portfolio positions (in developed and emerging market currencies) unchanged this morning, despite a sharp move higher in the USD yesterday. This is reflective of the fact that many of the positions are deep in the money and therefore turning points for these currency pairs are now far away. These turning points will come in closer should the USD continue to strengthen.

The USD DXY index faces strong resistance around 77.1 – a break of this level and a daily close above the downward trend line from March 2009 would mark a positive shift in the outlook for the USD.

The S&P500 has weakened further, moving lower after recording a key day reversal (KDR) on Wednesday. It is interesting that equities fell following the Federal Reserve's decision to gradually reduce the Term Securities Lending Facility, suggesting that market consensus remains that official support is required to sustain the current rally (and improve economic conditions).

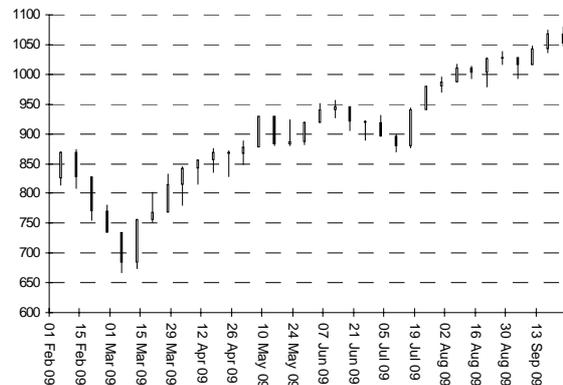
The S&P500 has broken through support at 1,057.5, the next region of support lies around 1,038. A close below 1,035 today would mark a key week reversal formation and would be a first major sign that the six month uptrend is vulnerable to reversal. The negative correlation between the USD and currencies would leave the dollar supported in this environment.

Durable goods orders, University of Michigan consumer confidence and new home sales are the important US data releases today. With medium term short-USD and long-equity positions (held by speculators) now stretched, any weakness in the economic data would leave these positions vulnerable to a sharp squeeze.

Table 1: 1-month correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY
2 YR SPD	-0.60	0.01	0.58	0.34	0.13
10 YR SPD	-0.48	-0.36	0.58	0.30	0.17
S&P500	0.83	-0.86	0.93	0.29	-0.66
Gold	0.89	-0.65	0.82	0.44	-0.91
Oil	0.08	-0.44	0.17	0.16	0.22
CRB	0.36	-0.63	0.52	0.08	-0.15

Chart 1: Key week reversal to be signalled in S&P500 today?



Trend following model signals

Trend Following Model Positions			
	Signal	Date	Entry Level
AUDUSD	long	15-Sep-09	0.8622
NZDUSD	long	10-Jul-09	0.6298
EURUSD	long	09-Sep-09	1.4480
GBPUSD	short	21-Sep-09	1.6270
USDCHF	short	17-Jul-09	1.0730
USDCAD	long	24-Sep-09	1.0745
USDSEK	short	09-Sep-09	7.0444
USDNOK	short	21-Jul-09	6.3025
USDJPY	long	22-Sep-09	91.93

Trend Following Model Positions			
	Signal	Date	Entry Level
USDCZK	short	19-May-09	19.709
USDPLN	short	09-Sep-09	2.8278
USDSGD	short	08-Sep-09	1.4337
USDTRY	short	15-Sep-09	1.4939
USDZAR	short	31-Aug-09	7.7525

Market Summary

	Close	Daily Change %		Close	Daily Change %
FX			Equities		
EUR/USD	1.4666	-0.46%	S&P500	1050.78	-0.95%
USD/JPY	91.275	-0.01%	DJIA	9707.44	-0.42%
AUD/USD	0.8650	-0.54%	FTSE100	5079.27	-1.17%
EUR/GBP	0.9129	1.27%	Eurostoxx50	2838.22	-1.70%
GBP/EUR	1.0953	-1.24%	Shanghai Composite*	2853.55	-0.14%
GBP/USD	1.6059	-1.73%	*latest price		
GBP/JPY	146.60	-1.72%	Commodities		
GBP/CHF	1.654	-1.45%	Crude Oil \$/bl	65.89	-4.47%
GBP/AUD	1.857	-1.18%	Gold \$/oz	994.1	-1.42%
GBP/CAD	1.749	-0.38%	Copper c/lb	271.0	-3.51%
GBP/NZD	2.243	-1.19%	Silver \$/oz	16.26	-3.42%
GBP/NOK	9.357	-1.30%	Baltic Dry	2163	-0.55%
GBP/ZAR	12.004	-1.33%	Swaps %		
GBP/CNY	10.963	-1.72%	US 5yr	2.693	-5.2
Bonds %			EUR 5yr	2.726	-5.3
		bp	UK 5yr	3.320	-9.0
US 10Yr	3.381	-3.7	Official Rates %		
EUR 10Yr	3.305	-6.8	UK	0.50	
UK10 Yr	3.751	-1.4	US	0.25	
Other			EU	1.00	
VIX	24.95	6.22%	Japan	0.10	
iTraxx XOVER	567.92	9.8			
DJ Agriculture Index	58.09	-0.15%			

This document has been prepared for information purposes only and is based on information believed to be reliable. This information is provided as a courtesy to you and does not create an obligation for Bank of Scotland Treasury ("BoS Treasury") or another Group company within Lloyds Banking Group to notify you of any changes to this data or to do so in the future. Changes in rates of exchange or rates of interest may have an adverse effect on the value or price of these investments. Spot and forward foreign exchange transactions generally are not 'designated investments' as defined in the UK Financial Services & Markets Act 2000 ("the Act") and therefore do not benefit from any of the protections contained either in the Act or in the rules of the FSA. Past performance is not necessarily a guide to future performance. This document has been written with market professionals in mind and recipients should seek guidance and advice from a suitably qualified professional if they find anything contained herein confusing or unclear. The distribution of this document in other jurisdictions may be restricted by local laws and recipients into whose possession this document comes should inform themselves about, and observe any such restrictions. This information has been provided for the use of the recipient only and must be treated as proprietary and confidential information. It may not be passed on or reproduced in whole or part under any circumstances without express written consent from BoS Treasury. Although the information contained herein is believed to be correct, Lloyds Banking Group does not guarantee its reliability or its accuracy. Opinions expressed are subject to change without notice, as are prices and availability, which are indicative only. In preparing this publication we have not considered your objectives, financial situation or needs. Appropriate independent advice should be obtained before making any such decision. Lloyds Banking Group specifically disclaims liability for any loss, claim or damage suffered by you or any third party resulting directly or indirectly from any use you may make from this data without limitation. Provision of this information does not constitute either a bid or offer to undertake any transaction or commitment by any Lloyds Banking Group company to make such an offer. Lloyds Banking Group or its employees may own or build positions or trade in such securities and derivatives and may also sell them whenever considered appropriate. Lloyds Banking Group may also provide banking or other advisory services to any company mentioned herein.

Bank of Scotland Treasury is a division of Bank of Scotland plc which is part of Lloyds Banking Group. Registered Office: The Mound Edinburgh EH1 1YZ. Registered in Scotland. Registered No SC 327000. Authorised and regulated by The Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. Australian residents please note: In Australia, Bank of Scotland plc is registered as a foreign company, Australian Registered Body Number 126 955 557. The liability of its members is limited.