

Daily Market Strategy

Friday, 16th October 2009

Market Strategy

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- GBP/USD upside favoured
- Michigan confidence may disappoint, BofA & GE earnings

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/\$: 1.6328, €/£: 1.4929, \$/¥: 90.90

UK 5y sw: 3.23%, US 5y sw: 2.77%, EU 5y sw: 2.80%

A 3.5% bounce for GBP/USD over three days has made us re-think the short-term outlook as markets assess the implications of a *possible* pause in BoE QE and GBP shorts have no choice but to cover. Perversely, whilst there is a case to sell GBP (on rallies) on the notion that a pause in asset purchases by the BoE could aggravate downside risks to the economy and keep inflation lower for a longer period, one can also state that GBP has lagged other G10 currencies vs the USD since the BoE's QE increase in August. In the short-term, there is risk of profit taking in stocks and commodities (including mining companies in the FTSE) as well as disappointing UK Q3 GDP data next week. The strong technical bounce in cable above 1.60 also validates a cautious approach to sterling shorts. Caution also best defines the outlook for gilts and swaps as the Fed and BoE near the completion of Treasury/gilt purchases and key resistance levels give way.

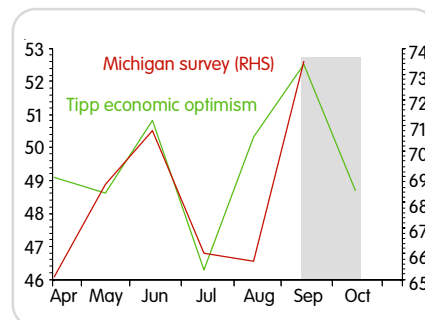
Ahead today: Q3 earnings from GE and BofA. US TIC flows for August, industrial production and capacity use for September and the Michigan survey of consumer confidence for October. The latter could surprise to the downside (relief bounce in bonds/profit taking in stocks?) following a disappointing fall in the TIPP survey below 50.0 (see chart). EU-16 foreign trade statistics and Canadian CPI are also due.

FX: The rally in GBP crosses gained traction in Asia overnight and saw GBP/USD consolidate its position above 1.6250 and EUR/GBP stabilise below 0.92. With no central bank speakers scheduled, focus will be on flows and the Michigan survey. ECB president Trichet only temporarily succeeded to slow the rise in EUR/USD yesterday towards 1.4857.

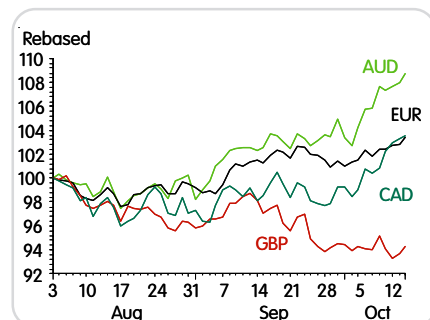
Rates: UK 5y swaps threaten to extend to 3.25% following yesterday's move through 3.20%. Profit taking in equities could trigger some relief fixed income buying and cause 2y/10y gilt curve steepeners to unwind from 271bps. Resistance is at 275bps. For 10y yields, a back-up to 3.60% may be difficult to avoid following the move through 3.53%. Suncorp-Metway yesterday launched a £300mn, 5y issue at 190bps over gilts. US 10y yields are on target to hit the Sep 23 high at 3.51%. TIC data will be evaluated for overseas Treasury buying.

	Close	Daily Change %
FX		
EUR/GBP	0.9186	-1.67%
GBP/USD	1.6268	1.80%
EUR/USD	1.4948	0.15%
USD/JPY	90.555	1.24%
AUD/USD	0.9206	0.61%
Bonds %		bp
US 10Yr	3.457	4.3
EUR 10Yr	3.297	7.0
UK10 Yr	3.498	9.6
UK 5yr Swap	3.220	8.3
Equities		%
S&P500	1096.56	0.42%
FTSE100	5222.95	-0.63%
Eurostoxx50	2939.09	-0.40%
Shanghai Composite	2959.25	-0.69%
Commodities		%
Crude Oil \$/bl	77.58	3.19%
Gold \$/oz	1050.2	-1.15%
Copper	285.9	0.51%
Baltic Dry	2688	3.50%
Other		
VIX	21.72	-4.99%
iTraxx XOVER	508.77	-2.9

US consumer confidence : risk of bigger than consensus drop in Michigan survey today



Compared to other G10 currencies, GBP has some catch-up to do vs the USD



Today's Events

EU-16 Trade Balance, Aug
US TIC, Aug
US Industrial Output, Sep
US Capacity Use, Sep
University of Michigan Confidence, Oct
Canada CPI, Sep
Canada CPI, Core, Sep

Time

10:00
14:00
14:15
14:15
15:00
12:00
12:00

Consensus

+€2.5bn
+\$30.0bn
+0.1%
69.7%
73.3
+0.2%
+0.1%

Previous

+€12.6bn
+\$15.3bn
+0.8%
69.6%
73.5
zero
+0.1%

ECB speakers: Bini-Smaghi (09:00)
US Q3 earnings: BofA, GE

Technical Analysis

Paul Rodriguez, Senior Technical Analyst

- European equities look set to take a breather this morning as Friday profit-taking looms. Into next week, the recent bullish trends are still dominating proceedings and another close above 10,000 for the Dow has helped sentiment, but a retracement today should be anticipated. The main target/barrier approaching is in the S&P500 (favoured due to its broader spectrum of stocks) at 1,106. This is a sell level if hit with a tight stop. This should approximate to 5,400 in the FTSE futures and 6,000 in DAX index futures. Shanghai stocks are still reluctant to break above 3,000 and base metals remain range-bound. These factors imply some caution, but otherwise the focus is on higher equities next week.
- The main story in the FX markets is the resurgent pound and the weakening yen, two themes that could have much further to run. Sterling should continue to be the favoured vehicle for expressing a weaker yen view as the euro looks set to ease back against the dollar towards 1.4845/50 key support (driven by profit-taking in gold). GBP/JPY resistance at 150 may prove a sticky short term hurdle but it is not unreasonable to expect 154 to be tested into November. EUR/GBP support runs at 0.9088, a move below would make for an interesting topping formation although there are very early signs of a possible head and shoulders reversal (implies more range trading but is ultimately GBP bullish). USD/JPY should shuffle back up to 93.00 - although watch 91.74 (especially if equities show broader weakness). Today could see the dollar take back some losses against the commodity currencies. Base and precious metals are showing some weariness (more base than precious metals to be fair) and the trends in the EM and commodity currencies have been good. Booking some profits here looks sensible. Looking to re-enter on a retracement should mirror gold testing 1,034 (the previous high) before the trend resumes.
- Yields continue to broadly squeeze higher. The main focus was in the UK where short sterling completed a minor top in the Dec.11 future and gilt futures were aggressively sold. The next target for UK 10y yields is 3.60% (3.56%) with 5 year UK swaps looking to touch the 200 day m.a. at 3.27%. Watch US 10y yields at 3.50% - a massive level. My bias is for a break to 3.60%.

Chart of the day: Dow Jones Agricultural Index



Key Levels

	EUR	GBP	JPY	EUR/GBP	GBP/EUR
R2	1.5287	1.6743	95.15	0.9520	1.1135
R1	1.4966	1.6455	91.80	0.9482	1.1018
Current Spot	1.4918	1.6344	90.97	0.9127	1.0956
S1	1.4845	1.6125	87.14	0.9076	1.0546
S2	1.4407	1.5709	85.00	0.8981	1.0504

Spot prices as of: 07:03:16 Source: Bloomberg

A base is forming here with resistance at 133.00 (mentioned yesterday). Look for a breakout to the upside through this key level with 140 the initial target.

	Spot	Bias	Entry	Target	Stop	Comment/Levels
EUR/USD	1.4915	Bullish	1.4650	1.5287	1.4650	1.4860/70 support- watch for another pullback today.
USD/JPY	90.93	Bullish	<u>90.50</u>	94.00	89.40	Yen to broadly weaken- Equity mkts having traction.
USD/CHF	1.0174	Bearish	1.0360	1.0000	1.0260	Stop lowered.
GBP/USD	1.6299	Bullish	1.6125	1.6750	1.5930	1.6450 is key resistance- but 1.6750 is possible (massive level)
EUR/GBP	0.9152	Bearish	0.9311	0.9000	0.9280	GBP set to bounce further.
GBP/JPY	148.20	Bullish	143.71	144.57	139.75	Base completed. 150.00
EUR/JPY	135.62	Bullish	<u>133.00</u>	135.00	131.75	Once again, buy level has come frustratingly close.
CAD/JPY	88.01	Bullish	87.20	92.00	86.30	
AUD/USD	0.9220	Bullish	0.8888	0.9291	0.9175	Raise stop/ consider taking some profit.
USD/CAD	1.0331	Bearish	1.0650	1.0000	1.0375	Cover USD short.
NZD/USD	0.7436	Bullish	0.7360	0.7600	0.7415	Stop raised.
USD/BRL	1.7011	Bearish	1.8338	1.7000	1.7175	Target close. Stop lowered.
USD/PLN	2.8145	Bearish	2.8100	2.7000	2.8230	
USD/HUF	179.40	Bearish	179.20	175.00	180.65	

Spot prices source: Bloomberg

ENTRY - Targetted

ENTRY - Active

Quantitative Market Analysis

Naeem Wahid, Quantitative Strategist

The S&P500 continues to hold its upward trend, heading towards pre-Lehman levels (approx 1250). The US earnings season remains very strong with the majority of companies so far providing upward surprises. Bank earnings are firm, with Goldman Sachs joining JP Morgan, indicating strong performance in Q3. Google posted an upward surprise in its report after the market close yesterday. Additionally, they suggested that the worst is now over and the outlook should improve over the next quarter. Bank of America is due to announce Q3 performance today with analysts expecting a loss of \$0.12 per share.

Commodities (as analysed through our favoured broad based CRB index) have broken higher again (tracking equities), following on from the bullish breakout of the recent triangular formation. The 1-month correlation between commodities and commodity currencies (against the USD) is very strong – see table across. In that context we continue to look for further upside gains in these currencies. We are somewhat cautious that a number of technical indicators are suggesting that commodity currencies are overbought against the USD, however, for now they remain in a strong upward trend.

Overnight, GBP/JPY continued to squeeze higher, driven by strength in both GBP/USD and USD/JPY. US/JP interest rate spreads (based on 2-year interest rate swaps) are drifting higher, supported by yesterday's above consensus CPI report. In this context, we continue to look for further upside gains in USD/JPY. Our in-house trend following model initiated a long position this morning. We continue to hold our discretionary long GBP/JPY position.

Japanese portfolio data (for the period ending 9th October) have been released by the Ministry of Finance overnight. The data show that Japanese investors sold foreign equities (Y35.4bn) whilst foreigners bought Japanese equities (Y391.9bn). This resulted in a net equity related inflow of Y427.3bn into Japan. In bonds, Japanese investors bought foreign bonds (Y256.2bn) as foreign investors sold foreign bonds (Y300.8bn) – resulting in a net outflow of Y557bn. On balance this results in a net outflow of Y130bn, partly explaining some of the reversal in USD/JPY.

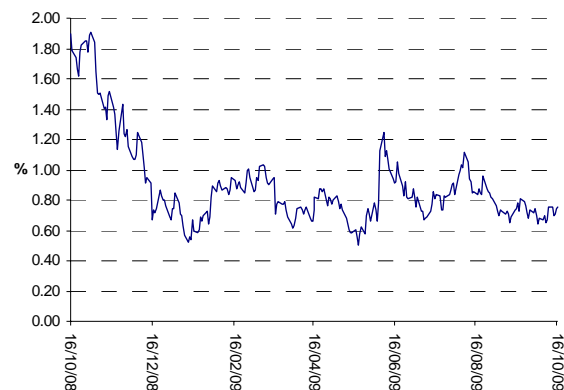
Trend following model signals

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	long	16-Jan-09	1.6270
USDCHE	short	17-Jul-09	1.0730
USDCAD	short	07-Oct-09	1.0593
USDSEK	short	09-Sep-09	7.0444
USDNOK	short	21-Jul-09	6.3025
USDJPY	long	16-Oct-09	90.55
Net-USD portfolio position			-78%

Table 1: 1-month correlations

	AUDUSD	USDCAD	EURUSD	GBPUSD	USDJPY	EURJPY	AUDJPY
2 YR SPD	0.94	0.92	0.69	0.43	0.65	0.71	0.89
10 YR SPD	0.52	0.63	-0.66	0.36	0.65	0.79	0.86
S&P500	0.72	-0.76	0.87	0.26	0.20	0.64	0.88
Gold	0.92	-0.95	0.77	-0.18	-0.40	0.10	0.79
Oil	0.76	-0.86	0.78	0.27	0.05	0.47	0.85
CRB	0.88	-0.94	0.87	0.19	-0.04	0.44	0.93

Chart 1: US/JP interest rate spreads priming for a break higher



Trend Following Model Positions			
	Signal	Date	Entry Level
USDCZK	short	19-May-09	19.709
USDPLN	short	15-Oct-09	2.8237
USDSGD	short	08-Sep-09	1.4337
USDTRY	short	15-Sep-09	1.4939
USDZAR	short	31-Aug-09	7.7525
Net-USD portfolio position			-100%

Market Summary

FX			Equities		
	Close	Daily Change %		Close	Daily Change %
EUR/USD	1.4948	0.15%	S&P500	1096.56	0.42%
USD/JPY	90.555	1.24%	DJIA	10062.94	0.47%
AUD/USD	0.9206	0.61%	FTSE100	5222.95	-0.63%
EUR/GBP	0.9186	-1.67%	Eurostoxx50	2939.09	-0.40%
GBP/EUR	1.0886	1.70%	Shanghai Composite*	2956.35	-0.79%
GBP/USD	1.6268	1.80%	*latest price		
GBP/JPY	147.32	3.06%	Commodities		
GBP/CHF	1.651	1.80%			%
GBP/AUD	1.767	1.19%	Crude Oil \$/bl	77.58	3.19%
GBP/CAD	1.682	2.81%	Gold \$/oz	1050.2	-1.15%
GBP/NZD	2.185	1.13%	Copper c/lb	285.9	0.51%
GBP/NOK	9.032	2.01%	Silver \$/oz	17.36	-2.94%
GBP/ZAR	11.815	2.16%	Baltic Dry	2688	3.50%
GBP/CNY	11.109	1.84%	Swaps %		
Bonds %					bp
		bp	US 5yr	2.757	5.9
US 10Yr	3.457	4.3	EUR 5yr	2.795	5.1
EUR 10Yr	3.297	7.0	UK 5yr	3.220	8.3
UK10 Yr	3.498	9.6	Official Rates %		
Other					
VIX	21.72	-4.99%	UK	0.50	
iTraxx XOVER	508.77	-2.9	US	0.25	
DJ Agriculture Index	61.97	0.12%	EU	1.00	
			Japan	0.10	

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