



**Markets Update:
Eurozone Stress to Stabilise.
The Fed's not Done.....
More USD Weakness**



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CORPORATE & INVESTMENT BANKING

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European Central Bank, September 2012

Steven Saywell
Head of FX Strategy, Europe

FX Themes



USD: Easy Fed policy has been key in driving the USD lower, QE3 remains a distinct possibility in H2 2012. Further Fed easing will dominate FX.

Reserve diversification bolsters USD weakness, 'Other' currencies to benefit more so than EUR. FX Reserves rebounded in Q1 but likely stabilised in Q2.



EUR: EUR to recover as political situation stabilises, Greece stays in, progress to fiscal union. EUR to under perform on crosses as the ECB cuts rates.



Asia: As Europe & the US slow, USD weakness will benefit Asian FX most even if CNY appreciation moderates



JPY: USDJPY to rally inline with trend in US yields – the key driver of USDJPY not Japanese factors.



GBP: Balance sheet expansion through QE is close to peaking. GBP is at a cross roads but is set to rise vs EUR and US as the UK outperforms.



CHF: No change in SNB policy following new board members. EURCHF to rally as EZ politics stabilises and global growth recovers. Rumours of a 1.25 floor may help rise



AUD, NZD, CAD: Pockets of EM resilience + Fed QE3 will be enough to keep commodity currencies strong. Robust equities also support the group.



NOK, SEK: Eurozone factors to dominate. NOK & SEK appreciation to be limited. SEK to underperform NOK.





Easy Fed Policy is key,
The Fed's not Done.....
More USD Weakness



The US economic recovery has disappointed

95



Source : Ecowin Reuters, Bloomberg, BNP Paribas



Recovery never became self-sustaining...



The Fed downgrades its economic expectations

Federal Reserve Forecasts for Growth and Unemployment

FOMC Economic Projections¹

Real GDP Growth	2012	2013
Jun 2012	1.9 to 2.4	2.2 to 2.8
Apr 2012	2.4 to 2.9	2.7 to 3.1
Jan 2012	2.2 to 2.7	2.8 to 3.2
Nov 2011	2.5 to 2.9	3.0 to 3.5

Unemployment	2012	2013
June 2012	8.0 to 8.2	7.5 to 8.0
April 2012	7.8 to 8.0	7.3 to 7.7
Jan 2012	8.2 to 2.5	7.4 to 8.1
Nov 2011	8.5 to 8.7	7.8 to 8.2

Source : US Federal Reserve, BNP Paribas



Fed downgrades are a key rationale for QE3



US data has deteriorated significantly

US 10yr yields vs. US economic data surprises

0130

Source : Ecowin Reuters, Bloomberg, BNP Paribas



US yields remain at very low levels as data weakens



QE has been successful in boosting risk assets

SPX v. Fed Balance sheet

trillion and billions

Source : Ecowin Reuters, Bloomberg, BNP Paribas



Risk assets draw significant support from Fed QE



....and curtailing risk

DXY vs. VIX

00.5

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



QE periods see VIX suppressed, dollar weaker



The USD has trended lower during periods of QE

Fed \$ Index vs. Fed Balance sheet

02:50:00

Source : Ecowin Reuters, Bloomberg, BNP Paribas



**Dollar firmer between end of QE1 and Jackson Hole
'heads up' for QE2.....**



USD to weaken vs. commodity currencies

NZDUSD lagging behind recent S&P 500 Equity Index rally

0805

 **Commodity Currencies increasingly correlated to equities rather than commodities**



Commodity Prices & Equities Diverge

S&P 500 Equity Index vs CRB Index

2000

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Source : Ecowin Reuters, Bloomberg, BNP Paribas

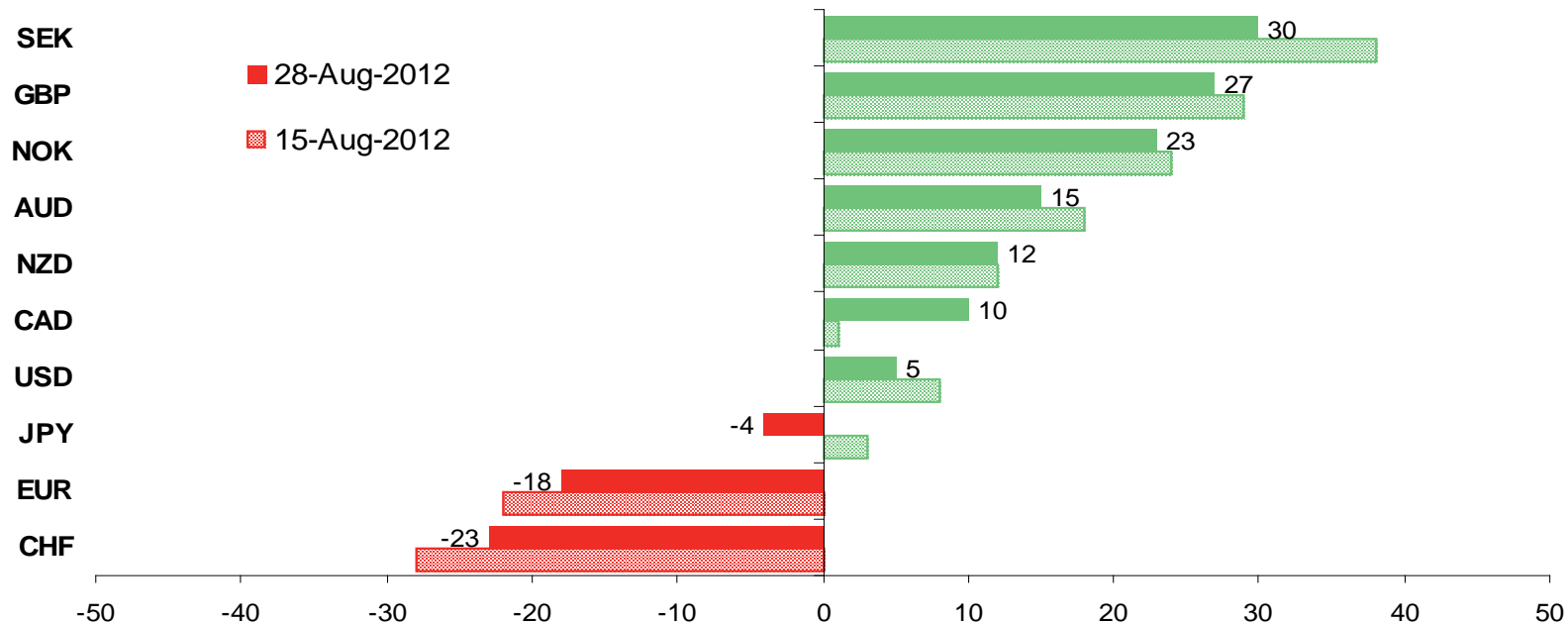


**Equities diverge from commodity prices...
But recently commodities have narrowed the gap**



FX market is short EURs and long USDs

BNP Paribas Estimate of FX Market Positioning



Methodology

- Client Exposure – Internal sales desks' estimate of FX investor exposure
 - IMM – The Commitment of Traders (CFTC) is a widely used proxy for US-based hedge-fund/CTA activity.
 - Risk reversals – Risk reversals indicate the relative price of calls relative to puts, and thus incorporate a option "market sentiment" function.
 - Beta – Decomposition of the BTOP managed currency index.
 - BNPP Trending Indicator. - A technical measure of the strength of a currencies momentum.
- The overall currency score is then calculated as the equally weighted sum of the components

➤ **USD longs have fallen sharply but EUR shorts remain extreme. Potential for Eur to rally on "risk-positive" news**



Deteriorating US C/A deficit funding

TICS Net Long-Term Portfolio Flows vs. Current Account

Q25

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



Signs the US struggles to fund its current account with long term portfolio flows.....



Negative real interest rates keep USD weak

US real interest rates vs. Fed \$ USD

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



Negative US real interest rates continue to support US capital outflows whenever risk appetite is healthy





EUR Crosses Under perform as ECB cuts rates



EURUSD has narrowed gap with 2-year swap ratio

EURUSD vs. 2 Year Swap Ratio (Euro/US)

0.50

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



...or relative ECB/Fed rate expectations



Weighted-average swap spread is more successful

EURUSD vs. 2,5,10 yr weighted average swap spread

2020



Source: Euromoney Reuters, Bloomberg, BNP Paribas



Our best indicator now signals EURUSD upside



EUR is set to remain weak on the crosses

EURAUD and 2 yr Swap Spread Ratio

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Source : Ecowin Reuters, Bloomberg, BNP Paribas

Source : Ecowin Reuters, Bloomberg, BNP Paribas



EURAUD had traded lower as relative yields have favoured AUD





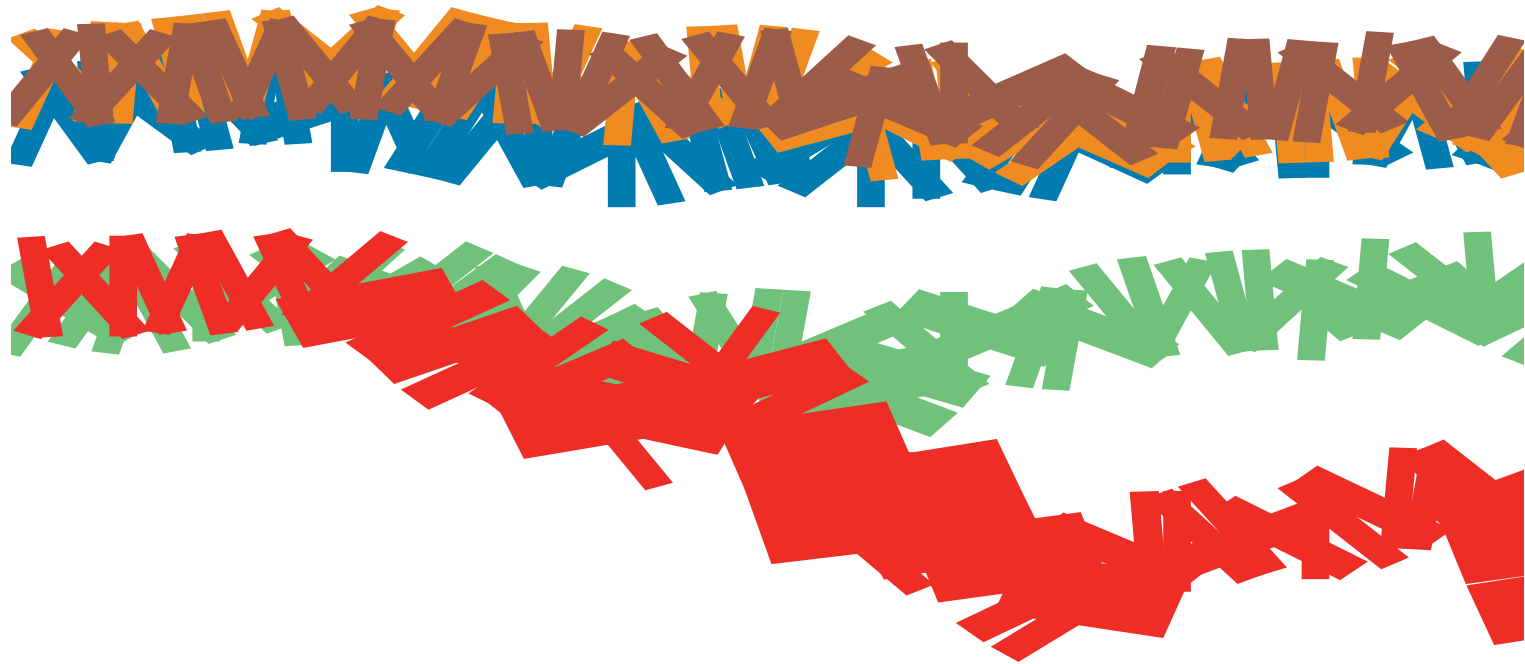
Euro area stress - A driver of EUR too



Eurozone stresses have impacted the EUR

10-Year yield spreads to the bund

Oct



Source : Ecowin Reuters, Bloomberg, BNP Paribas

▶ Greece is volatile, Portugal, Ireland, Spain & Italy improve



LTRO and Mr Draghi have calmed EZ peripheral bond markets

EURUSD and Italian-German 10-year yield spread

FIG 10

Source : Ecowin Reuters, Bloomberg, BNP Paribas

 **The easing of eurozone peripheral stress has supported
EUR**



LTRO and Mr Draghi have boosted financial stocks

EURUSD and Eurozone Financial Stocks

8000

Source : Ecowin Reuters, Bloomberg, BNP Paribas



The rally in eurozone financial stocks has moved in tandem with the EUR



EUR/G4 crosses most sensitive to euro zone stress

EUR/G4 crosses rally the most on declining euro area stress

EUR

Source : Ecowin Reuters, Bloomberg, BNP Paribas

➤ **EURUSD, EURGBP and EURJPY most vulnerable to a rally on any ECB action to lower peripheral yields**



EUR can still weaken against commodity currencies

Crosses like EURAUD can still fall despite lower peripheral yields

3Q10

Source : Ecowin Reuters, Bloomberg, BNP Paribas



**EUR can remain weak against commodity currencies
even if eurozone stress declines**



EURUSD can recover sharply

Long EURUSD targeting 1.2800



Source : Bloomberg, BNP Paribas

➤ **ECB action to lower risk premia and Fed QE3 to see EURUSD rally**



Euro zone Financial Account Breakdown

Broad EUR flow of funds support has weakened

BNP

Source : Ecowin Reuters, Bloomberg, BNP Paribas

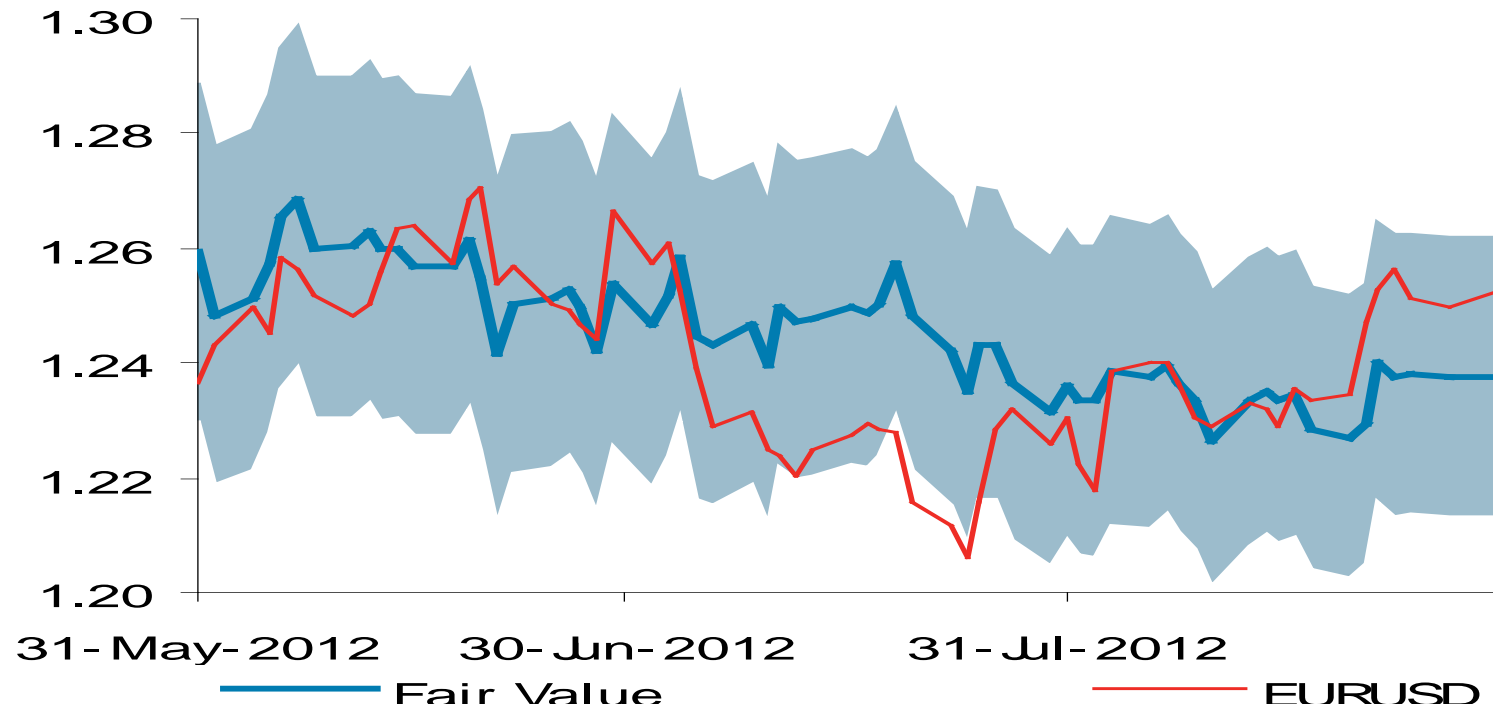
 **BoP flows support has weakened led by weakening flows into debt markets**



Our STEER model signals EURUSD is close to fair value

BNP Paribas STEER™* fair value model EURUSD

BNPP STEERs are regression based short-term fair-values based on relationships between exchange rates, interest rate markets, equity markets and commodity markets.



Source : Ecowin Reuters, IMM, Bloomberg, BNP Paribas



**EURUSD trades above fair value but...
within its +/- 1.5 std. dev. corridor**



CFTC data suggests short EUR position is still large

Net long EUR position among non-commercial investors (CFTC)

\$45000

Source : Ecowin Reuters, IMM, Bloomberg, BNP Paribas



Record net short EUR position has diminished. But remains very large



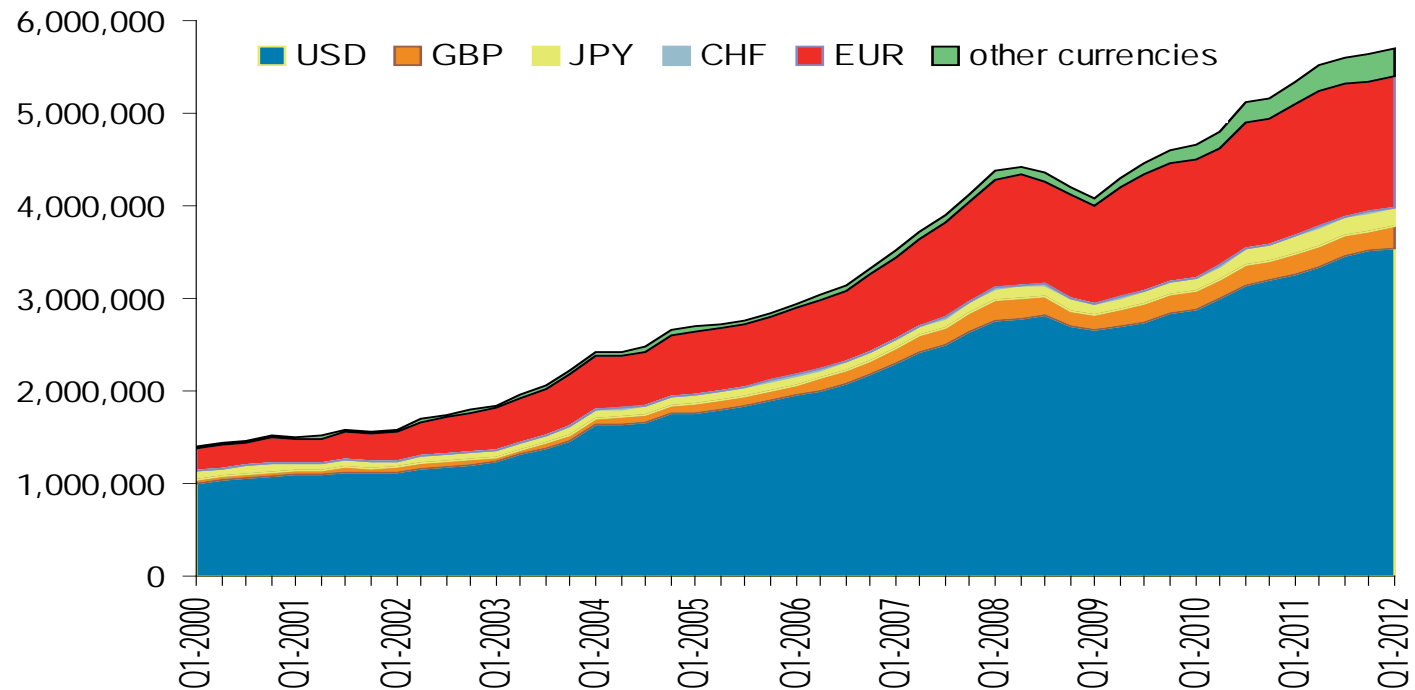


Reserve Diversification explains
USD weakness, 'others' more so
than EUR strength



Global FX reserves are growing, driven by EM countries

IMF COFER Reserves: Total Allocated Reserves



Source: Reuters Ecowin, Bloomberg, IMF, BNP Paribas

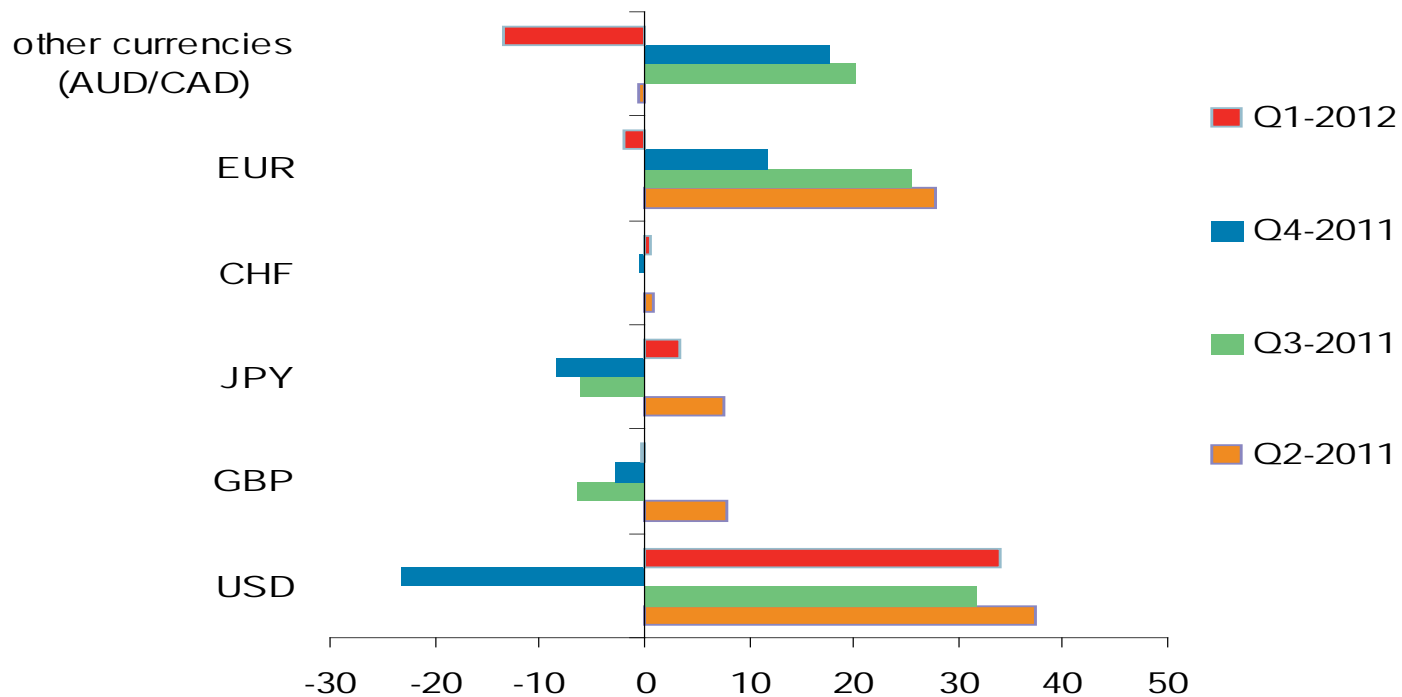


Acceleration in global reserves growth helps explain USD weakness



Buying of EURs may rebound from Q2

Change in Reserves (FX-adjusted) : Q2 2011 – Q1 2012



Source: Reuters Ecowin, Bloomberg, IMF, BNP Paribas

▶ Reserves Rebounded but Diversification Stopped in Q1



FX Reserve Growth likely maintained in Q2 2012

FX Reserve Proxy vs. IMF COFER Total FX reserves

① thousand billions

Source : Ecowin Reuters, Bloomberg, BNP Paribas

 Our new “FX Reserves Indicator” suggests a rebound in Q2 from Q1



Reserve growth consistent with a weak USD trend remaining

FX Reserve Proxy vs. EURUSD appreciation

01/35

15



**... in Stark Contrast to the Collapse Seen in 2008-09
(reserve growth vs. EURUSD appreciation)**



Higher oil revenues support to support EURUSD

OPEC oil reserves vs. EURUSD

0.18



Source : Ecowin Reuters, Bloomberg, BNP Paribas



'Arab Spring' impact on oil prices one element of reserves growth...





USDJPY to move inline with trend
in US yields – the key driver of
USDJPY.



Yen follows current account surplus

Yen TWI vs. Japanese C/A surplus

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



Japan current account shrinkage associated with Yen strength



USDJPY had followed yield spreads

USDJPY vs. US-JP 2yr yield

USD

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



2yr spreads important - drives (high) hedge ratios



...but USDJPY sensitivity to yields has increased in 2012

USDJPY vs. US-JP 2yr yield

06/75



Source : Ecowin Reuters, Bloomberg, BNP Paribas



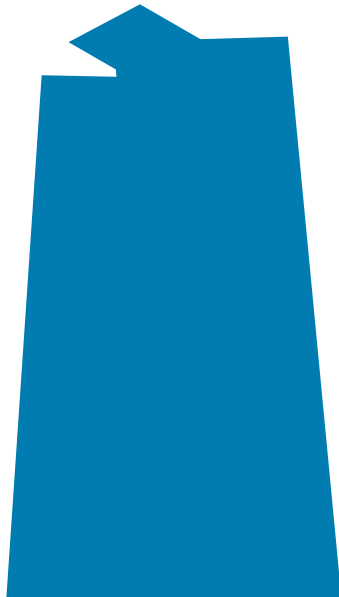
Since February, US yields have driven USDJPY



Real trade weighted JPY is far from highs

USDJPY vs. JPY Real Effective Exchange Rate

90



Source : Ecowin Reuters, Bloomberg, BNP Paribas



Unlike USDJPY, REER remains mid range and far from highs



MOF/BOJ intervention has not prevented rise

USDJPY and BoJ Intervention



Source : Ecowin Reuters, Bloomberg, BNP Paribas



BoJ Intervention efforts have done little to sustain USDJPY rallies



BOJ QE style easing has not helped weaken JPY

USDJPY vs. BoJ Total Assets

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



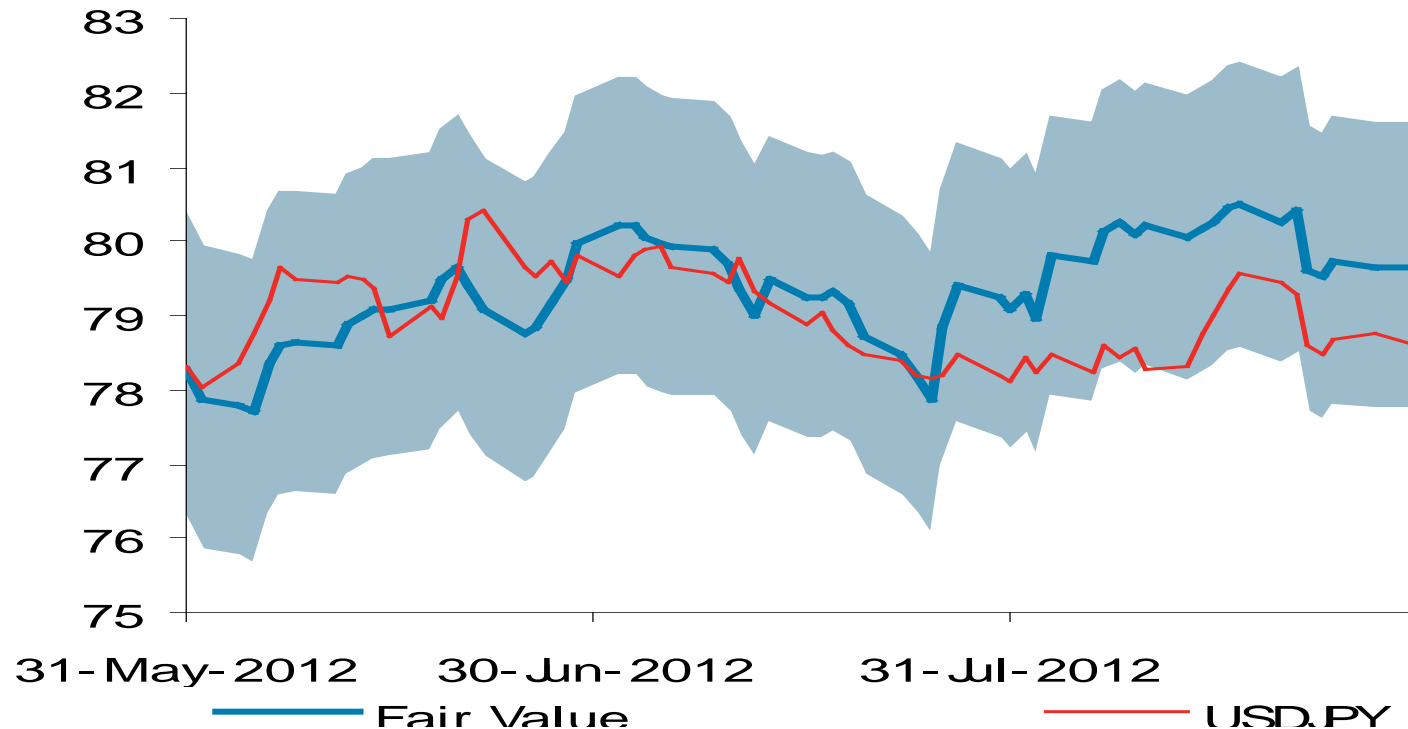
BoJ balance sheet expansion has not weakened JPY



Our STEER model signals USDJPY trades below fair value

BNP Paribas STEER™* fair value model USDJPY

BNPP STEERs are regression based short-term fair-values based on relationships between exchange rates, interest rate markets, equity markets and commodity markets.



Source : Ecowin Reuters, IMM, Bloomberg, BNP Paribas



Slight USDJPY upside signalled by STEER estimate



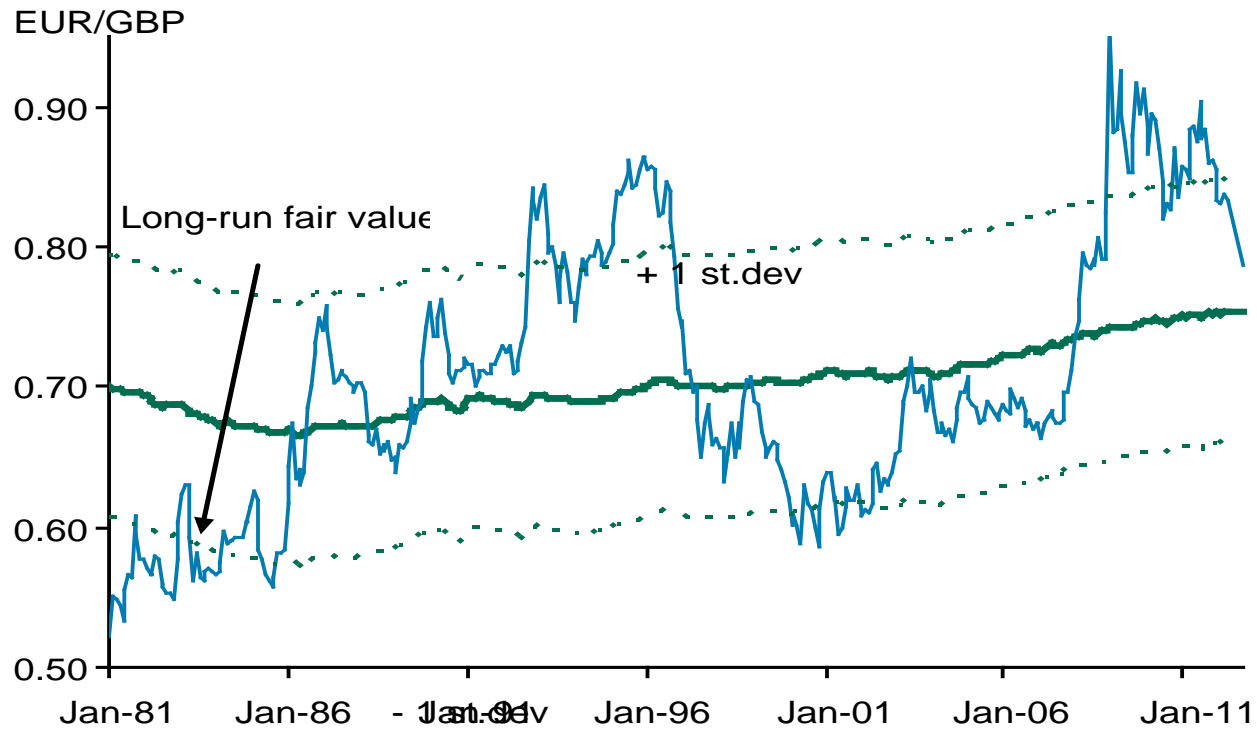


GBP is set to appreciate



EURGBP is significantly above long-term fair value estimates

EURGBP vs. BNP Paribas Long-term Fair Value Model



Source : Ecowin Reuters, Bloomberg, BNP Paribas



There is significant potential for EURGBP to weaken



QE has not weakened Sterling

GBP TWI vs. UK Bank of England Balance Sheet

£/100

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Source : Ecowin Reuters, Bloomberg, BNP Paribas



BOE balance sheet expansion or QE has not weakened GBP in the past



Pre 2007, EURGBP traded in the 0.60 – 0.70 range

EURGBP vs. EU-UK 2 Year Swap Spread

08/5/5



Source : Ecowin Reuters, Bloomberg, BNP Paribas

➤ **During the period of strong UK outperformance, EURGBP tended to trade below fair value**



Shifting yield spreads has pushed EURGBP lower

EURGBP vs. EU-UK 2 Year Swap Spread

0a375

Source : Ecowin Reuters, Bloomberg, BNP Paribas



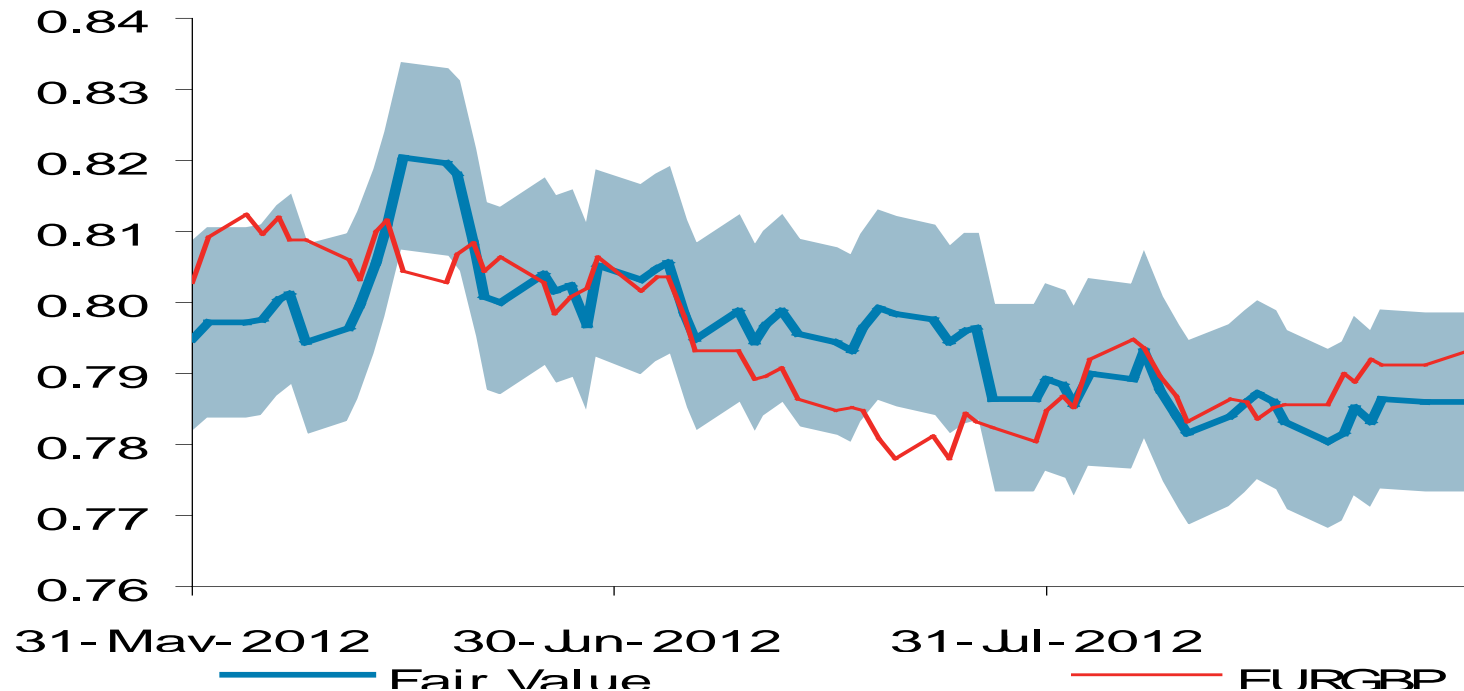
Earlier monetary policy normalisation in the UK vs the eurozone should push EURGBP lower



Our STEER model signals EURGBP is close to fair value

BNP Paribas STEER™* fair value model EURGBP

BNPP STEERs are regression based short-term fair-values based on relationships between exchange rates, interest rate markets, equity markets and commodity markets.



Source : Ecwin Reuters, IMM, Bloomberg, BNP Paribas



EURUSD trades slightly above its +/- 1.5 std. dev. corridor



EURGBP breaks out of downtrend (temporarily??)

EURGBP technical outlook



Source Bloomberg, BNP Paribas



General EUR rebound suggest near-term risk for EURGBP is higher



EURGBP starts to diverge from EURUSD

EURGBP vs. EURUSD

EURUSD

Source : Ecowin Reuters, Bloomberg, BNP Paribas



EURGBP links to EURUSD begin to weaken



Non-Resident Demand for Gilts become erratic

Monthly Changes in Amount of Gilts Held by Non-Residents (GBP Bln)

0/75

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Source : Ecowin Reuters, Bloomberg, BNP Paribas

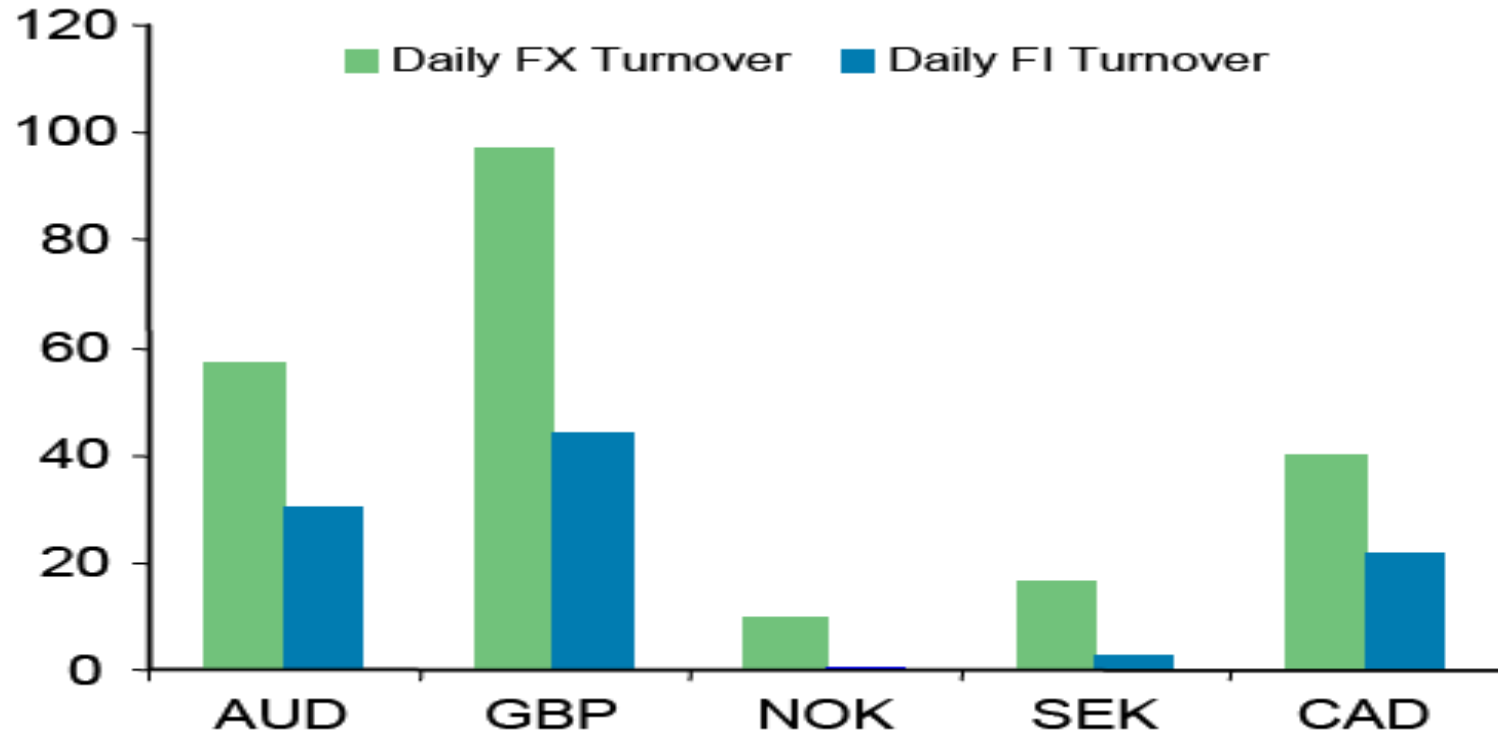


Theme of GBP as safe-haven is beginning to diminish



Depth of capital markets favours GBP

Daily FX and Government Bond Turnover for Select Currencies



Source : ABS, Bloomberg, BNP Paribas

➤ **Depth of capital markets make Short EURGBP a safer way to trade euro area stress than short EURSEK**





Easing of eurozone stress key for durable Swiss Franc reversal



Easing of Eurozone stress key for durable Swiss Franc reversal

EURCHF v. 2-year swap spread

00000

Source : Ecowin Reuters, Bloomberg, BNP Paribas



CHF appears extremely overvalued vs relative interest rates



Easing of Eurozone stress key for durable Swiss Franc reversal

EURCHF v. Saving deposits in CHF bn

900



➤ Real money (deposit inflows) key driver of CHF strength



Our estimate of EURCHF without SNB intervention

EURCHF vs. German-Italian 10y yield spread

EURCHF

|

Source : Ecowin Reuters, Bloomberg, BNP Paribas



EURCHF still the main outlet for Euro-peripheral stress



SNB Reserves were steady until May and June

EURCHF v. Swiss FX Reserves

0850

Source : Ecowin Reuters, Bloomberg, BNP Paribas



SNB had to intervene intensely during May & June as eurozone stress intensified



SNB FX Reserve Holdings in GBP increasing

SNB FX Reserve Holdings

990.0

|

Source : Ecowin Reuters, Bloomberg, BNP Paribas

 **SNB reserve allocation in GBP has increased from a low proportion, other central banks likely to follow**





Commodity currencies can stay strong



Commodity Currencies can stay strong

AUDUSD vs. USDCNY 12M NDF

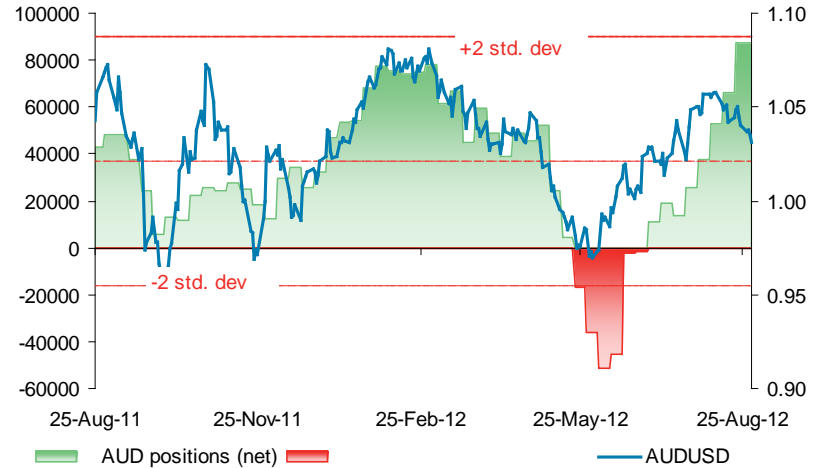
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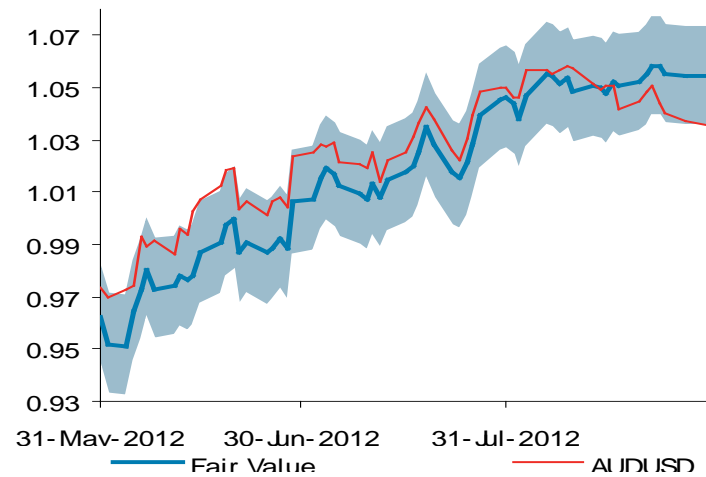
USDCAD vs. oil prices

0800

CFTC: AUD longs have increased again



STEER signals AUDUSD falls below its fair value



Forecasts

USD Bloc	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14
EURUSD	1.30	1.35	1.28	1.35	1.35	1.38	1.34
USDJPY	78	77	76	76	75	75	78
USDCHF	0.92	0.90	0.94	0.93	0.96	0.98	1.01
GBPUSD	1.67	1.73	1.68	1.78	1.82	1.86	1.86
USDCAD	0.98	0.96	1.00	0.95	0.94	0.94	0.96
AUDUSD	1.06	1.08	1.02	1.10	1.12	1.12	1.10
NZDUSD	0.84	0.86	0.80	0.88	0.90	0.90	0.87
USDSEK	6.85	6.67	7.15	6.78	6.67	6.52	6.57
USDNOK	5.85	5.56	5.86	5.56	5.63	5.51	5.67
EUR Bloc	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14
EURJPY	101	104	97	103	101	104	105
EURGBP	0.78	0.78	0.76	0.76	0.74	0.74	0.72
EURCHF	1.20	1.22	1.20	1.25	1.30	1.35	1.35
EURSEK	8.90	9.00	9.15	9.15	9.00	9.00	8.80
EURNOK	7.60	7.50	7.50	7.50	7.60	7.60	7.60
EURDKK	7.46	7.46	7.46	7.46	7.46	7.46	7.46
E. Eur Bloc	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14
EURPLN	4.40	4.20	4.30	4.35	4.30	4.10	3.90
EURCZK	25.50	25.10	24.70	24.90	24.50	24.10	23.60
EURHUF	280	270	275	273	277	272	280
EURRON	4.45	4.40	4.38	4.42	4.35	4.37	4.35
USDZAR	8.65	8.00	7.65	7.50	7.40	7.20	7.81
USD RUB	33.39	31.53	32.06	30.93	31.71	30.91	30.70
USDTRY	1.77	1.75	1.82	1.77	1.77	1.77	1.80
Asia Bloc	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14
USDSGD	1.26	1.24	1.22	1.20	1.18	1.15	1.20
USDMYR	3.15	3.10	3.05	3.00	2.95	2.90	2.85
USDIDR	9400	9200	9000	8800	8700	8500	8500
USDTHB	31	30	30	29	29	28	28
USDPHP	42.00	40.00	39.50	39.00	38.50	38.00	38.00
USDHKD	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USDRMB	6.31	6.29	6.25	6.21	6.18	6.20	-----
USD TWD	29.50	29.00	28.50	28.00	27.80	27.50	27.50
USD KRW	1150	1100	1050	1050	1050	1050	1050
USD INR	55	54	53	52	51	50	45
USD VND	21000	21000	21000	21000	21000	21000	21000
Latam Bloc	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13	Q1 '14
USDARS	4.68	4.85	5.00	5.15	5.35	5.55	5.70
USDBRL	2.00	1.95	1.94	1.97	2.01	2.05	2.07
USDCLP	495.00	482.00	485.00	490.00	495.00	505.00	508.00
USDMXN	13.30	12.40	12.20	12.30	12.50	12.80	12.90
USDCOP	1820.00	1800.00	1790.00	1780.00	1800.00	1820.00	1831.25
USDVEF	4.30	4.30	7.00	7.00	7.00	7.00	7.00



How to Access our Research

www.GlobalMarkets.bnpparibas.com

The screenshot displays the BNP Paribas GlobalMarkets website. At the top, the BNP Paribas logo and tagline "The bank for a changing world" are visible. The navigation menu includes Home, Commodities, Credit, Equity Derivatives, FX, Rates, Indices, Research & Strategy, Client Service, eTrading, and Prime Brokerage. A large banner features the text "The destination to begin your journey" over a background image of a train station. A "Sign in to GlobalMarkets" form is present, with fields for Username (danielle.catananzi@uk.bnpparibas.com) and Password, and checkboxes for "Remember Username" and "These are my BondHub credentials". Below the banner, there are sections for "Links" (Related Links, Downloads), "Research & Strategy" (eTrading, Client Service), "Market Data & Analytics", and "Proprietary Indices". A "Charts" section displays a line graph titled "G7 Leading Indicators" comparing "G7 Leading Indicator (% 3m/3m aar, lag 3m)" and "G7 Industrial Production (% 3m/3m aar)" from 2000 to 2010. The bottom of the page features a "Welcome to BNP Paribas" banner.

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