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

Recovery never became self-sustaining…

Source: Ecowin Reuters, Bloomberg, BNP Paribas
The Fed downgrades its economic expectations

Federal Reserve Forecasts for Growth and Unemployment

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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

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

Risk assets draw significant support from Fed QE ….

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
….and curtailing risk

DXY vs. VIX

QE periods see VIX suppressed, dollar weaker

Source: Ecowin Reuters, Bloomberg, BNP Paribas
The USD has trended lower during periods of QE

Fed $ Index vs. Fed Balance sheet

Dollar firmer between end of QE1 and Jackson Hole ‘heads up’ for QE2……

Source: Ecowin Reuters, Bloomberg, BNP Paribas
USD to weaken vs. commodity currencies

NZDUSD lagging behind recent S&P 500 Equity Index rally

Commodity Currencies increasingly correlated to equities rather than commodities
Commodity Prices & Equities Diverge

S&P 500 Equity Index vs CRB Index

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

Source: Ecowin Reuters, Bloomberg, BNP Paribas
FX market is short EURs and long USDs

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

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
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

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)

...or relative ECB/Fed rate expectations

Source: Ecowin Reuters, Bloomberg, BNP Paribas
Weighted-average swap spread is more successful

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

Source: Ecowin, 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

EURAUD had traded lower as relative yields have favoured AUD

Source: Ecowin Reuters, Bloomberg, BNP Paribas
Euro area stress
- A driver of EUR too
Eurozone stresses have impacted the EUR

10-Year yield spreads to the bund

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

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
LTRO and Mr Draghi have calmed EZ peripheral bond markets

EURUSD and Italian-German 10-year yield spread

The easing of eurozone peripheral stress has supported EUR

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
LTRO and Mr Draghi have boosted financial stocks

EUROUSD and Eurozone Financial Stocks

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

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
EUR/G4 crosses most sensitive to euro zone stress

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

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

Source: Ecowin Reuters, Bloomberg, BNP Paribas
EUR can still weaken against commodity currencies

Crosses like EURAUD can still fall despite lower peripheral yields

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

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

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

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
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.

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)

85000

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

Source: Ecowin Reuters, IMM, Bloomberg, BNP Paribas
Reserve Diversification explains USD weakness, ‘others’ more so than EUR strength
Global FX reserves are growing, driven by EM countries

Acceleration in global reserves growth helps explain USD weakness

Source: Reuters Ecowin, Bloomberg, IMF, BNP Paribas
Buying of EURs may rebound from Q2

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

Reserves Rebounded but Diversification Stopped in Q1

Source: Reuters Ecowin, Bloomberg, IMF, BNP Paribas
FX Reserve Growth likely maintained in Q2 2012

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

Source: Ecowin Reuters, Bloomberg, BNP Paribas
Reserve growth consistent with a weak USD trend remaining

FX Reserve Proxy vs. EURUSD appreciation

... 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

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

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

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

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

Unlike USDJPY, REER remains mid range and far from highs

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
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

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

There is significant potential for EURGBP to weaken
QE has not weakened Sterling

GBP TWI vs. UK Bank of England Balance Sheet

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

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

Source: Ecowin Reuters, Bloomberg, BNP Paribas
Shifting yield spreads has pushed EURGBP lower

EURGBP vs. EU-UK 2 Year Swap Spread

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.

EURUSD trades slightly above its +/- 1.5 std. dev. corridor
EURGBP breaks out of downtrend (temporarily??)

EURGBP technical outlook

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

Source Bloomberg, BNP Paribas
EURGBP starts to diverge from EURUSD

EURGBP vs. EURUSD

EURGBP links to EURUSD begin to weaken

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
Non-Resident Demand for Gilts become erratic

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

Source: Ecowin Reuters, Bloomberg, BNP Paribas

Theme of GBP as safe-haven is beginning to diminish
Depth of capital markets favours GBP

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

Source: ABS, Bloomberg, BNP Paribas
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

CHF appears extremely overvalued vs relative interest rates

Source: Ecowin, Reuters, Bloomberg, BNP Paribas
Easing of Eurozone stress key for durable Swiss Franc reversal

EURCHF v. Saving deposits in CHF bn

Real money (deposit inflows) key driver of CHF strength

Source: Ecowin Reuters, Bloomberg, BNP Paribas
Our estimate of EURCHF without SNB intervention

EURCHF vs. German-Italian 10y yield spread

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

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

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

USDCAD vs. oil prices

CFTC: AUD longs have increased again

STEER signals AUDUSD falls below its fair value
## Forecasts

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