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FX month in review: a significant pivot?

The last month has been an eventful one once again for FX, with the coming and going of the US mid-term election on November 2 and the much anticipated QE2 announcement from the US Federal Reserve on the following day. Then on November 11-12, we had the Seoul G-20 meeting where. Here is our look at the major developments since our last report.

- **QE2 – the caboose of the gravy train?** Finally, the Fed's much anticipated QE2 announcement is in the rear view mirror and this highly speculative market can get down to deciding whether the new treasury buying program as announced will be as salutary for risk assets as the market seemed to think it would be before the announcement. In the wake of the announcement, the market, though heavily positioned for a weaker USD and higher risk asset prices, actually managed to extend that trade for a few days as the dollar was pushed to its lowest levels versus a basket of the remaining G-10 currencies since before the Lehman bankruptcy. But by mid-November, there seems to be a growing sense of unease as the world frets whether QE2 may be creating more problems than it solves, and whether the Fed will be so constrained by internal dissent and hostility on Capitol Hill that its role going forward will be highly constrained.
- **Euro back in hot water.** The respect the Euro finally achieved in recent months on its persistently tight central bank policy in a world of QE and higher rates at the shorter end of the curve faded quickly in November as the ECB's tight policy did little to help the situation at the EuroZone periphery, where the PIGS are suddenly back wallowing in the misery of their unsustainable debt load and alarming fiscal shortfalls. The potential trajectory for the EUR and the USD is fast switching places as the ECB may quickly find that it got too tight too fast and as the Fed has already hung itself on its QE rope. Key to watch for in the coming weeks is the reaction to the coming bailout solution for Ireland. Will this put a lid on the issue for now, or does the market begin immediately to press on the issue of the next bailouts for Greece and then Portugal? France's Sarkozy and Germany's Merkel have upped the stakes recently by demanding that bond holders take a haircut on any solution to the PIGS debt. While they have partially backtracked on this rhetoric, it certainly spooked the market sufficiently to require a far larger risk premium on holding Euro-denominated assets. If the contagion fear spreads to Spain, the situation will become unbearable as the Euro bailout fund is too small for a Spanish bailout. This would require a new and stronger ECB/political union framework if Europe wants to remain united politically and keep its single currency. 2011 will be an interesting year for the EuroZone.

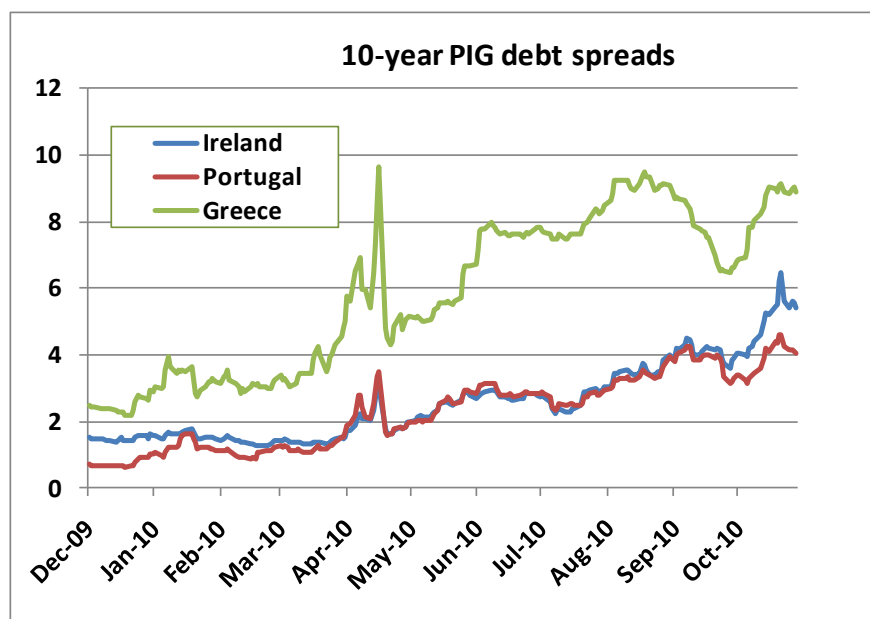


Chart: PIG spreads. The chart above shows the spreads on Irish, Portuguese, and Greek 10-year debt vs. German Bunds. As a bailout solution has approached for Ireland, the spreads have come in again, but will it be enough to prevent contagion beyond these three countries?. The EuroZone can only managed to put a lid on the situation if the crisis stops with these three. Data source: Bloomberg.

- **G20 – a fizzler at best.** Expectations were rather high ahead of the G20 meeting in Seoul on November 11-12 as the currency war theme was heating up to an almost unbearable level heading into the meeting. Rather than this meeting seeing a strong focus on China and its undervalued currency, however, the Fed ensured that the focus would shift strongly to the US' contribution to global tensions on currency matters due to the Fed's recent launch of QE2 and the speculation in commodities and pressures from capital inflows this has created for the rest of the world. The meeting ended with a nice sounding statement that only promised little more than the usual pabulum of working closer together studying the matter further. Going forward, this meeting shows that the market will therefore be left to the whims of the global economy's individual players, who risk acting unilaterally to enact capital controls and protectionist policies in perceived self interest. This path is a dangerous one, particularly if a true trade war breaks out in the year to come.

Going forward: is QE2 ending the prospects of QE3?

As we discussed in our last report, the risks of QE2 are many, and include the idea that investors will be forced to find absolute stores of value in the commodities and "alternative money" precious metals markets (the latter not your standard commodity in these nervous times as we saw in the latest runup) as long as the major developed central banks are bent on devaluing their currencies in order to slowly ease the weight of their over-burdensome debt. But the risk in this policy is for the wrong kind of inflation - cost push inflation that squeezes wage earners with no bargaining power to see wage increases in this economy and that also squeezes corporate profit margins as input costs climb while pricing power is absent due to slack end demand. This issue is already on the table after the aggravated price rises in most commodities in recent months.

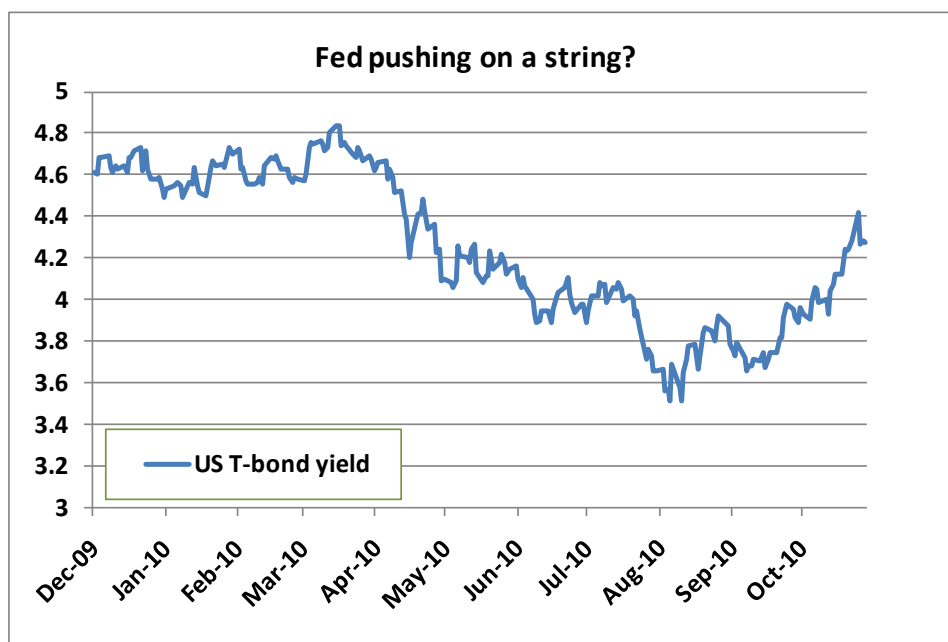


Chart: US 30-year T-bond yield. It's arguable that the Fed is pushing on a string with it's latest move into quantitative easing, as the entire phase from anticipation of the move to its actual announcement saw the longest end of the yield curve heading higher as investors feared the inflationary consequences of the Fed's printing money. Is this a sign that future attempts at QE are off the table?

If the commodities boom here is merely a speculative bubble that is wiped away as risk assets sell off sharply and the US dollar rallies (an argument that is a bit easier to make as we go into the second half of November and see how a few percent of upside in the USD has generated a very chunky sell-off in the commodities complex), and if government bonds rally strongly again, then the chances of a QE3 are put back on the table. Even then, one wonders what kind of room to manoeuvre the Fed has with a very interesting Tea-Party infiltrated Congress set to convene in the New Year and with some clear dissent from within the Fed. If the US double dips and yields drop again, will Congress and the voting population blame the Fed for the economy's dire straits because it has kept alive the debt ghosts from the past cycle and even transferred them to the public balance sheet, or will they beg the Fed to print even more money?

Carry Trade Model – markets back in tight correlation

Last time we noted the degree to which the risk-happy market decided the USD is the only currency (perhaps the pound deserves an honourable mention) to use as a funding currency in the global carry trade, as every uptick in pro-risk assets was matched with a downtick in the greenback and vice versa. Indeed, the trade is clearly a reflexive, or self-reinforcing phenomenon. In the two weeks leading up to this report, however, the USD has reversed to the strong side as risk conditions have become a bit more wobbly. Interestingly, at the same time, US yields have actually risen very sharply as the market apparently thinks that the reality of QE2 will undershoot the expectations – or it was at least a good excuse to take profit on long bond trades put on in anticipation of the Fed's policies after the good old buy the rumor, sell the fact pattern.

The action in bond markets has forced the USD and the JPY to decouple even further from one another (USD has rallied, while the JPY sold off) – a decoupling we also noted the last time around, as we pointed out that the market was strangely willing to keep a stable view on the JPY despite the BoJ's own new foray into quantitative easing.

Carry Trade Outlook – turning point?

We fretted last time whether signs of a divergence in the behaviour of the USD versus underlying risk conditions might continue. We worried too soon, however, as the subsequent market action has underlined that the USD and global risk appetite remain very closely linked. It appears that this linkage will continue for the foreseeable future. So far, risk conditions as defined by the fast carry trade index have been supportive of the USD carry trade (and vice versa) for most of the period between early July and now as the index has spend most of its time above zero. The overall carry trade index has shown little useful behaviour in the recent cycle, save for perhaps trending in the positive direction along with the anti-USD trades.

This suggests that it is the dollar itself that is used as the universal risk barometer and may be leading the market. Still, a number of risk components are showing rapid signs of deceleration that may finally be leading to a more significant consolidation in risk and to more USD strength. And on a technical basis, we've seen an interesting rejection of USD weakness just after the currency had crossed to a new low in the wake of the QE2 announcement from the Fed on Nov. 4. Is this finally some confirmation that we are looking at key turning point or simply a technical red herring? The coming period into the end of the year is likely to give us the answer.

Saxo Bank Carry Trade Model Charts

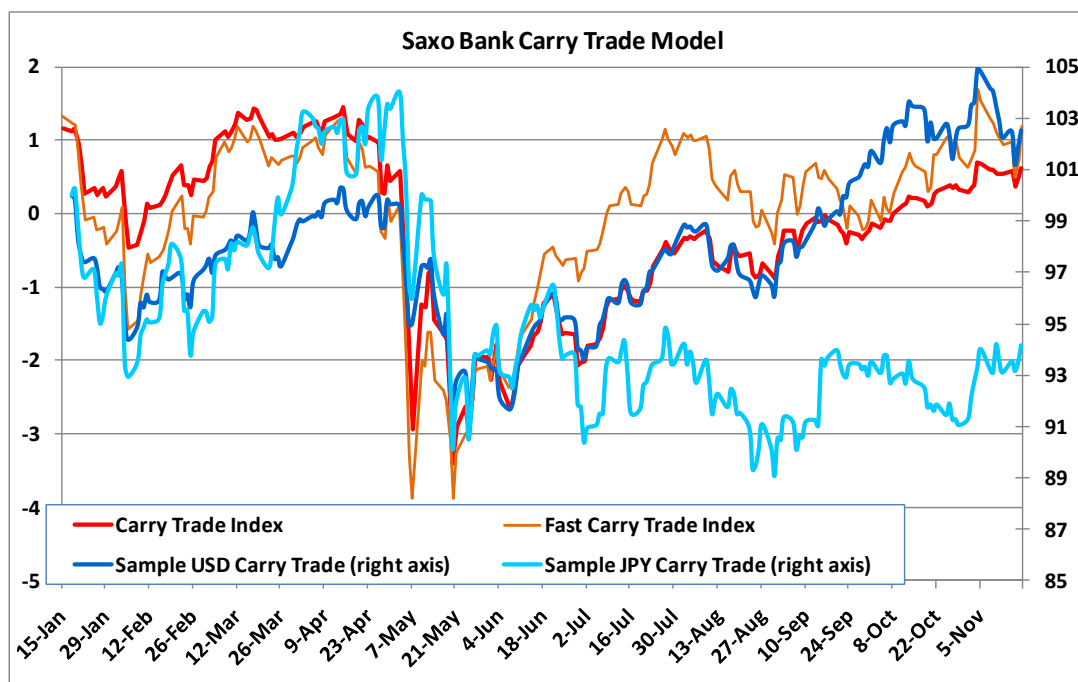


Chart: Saxo Bank Carry Trade Model. Correlation of the USD with risk conditions came back into tight positive correlation over the last month. The chart shows that the JPY is not popular with the carry trade crowd, with less correlation with broader risk measures. Still, a bit more pressure has come to bear on the JPY after the recent backup in government bond yields. (The two sample carry trades show the carry-less recent performance of a basket of 7 currencies (AUD, NZD, PLN, TRY, MXN, IDR, BRL) vs. the USD and JPY.) Chart derived from data from Bloomberg.

Carry Trade Model Components

Below we have a look at the six Carry Trade Model components – note that the graphs show the components using the fast averaging period that is used to create the Fast Carry Trade Index. The fast index is more responsive, even if it is perhaps more prone to a noisy signal (sampling periods are always a compromise for models like this one).

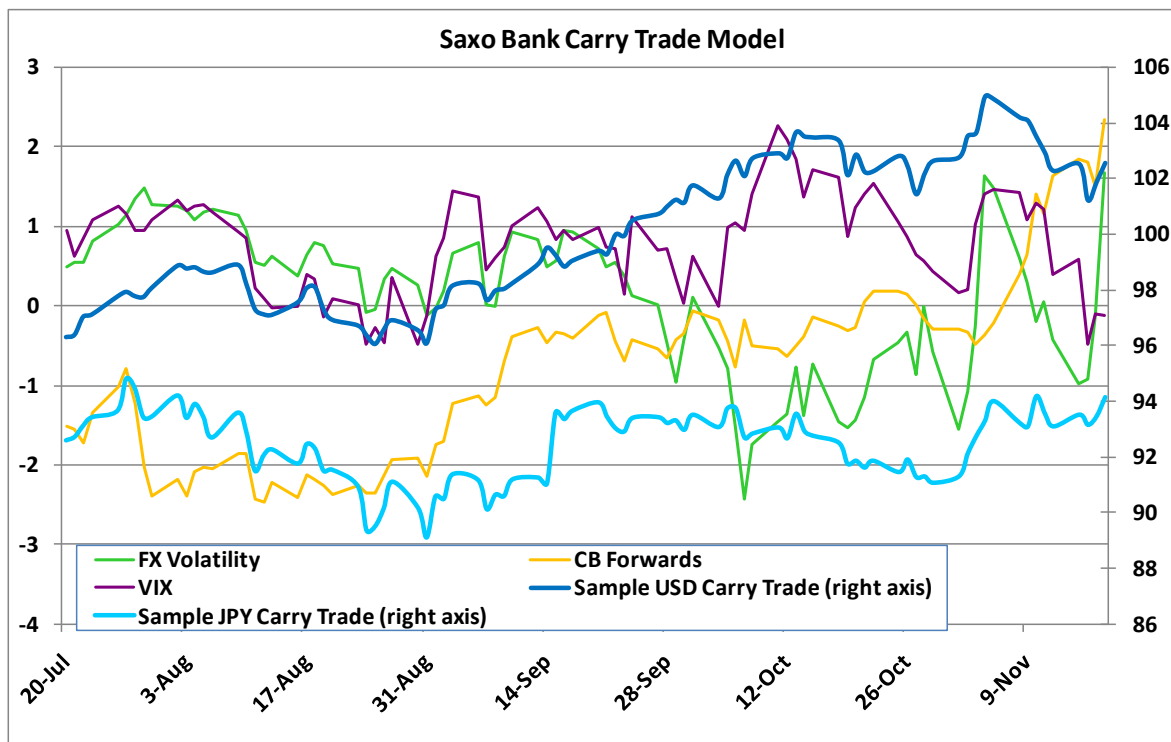


Chart: Fast Carry Trade Index Components 1. The noise level and volatility of the indicators has been rather high of late. FX volatility in particular has been volatile. Note the sharp fall-off in the VIX to below 0, which suggests a good deal of nervousness in the US equity market. Meanwhile, CB forwards have moved higher – though this signal may be a bit exaggerated due to very low volatility of late (so any move appears large on a standard deviation basis). Chart derived from data from Bloomberg

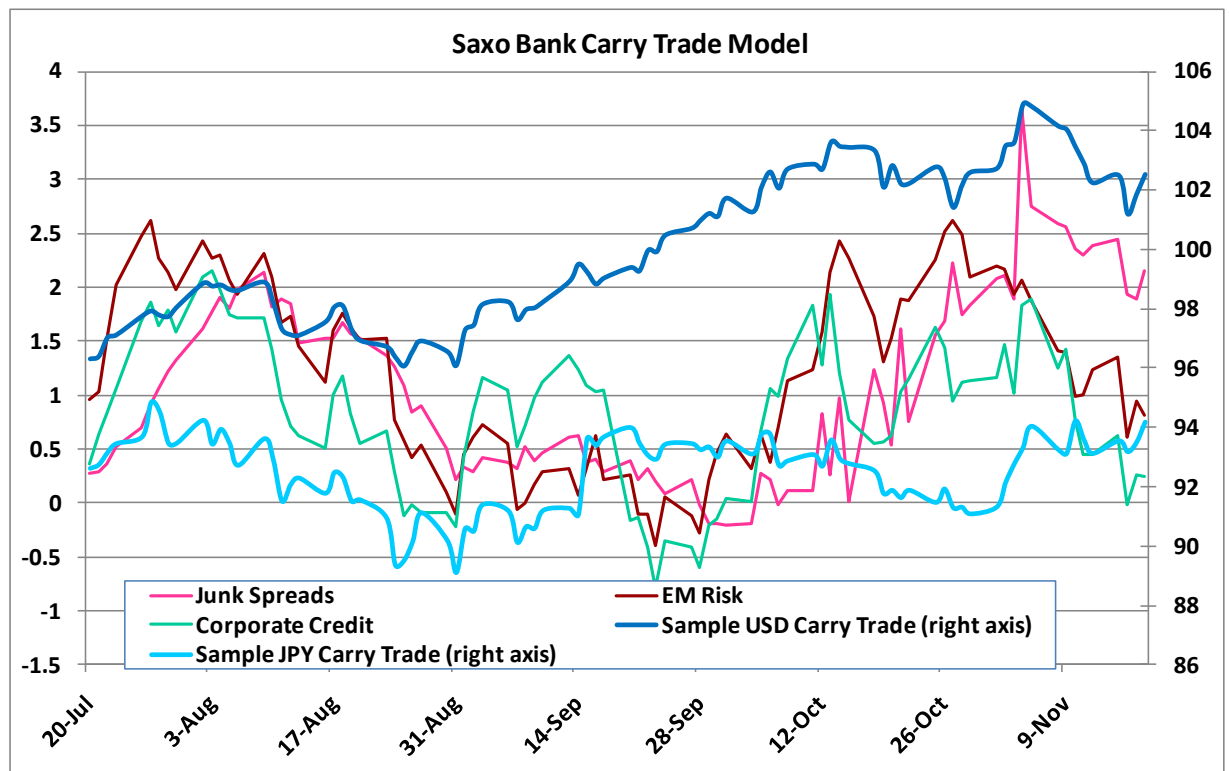


Chart: Fast Carry Trade index Components 2 (previous page3) The remaining components of the carry trade model suggest growing weakness in EM spreads in particular, and also in corporate credit, which is actually all the way back to the zero bound. In fact, if we remove the large drop in FX volatility and the exaggerated effect of the CB forwards, which really haven't moved that much, we see that risk conditions are actually much closer to neutral than the overall index suggests. Chart derived from data from Bloomberg

Central Bank Watch: Nudging slightly higher

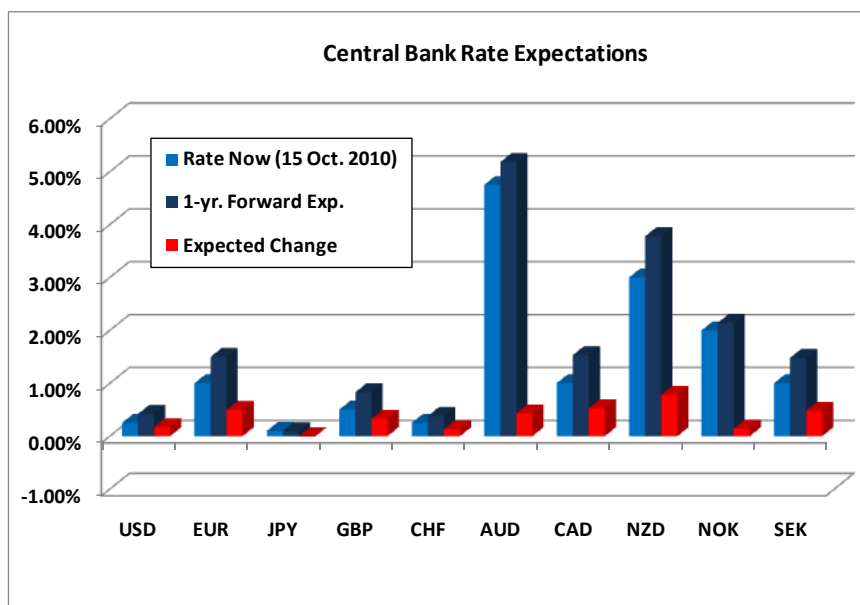


Chart: Central Bank expectations remain low, but market still looking for a bit more tightening. Since our last report, Sweden and Australia have hiked rates again, and New Zealand is expected to join them in the coming quarter or so with another hike. We're not sure what those looking for a hike from the ECB are thinking. But in general, expectations are extremely modest. Chart derived from data from Bloomberg

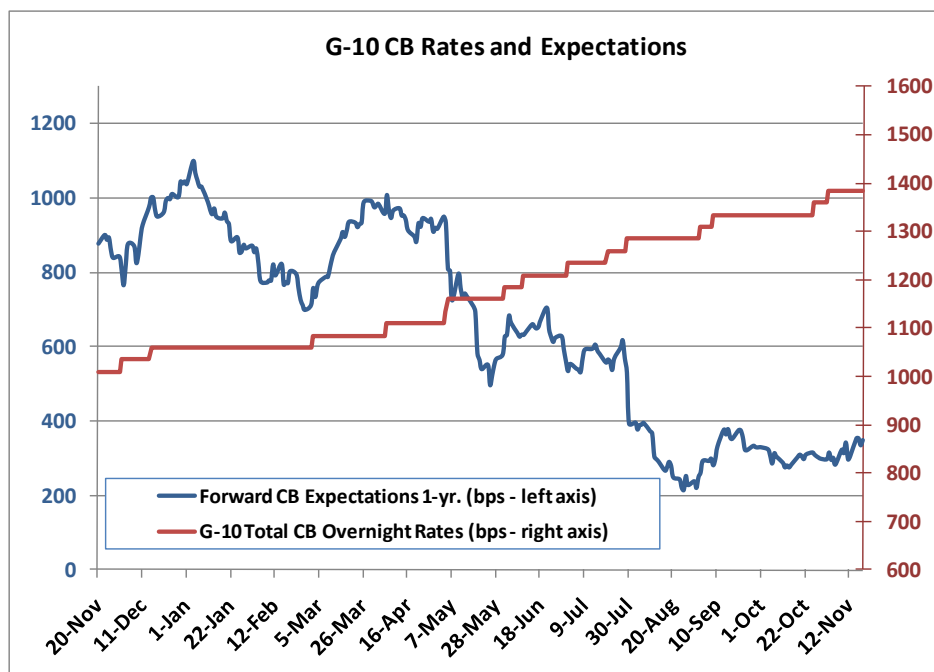


Chart: G-10 CB rates and rate expectations in aggregate: Overall CB expectations for the year forward nudged a bit higher even after the RBA and Riksbank hikes. Eventually, we would expect for expectations to resume their downward trend and even go negative. Chart derived from data from Bloomberg

Saxo Bank G-10 FX Forecasts

Base Case: Now that the Fed's much anticipated QE2 move is in the rear-view mirror, the speculative bubble the anticipation of further QE had engendered has finally shown signs of deflating – or at least the incredibly persistent rally in risk versus the USD sell-off has finally consolidated reasonably since our last report. The view going forward is that the Fed will be highly constrained by division within the actual FOMC and by political head winds from the new Congress that convenes in the New Year. We assume that the recent spate of USD weakness has largely played its course and that the focus could shift now to the Euro and its woes. An ugly period for the EuroZone could remind the world that risk premia are extraordinarily low and that it may have taken its pro-risk speculative case way too far in the previous cycle.

Alternative Scenario(s): The alternative scenario is another come back in risk, though this time, not even in our alternative scenario do we envision risk making a strong enough come back to breach the extremes we have seen thus far in USD weakness and EUR and AUD strength, for example. The JPY is one big wild card here. If risk comes off heavily enough, it would seem that some investors might finally find more solace in bonds, even as everyone seems to hate them despite the (or because of the longer term) implications of QE. That would be a JPY positive, or might at least brake its decline (we are not believers in a stronger JPY beyond the next spike or two in risk aversion versus the more pro-risk currencies). But if long bonds continue to sell off with risk assets, this could mean that the JPY will be generally weaker, especially versus the greenback.

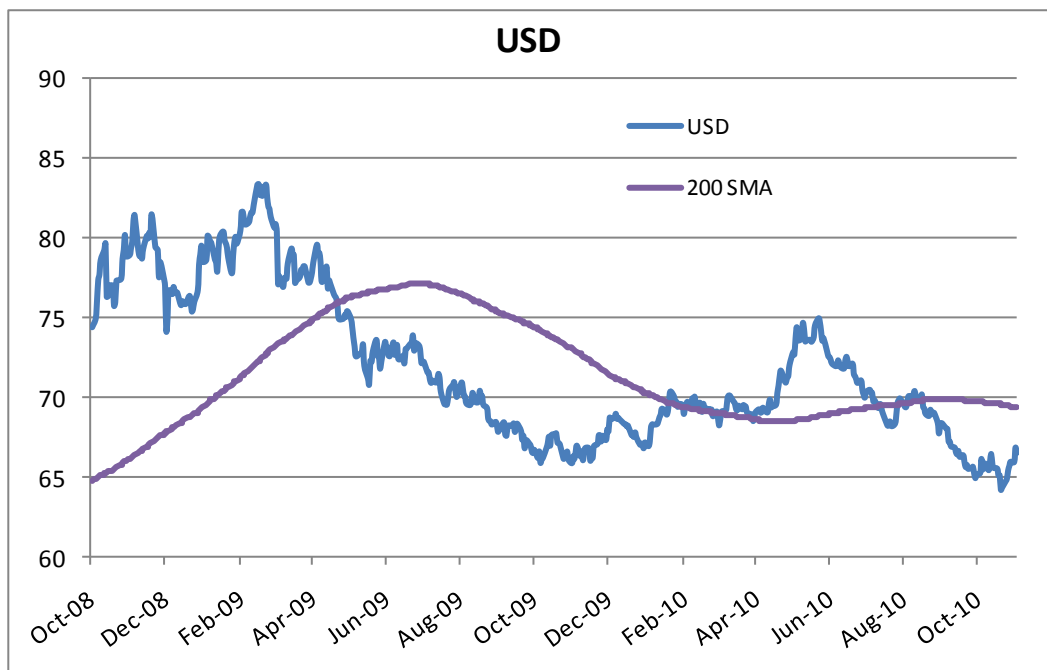
Table: Saxo Bank G-10 FX Forecasts

Currency Pair	1M	3M	12M	Alternative (1-2M)
EURUSD	1.3000	1.1700	1.1000	1.4200
USDJPY	85.00	89.00	102.00	80.00
EURJPY	111.00	104.00	112.00	114.00
EURGBP	0.8400	0.7900	0.7600	0.8600
GBPUSD	1.5500	1.4800	1.4500	1.6500
EURCHF	1.3800	1.3800	1.4000	1.3000
USDCHF	1.0600	1.1800	1.2700	0.9500
AUDUSD	0.9000	0.8000	0.7000	1.0200
AUDJPY	76.50	71.00	71.00	82.00
AUDNZD	1.2500	1.2500	1.2100	1.2750
NZDUSD	0.7200	0.6400	0.5800	0.8000
USDCAD	1.0600	1.1400	1.2000	1.0000
EURNOK	8.25	8.00	7.75	8.00
EURSEK	9.50	9.75	9.00	9.15
EURPLN	4.15	4.50	4.75	3.85
USDZAR	7.25	8.25	9.00	6.75

Saxo Bank G-10 FX Outlook

Note that all of the charts below show the currency versus an evenly weighted basket of the remainder of the G-10 currencies with an Index of 100 approximately 10 years before the present date. All chart content is derived from Bloomberg data

USD



The USD finally saw a reasonable bounce after trading at the lowest level since before the Lehman bankruptcy in 2008. There is an awful lot of wood to cho, however, before we can describe the structural view on the USD as bullish. Still, could the new post-QE2 environment be far more USD supportive than the market currently expects?

The post QE2 environment has turned more positive for the USD, which managed to fight back after the initial further jolt of USD weakness and yet another wild extension of the rally in pro-risk assets in the few days following the announcement by the Fed that it planned to buy some \$75 billion of assets per month for the next eight months (in addition to some \$30 billion or more from maturing mortgage paper it holds on its balance sheet).

The risk rally coming back to earth so quickly in the wake of the QE2 announcement is an interesting development as it feels like the market is quicker to react to the anticipation and reality of Fed easing and therefore also quicker to go on to the next theme. Back in 2007, the equity market managed to rally for the better part of a month after the first Fed rate cut of the cycle. This time, the risk rally lasted less than a week after the new QE2 announcement. We assume, of course, that the low water mark for the USD and high water mark for risk assets is now in place when we write this.

Going forward, the risks to the US dollar from a Fed easing angle are reduced if the global markets decide this is not a good time to get back on the risk bandwagon, QE or no QE. There is still plenty of excess pro-risk positioning that can be unwound from the previous rally. Other issues weighing on global risk are the continued

festering of EuroZone sovereign debt worries, not to mention huge outstanding problems in the US itself, including the ongoing mortgage foreclosure fiasco and the parlous state of state and municipal finances. The last of these issues seems to be coming to a head here in November as spreads have gone amok in municipal bond issues. There is even talk of the need for a QE3 that focuses on buying munis.

Also, the political and increasingly popular backlash against the Fed will mean that we may have seen the peak in the easing cycle from the Fed here not long after the stimulus from the Obama administration is fast fading from view. If jobless benefits are not extended (the initial vote saw a rejection of the attempt to extend benefits beyond 99 weeks), then this could also take billions of dollars of buying power out of the US consumer as well, as millions of jobless are at risk.

Outlook

Here we repeat a paragraph from last month's outlook, as it still aptly sums up what has happened and may continue to happen to the previous market paradigm:

We trudge masochistically on [a bit more wind at our backs now that a sharp correction has set in] with the view that "this cannot end well" and that the market's current hopes for a risk positive outcome to a renewed move by the Fed into QE will fail to justify asset prices at their current level, much less any hope that the US economic outlook is bright when the consumer has hardly even started deleveraging (the latest evidence is that the supposed behaviour change on the part of the US consumer has not even happened and that the only deleveraging that is really occurring is via default). And the flipside of much of the market's hot money flows and pro-risk positioning at the moment is with a structural short USD trade. Caveat venditor!

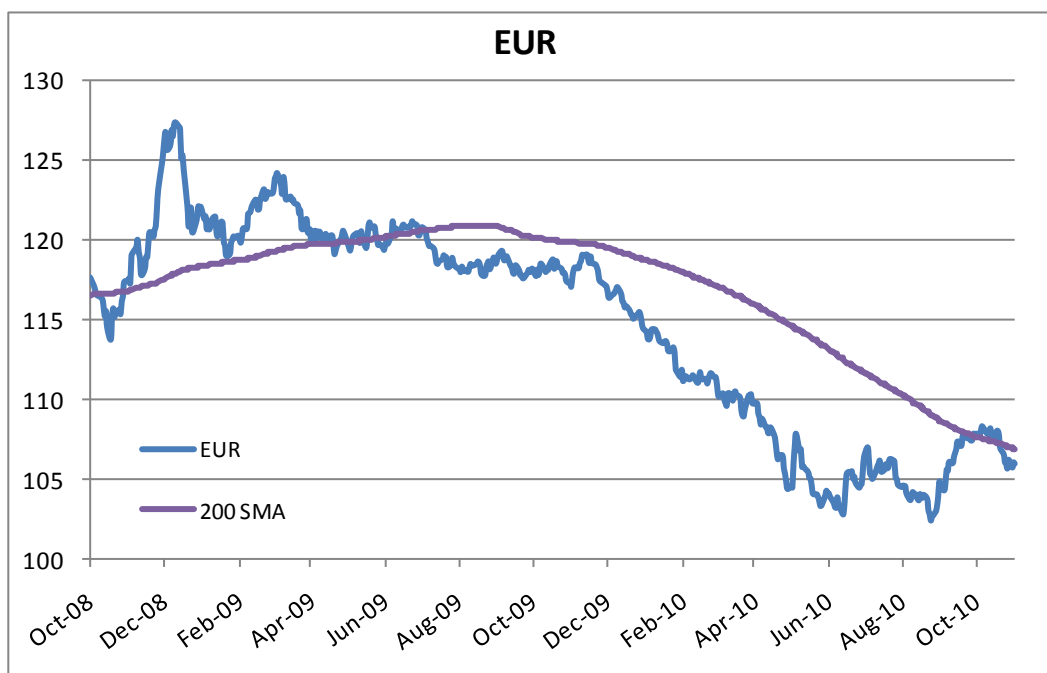
We note the long overdue USD strength with some relief after having held out against the QE-driven speculative move for so long. Still, there is a lot of wood to chop before the USD will look like it's back on a stable footing and the trajectory here remains uncertain. Do we carve out a range rather slowly and see USD strength in fits and starts or is there underappreciated risk of high volatility and a spike in USD strength as the market deleverages more quickly from the previous paradigm? Given how long the "previous paradigm" of Everything Up/USD down, we fear that the latter scenario is more likely than any of us would like for it to be, though timing of such a scenario is always impossible.

Remember that the December FOMC meeting will be the final one with the current FOMC voting composition. While known strong QE dissenter Hoenig will be leaving, the dove Evans will also be leaving, while a new dove Rosengren comes on board together with 3 more or less hawkish QE doubters – Plosser, Fisher, and Kocherlakota.

Next FOMC Meeting: December 14

Alternative scenario: *the USD makes a serious attempt at its lows for the cycle amid an attempt for the market to get back on the QE train as the risk bulls and growth Pollyannas talk up global growth prospects*

EUR

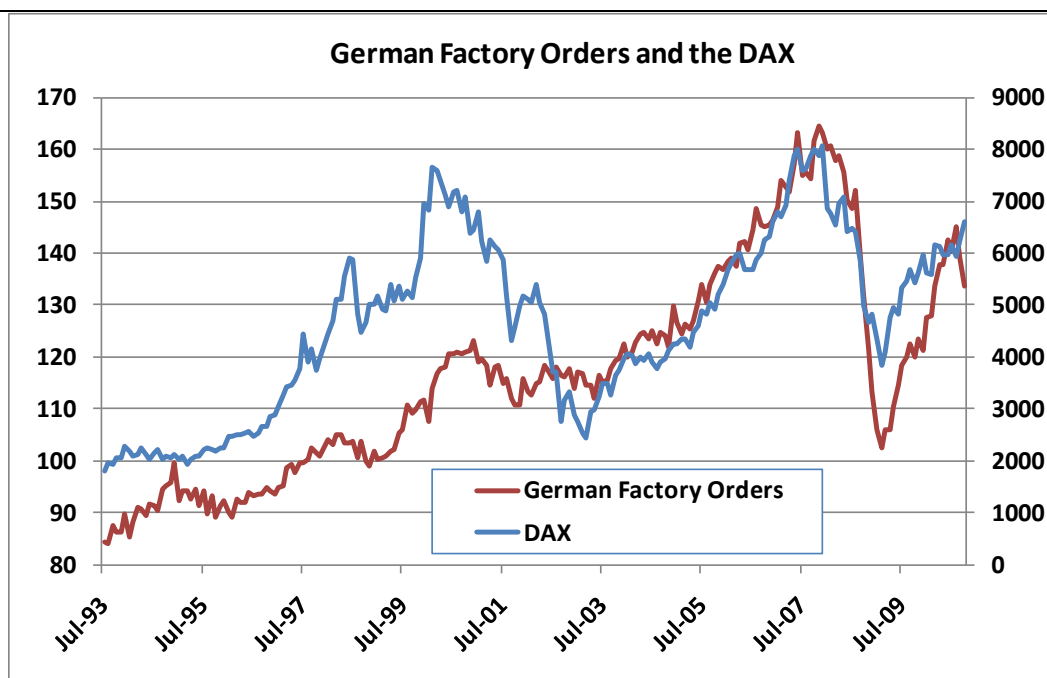


The Euro themes have flip-flopped again. Last month we had EUR strength on admiration for Trichets' tight monetary policy in a world of QE while now we have reverted to worries about the festering EuroZone sovereign debt crisis that never quite went away. Interesting question going forward: if risk aversion bites deeply, does the Euro currency itself (at least versus the pro-cyclical currencies) remain relatively stable due to a liquidity premium?

Last time, we started this section with: "The Euro has suddenly gone from goat to hero in recent weeks." But alas, all of the EU and ECB's attempts at putting a brave face on its sovereign debt crisis with large bailout packages and the pursuit of an "admirably" tight monetary policy while surrounded by QE profligacy could only drive the Euro so far to the upside. Now, the PIGS issue is back with a vengeance, with real plans of an Irish bailout in the works as we write this and the risk of contagion spreading by the day for Greece and Portugal. If the contagion risk spreads beyond those three little PIGs, then we begin to question the viability of the single currency and the EuroZone as a political entity.

Adding to the nervousness surrounding the Euro were comments from French and German heads of state on the need for sovereign bondholders to possibly take a haircut in the event of a bailout deal. Most of the sovereign bond holders are the European banks large and small, so any pursuit of such a policy would inflict pain on the entire EuroZone financial sector as the largest banks and holders of sovereign debt are in the core countries. Realizing how their comments were affecting sentiment, Sarkozy and Merkel have since tempered their stance with promises to put off any haircuts to 2013, but the market continues to question the degree to which the Euro core is willing to have its taxpayers bailout Club Med and Ireland from its debt excesses.

In addition to the sovereign debt troubles, we are seeing some signs around the edges that even Germany's high flying export economy is beginning to slow. Factory Orders are showing signs of a strong retreat as can be seen in the chart below.



German Factory orders have taken a sharp dip - is this noise or sign that the sharp V-shaped recovery triggered by inventory rebuilding is coming to an end. Also note that the recent peak in orders is only comparable to levels first reached back in 2006.

Outlook

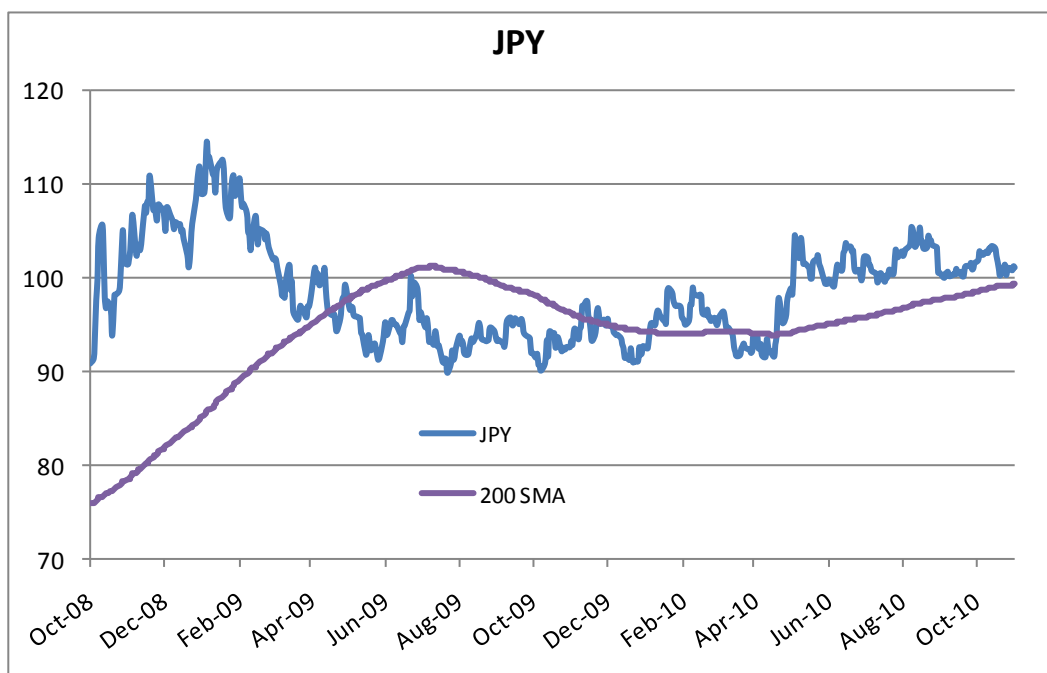
With German 2-year treasuries yielding over 100 bps, the widening in yield spreads at the short end of the yield curve for the Euro vs. its major counterparts from "Tight Trichet's" policy of recent months has likely run its course. While the ECB may or may not actually cut rates, the pressure from the sovereign debt crisis will require that the ECB come up with dramatic new measures – likely even real QE, which was previously considered anathema by Trichet and probably also considered off the table by those buying the Euro in recent months.

The ECB and the EU political leadership are going to have step up their coordination and commitment to union if the EuroZone wants to make a credible go at saving the single currency and the political union of Europe. It is our belief that the will is there to keep the Euro project going for now because of the fear of the fallout from allowing things to spin out of control and a disorderly dissolution of the union. Much further down the road, we're not so sure that the popular will is there to keep the Euro project going. 2011 will be an interesting year for the EuroZone.

Next ECB Meeting: December 2

Alternative scenario: EU officials manage to ring-fence the three PIG countries and the market tires of trying to predict contagion to Spain and Italy for now and the Euro manages to tread water for a while longer.

JPY



The JPY has gone virtually nowhere in recent months. On the one hand, traders are neglecting the currency because of the recent feeding frenzy surrounding the huge decline in the US driven by speculation of QE2. The JPY outlook remains dominated by interest rate spreads. Now, with the QE2 announcement out of the way, the JPY has fallen versus the USD as treasuries have sold off in a buy the news, sell-the-fact reaction to the Fed's announced bond buying.

Despite the BoJ's new interventionism announced at recent meetings that might have seen the market take a second look at its heavy short USDJPY position, it took a significant post QE2 backup in yields in the US to finally see the persistent, if low-momentum rally in the JPY versus the USD to consolidate. Looking away from the USD, the JPY has picked up a little steam versus the weaker corners of the markets as risk has come off, but remains more or less neglected by a market that can't seem to take a strong view on the currency.

Japanese industrial production numbers are trending the wrong way despite an apparently strong Q3 growth number. Worryingly, manufacturing PMI numbers have also come off of late and strong commodity prices are putting a squeeze on corporate profits in an economy that forgot what pricing power was almost a generation ago.

Outlook

We are generally negative on the JPY from here. While a new strong rally in bonds could offer the currency some support versus the riskier pro-growth currencies in the short to medium term, we are reluctant to consider the JPY any kind of value when the Japanese export-driven economy is suffering under margin compression and the risk of a fall-off in demand as the inventory cycle fades and at a time when the market is already quite long the currency.

On the central bank side, it is tough to find the JPY attractive as the BoJ is clearly ready and willing to grasp at new QE straws when it sees a stronger JPY or a weak economy. And in the bigger picture, the market must take note that the long run Japanese public debt load is the world's largest and that this fact might ought to see a larger risk premium in the currency than we see at present. There are a few signs of activity on the sovereign CDS

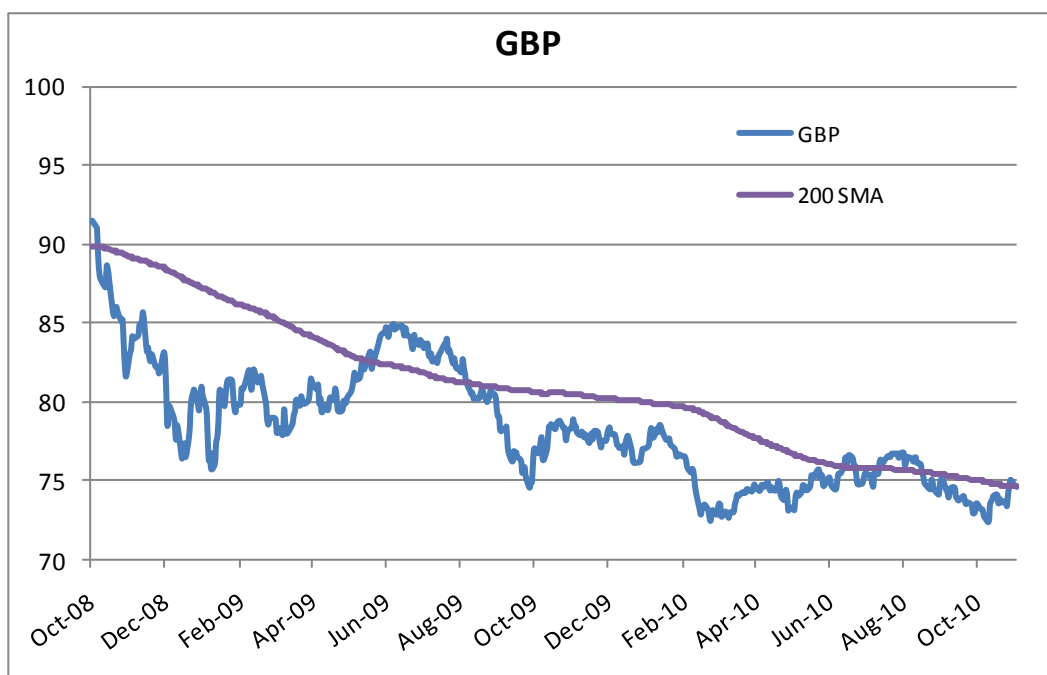
front that the market is beginning to sniff at the sovereign risk issue, and the potential for this to blossom into something massive is endlessly large.

The problem is that it's either a peaceful day or an avalanche on this issue, and rooting out the trigger that would change the market's sentiment on the JPY is difficult. Perhaps we see a Japanese "Weimar moment" if the economic slowdown gets sufficiently severe to set off a QE/money printing endgame (outright money printing was actually mentioned by a DPJ politician some time back) – or perhaps we have to wait until government bond rates rise sufficiently to reveal that Japan can't finance its own debt with domestic savings anymore and that foreigners won't touch it at such low yields and lousy fundamentals. Once Japan has to seek foreign funds in earnest, the country's currency goes up in smoke because a rise in yields would make the burden of interest payments on the debt explode.

Next BoJ Meeting: December 21

Alternative scenario: Bonds make a strong stand while risk appetite shows signs of perking up again. This sees USDJPY back down to new lows below the all-time low in 1995 of 79.95.

GBP



GBP made a reasonable comeback after briefly touching a new low for the cycle versus the rest of the G-10 currencies. Renewed Euro weakness on the PIGS crisis saw EURGBP pushed all the way back below its 200-day moving average by the time of this publication. On the flipside, GBPUSD showed signs of tiring on the USD comeback.

The pound turned the corner over the last month as the market consolidated from the "punish the money printers" theme, and because the renewed focus on the EuroZone sovereign debt crisis made it look very cheap suddenly versus the overbought Euro. A backup in UK interest rates at the short end of the curve also lent the

pound a helping hand.

The main concerns for the UK are remarkably similar to those of the US: a gaping trade deficit (though in the UK's case, we have seen new historic imbalances recently while the US is a good deal off its all time lows from 2006) and a central bank that is ready to expand its quantitative easing efforts again if conditions warrant.

A curious difference in the UK relative to the US and elsewhere remains the persistently high levels of consumer inflation. In the quarterly BoE Inflation Report issued this month, the BoE insists that inflation will eventually fall, though it did bump up its near term inflation forecasts for a number of factors it assumes will only cause one-off price rises, like the weak currency, rising commodity costs, and a change in the VAT.

All in all, we tend to believe the economic outlook will justify the Bank's view on inflation, as long as the sovereign risks never take hold again and as long as we don't see the resumption of the kind of central bank front-running/speculation that we saw with the run-up to the Fed's QE2 move.

Outlook

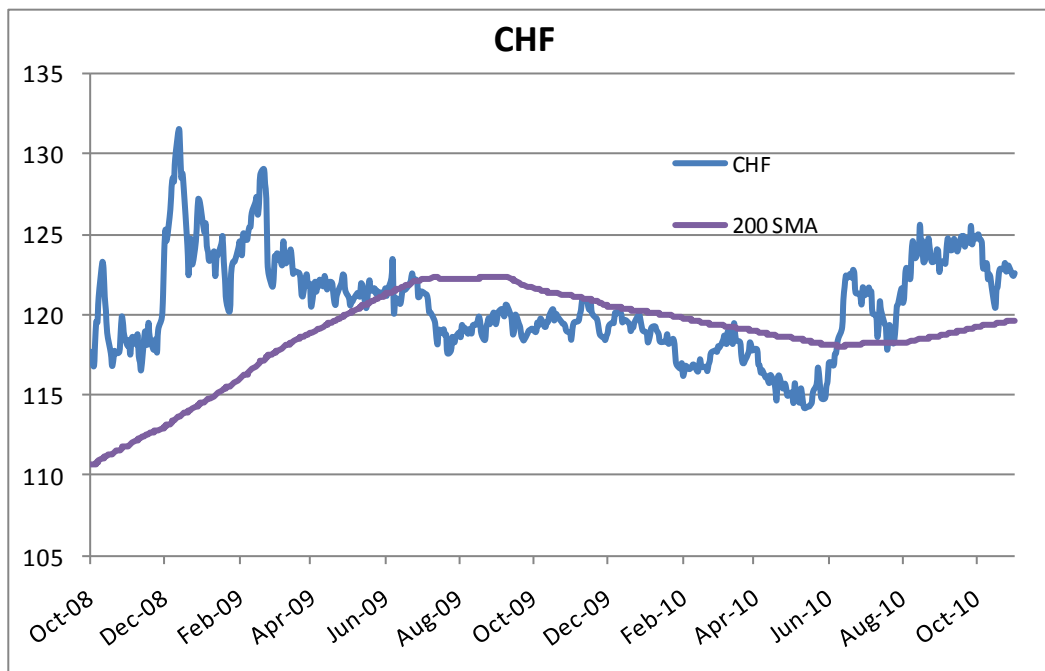
Our assumption that the pound would continue to trade more or less in correlation with the USD due to the similar themes the two currencies face, was the right one. In fact, the stronger pound ahead of the US FOMC meeting and then again afterwards perhaps showed that the pound might be a leading indicator at the moment on the greenback. Because the outlook for further BoE easing at the moment is rather circumscribed at the moment after the bank admitted that near term inflation could remain high, the market has seen yields at the short end of the curve rising as it prices out the need for QE. That assumption and the higher yields it has engendered may be erased once again if the UK economy weakens again further out. The likelihood of such an outcome is rather high now that the housing market in the UK is showing further strong evidence of beating a steep retreat and if we consider the backdrop of strong public austerity measures.

Still, if we head into a lower yield, risk averse environment, the pound may continue to do relatively well against the rest of the G-10 currencies for a time as it means that rate spreads will improve in favour of the pound versus currencies like NZD and AUD. The short EURGBP case is also easy to make as expectations for monetary easing from the ECB may need more rapid adjustment than those for the BoE. Against the greenback, however, the pound will have a hard time keeping up in an environment of risk aversion and safe haven seeking.

Next BoE Meeting: December 9

Alternative scenario: *If we revert to a risk happy market, with risk assets pushing back to the highs for the cycle, the pound would turn south once more in a broad sense, even if such circumstances would probably take GBPUSD to a new high for the year.*

CHF



The Swiss Franc looked weaker on higher world bond yields, but then rallied quite sharply against the Euro on the renewed PIGS debt crisis. But is the currency any longer the safe haven currency it used to be?

The Swiss Franc was sharply weaker versus the Euro when the "Tight Trichet" theme was all the rage and European rates were spiking higher and higher versus the moribund short rates in Switzerland. But the franc then quickly rebounded in early November when the Euro PIGS debt crisis reared its ugly head again and the Euro turned weaker across the board. It is interesting to note that the latest extension of the Euro sell-off in the days ahead of this report has not seen EURCHF any lower in the days before this report, a rather pronounced sign of weakness for the franc. As this same period also coincided with a strong sell-off in risk assets, and USDCHF spiked higher during the same period, it seems clear that there is no longer any credible safe haven status in the Swiss currency.

Rather, the Franc may be weakening for a number of reasons here: clearer signs of a deceleration in its economy. The export side of the Swiss economy can hardly be expected to thrive if strong challenges for Euro growth lie ahead as well. Second, didn't the SNB snap up Euro sovereign debt when it was intervening in huge quantities back in the day? The SNB may be bitten twice on its interventionism. Third, we have to consider the risk to the oversized Swiss financial sector every time risk assets sell off when we think of all the loans made to CEE economies and whether they will all be repaid.... (Bloomberg was out recently with an article "Hungarian Banks may face funding challenges". Oh dear.) Finally, interest rates are much higher now, making the franc far less attractive versus its G-10 peers, though this source of weakness may eventually fade if bonds retrench on safe haven seeking.

Outlook

As we pointed out last time, pairs like USDCHF and GBPCHF are trading as a function of the competitive devaluation theme (with clear influence from the direction in interest rates as well) – and with the fading of this theme and rally in the USD and to a lesser extent the GBP, CHF may stay sharply weaker against these two

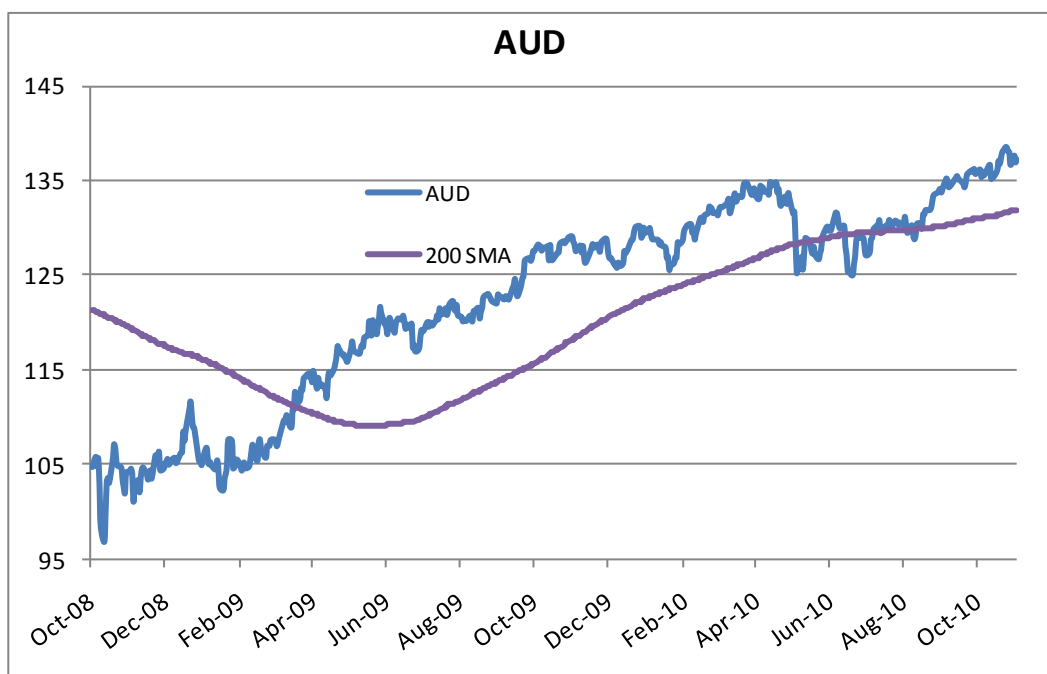
currencies – and risk aversion could continue to feed the unwind of the long CHF trade, which was built up under a different set up assumptions.

Against the Euro, we wonder if the highs are in for the franc as well, though we would like to see EURCHF back through the 200 day moving average (around 1.3800 as of this writing) for better confirmation that this is a realistic proposition.

Next SNB Meeting: December 16

Alternate scenario: EURCHF rises sharply and USDCHF dips slightly as the market finds reason for hope in Europe and global risk appetite rebounds.

AUD



The Aussie has eked out yet another new high for the cycle, but has come off rather sharply against the USD. Australia's economy is a one-trick mining pony and the commodities rally has just seen a huge wave of consolidation. What is the Aussie doing up here?

AUD managed to scratch its way to a new high water mark vs. the rest of the G-10 currencies over the last month. Then, the Aussie's star finally started to fade a bit shortly after the Fed's QE2 announcement as commodities and risk in general consolidated sharply lower. While AUDUSD was considerably off its highs for the cycle, more broadly speaking, the Aussie was less affected than usual in such a risk averse environment, considering its historically very tight correlation with risk appetite. That was most likely due to the strong focus on the struggling EuroZone debt crisis.

The Aussie also got a bit of a boost over the last month from the RBA, which surprisingly hiked rates another 25 basis points to bring the cash target to 4.75%. While this caused a strong kneejerk reaction higher in the currency, the market only added modest additional policy tightening to the forward curve. The market may be less comfortable now with getting aggressive on projection too much policy tightening because the RBA has

recently admitted that the currency levels are now an important component in its decision making – so the market has a tough time gauging where rates might go and this sets up the proposition of the currency and rates expectations chasing each other's tails in circles. As well, the RBA minutes don't suggest any alarm on inflation prospects from a wage perspective, though the view from the central bank is still strong enough that the market is predicting almost another 50 bps of tightening in the coming 12 months.

We continue to note that strength in the Australian economy is mostly limited to the mining sector. Over the last month, further signs of softening in the Aussie economy were to be found in cooling inflation data, Q3 house price data that showed a complete halt in house price appreciation (so prices are likely falling now – we've been warning of this for months based on sales activity) and very weak building approvals and construction data and a somewhat weak retail sales report.. The only positives were a flat services survey (better than the previous strong decline) and a less bad manufacturing survey for October than the one in September.

Outlook

The strong surge in commodity prices and risk has found an abrupt reversal to the downside in a post-Fed QE2 announcement environment here in mid-November. If this continues for any length of time, it will put the broader Australian dollar rally on very shaky footing indeed at its current, nosebleed levels.

We've tried to call the top in Aussie before, only to get burned. Still, we believe the Australian dollar is significantly overvalued, and that a continued unwinding of the QE-induced speculative bubble in global assets is the likeliest scenario going forward. A key for Australia and its currency in coming months will not only be risk assets in general, but also China, since it is fairly easy to argue that Australia is simply a derivative of the Chinese economy considering the Australia reliance on the resource/mining sector.

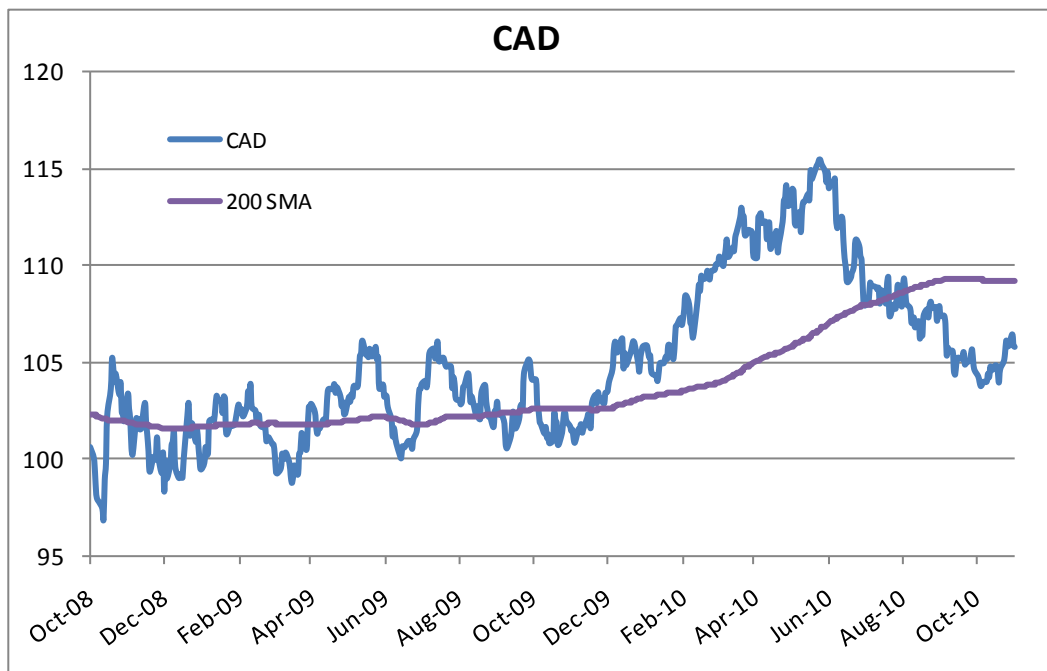
In China, authorities are concerned about recent inflation rates and are cracking down on credit and bank reserve requirements, both to cool inflation and the risks of a housing bubble (too late, actually, but zero cost of carry on Chinese apartments and local officials neck deep in a personal financial interest in keeping the bubble alive will make the price discovery mechanism very tricky indeed). The Chinese regime is also concerned with keeping their economy growing strongly at all costs – but the incredible build-out of infrastructure and overbuilding of apartment blocks may be a thing of the past as China now attempts a dramatic switch from its grotesquely imbalanced economy to a more balanced one with higher domestic consumption with its next five-year plan. This switch may or may not fail immediately, but even if it doesn't, any reduction in demand for Australian commodities exports will leave the mining-dependent Australia economy high and dry. We are already seeing signs that the Chinese authorities' crackdown on the economy is seeing a drastic slowdown in Chinese electricity production – a slowdown that also presaged the slowdown in Chinese GDP in 2008. Is this déjà vu all over again?

Add to this the ready-to-blow Australian housing bubble, which is larger than the US housing bubble was (in terms of price appreciation) and we get a sense that the market has underpriced risks to the Australia economy.

Next RBA Meeting: December 7

Alternative scenario: Risk appetite improves again and the market continues to bid up AUD on projections of infinitely high metals and coal prices and demand from China. That's been the scenario since June.

CAD



CAD has staged a mild comeback relative to the G-10 by mid-November on its proximity to the US economy and the resurgent USD and because it lacks exposure to the vortex created by the fears of a weak EuroZone on the PIGS sovereign debt crisis.

Over the last month, the Canadian dollar has bottomed out vs. the G-10, and has even managed to rally slightly against the rest of the G-10 currencies. Most of its recent strength came on the back of a stabilization of the USD that came a few days after the Fed's QE2 announcement and as most of the European currencies hit the skids on the renewed PIGS debt crisis. So just as the weak US economy and weak USD were seen as dragging the Loonie south in previous months, the greenback's recovery also dragged its satellite economy to the north a bit higher as well.

USDCAD was once again unable to take out the parity level against the US dollar, as the upward spiral in commodity prices and risk reversed sharply just as it appeared that crude oil was headed for a serious breakout higher – teasing markets with the highest spot levels since just after the Lehman bankruptcy.

Besides the risk to the resource side of the Canadian economy if commodities prices continue to correct lower, another risk is an unwinding of the country's housing bubble. The Canadian housing market is where the US housing market was in early 2007 – only fortunately without the amplifying effects of securitization/sub-prime, etc.. Still, a bubble is a bubble, and signs are that we are rapidly transitioning toward deflation of the bubble, though more on the activity side rather than the actual price side so far. Australia seems to be ahead of Canada in progressing towards an unwinding of its housing bubble, perhaps because policy there has been tightened much more drastically over the last 12 months.

An additional sour note for the Canadian currency was struck when the Canadian government decided not to approve the takeover of the world's largest phosphate fertilizer company, Potash, by Australia's BHP Billiton. It was apparently decided that the takeover was "not in the interest of Canada", one can surmise because phosphate is a vital fertilizer for food production and therefore a strategic national asset. Still, this was somewhat

of a surprise for a country that has shown itself to be one of the more open in the world on the M&A front and shows how much protectionist instincts may be taking over here in this new tense era for the global economy.

Finally, we saw further signs that Canadian terms of trade remain headed in the wrong direction.

Outlook

The Canadian dollar is unlikely to trade as a particularly high beta currency as it tends to trade like a low beta version of the US dollar. Looking further afield, CAD appears grievously cheap versus AUD and NZD. Against the former, it is at its weakest levels since 2004 and is very elevated against the kiwi as well. Those reluctant to touch the greenback might consider testing whether AUD is overvalued with AUDCAD shorts. That trade is likely only to bear fruit in a risk averse environment, however, as AUD has been the market's darling in the recent bull cycle.

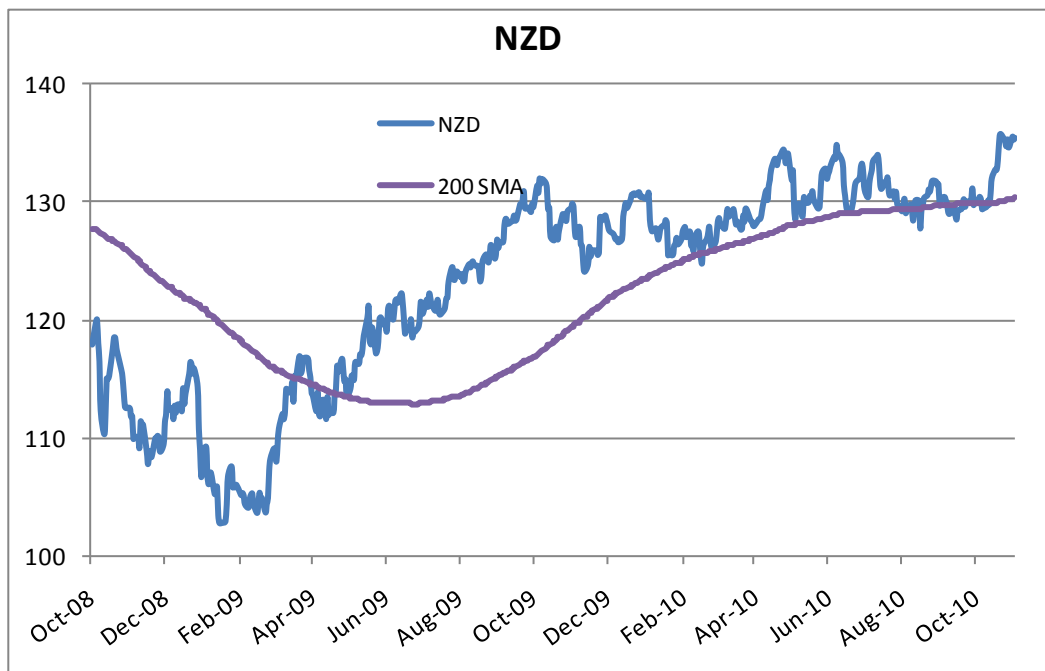
Curiously, the market has priced in a bit more tightening from the Bank of Canada lately, despite little to support that proposition. With core inflation hitting the skids in the US (most recent CPI core reading for October was at an all time low) and also close to a 10-year low in Canada, and with the Fed having moved to QE-land once again, and terms of trade headed in the wrong direction and oil prices now sharply off their recent highs, and USDCAD still close to parity, we think the BoC will be standing pat for some time to come.

Our question going forward is whether USDCAD can ever break out above the range that has defined it for so long between 1.00 and 1.08. We think so, but we'll need to see the whites of the risk bulls' eyes and crude oil prices perhaps below 70 dollars a barrel again to get traction on that view.

Next BoC Meeting: December 7

Alternative scenario: *if commodities and risk make a comeback, USDCAD could surprise and take out parity for a time, particularly if crude oil outperforms.*

NZD



NZD has pulled higher once again versus the broader market on still buoyant expectations for RBNZ rates and the commodities rally has helped boost the currency. But should we really be closing in on an all time high for the currency considering the potential risks out there?

The kiwi was a very strong performer over the last month since our October report, at least partially on its commodities-based economy. Some NZD strength may also be on expectations that the rebuilding activity from the recent earthquake could provide a boost to growth numbers for a few months even as this event was previously considered bearish as it put the RBNZ in a neutral stance for some time to see how the disaster might affect the economy. The currency's recent strength is somewhat at odds with the economic data and even interest rate spreads, which don't suggest much basis for the current pricing of the currency.

The strong kiwi is not particularly helpful for New Zealand's economic prospects, which need higher commodity prices and a lower currency to get the economy rolling again, as the domestic economy is hardly likely to get anything going with its old housing bubble that never got a chance to deflate properly because the global financial crisis came along just in time for the RBNZ to take rates down to such lower levels. Still, house prices are in a persistent, if slowly grinding, downtrend.

Outlook

NZD and AUD look overvalued, but both will require a more persistent correction in risk and perhaps on top of that, signs of a real slowdown in China before any real sell-off can develop. The NZD may act as a kind of lower beta version of the Aussie – the one G-10 currency it is likely to appreciate against if risk appetite/competitive devaluation trades beat a hasty retreat due to the Aussie's poster child status in this market. Against the US currency, on the other hand, the kiwi might be set for a fall if the world ponders the fallout from a global retrenchment in risk appetite as the developed countries risk a double dip in their economies.]

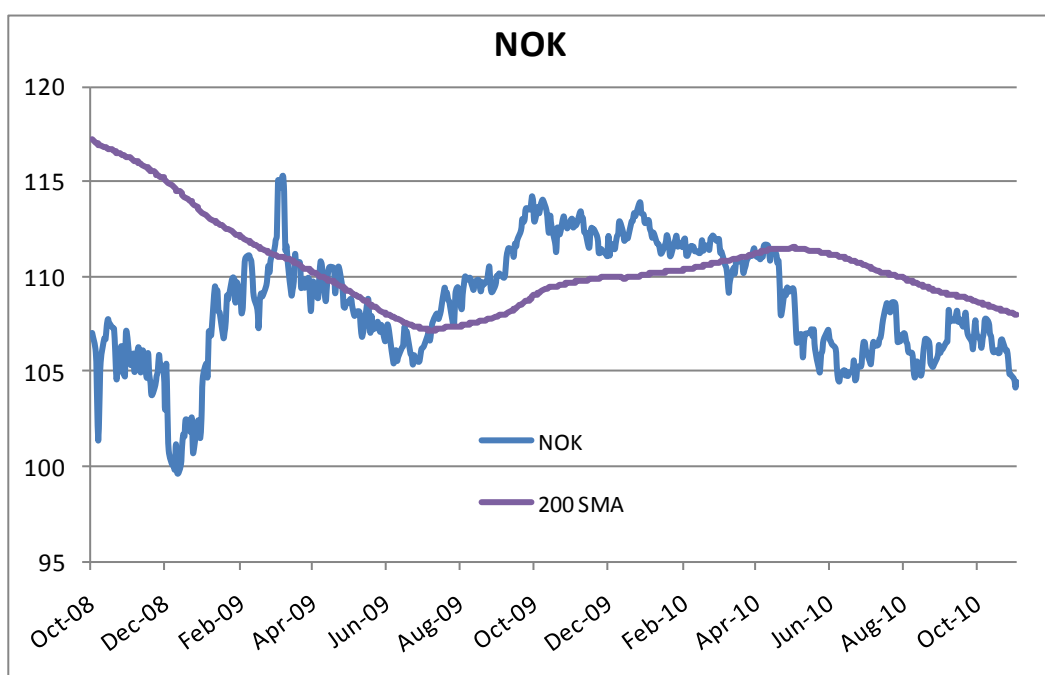
Another force potentially holding the kiwi back from further gains is the RBNZ, which is clearly uncomfortable with the strong currency and complained strongly about its strength preventing a "rebalancing" of the economy back

toward stronger exports. Still, PM Key didn't help the situation much by shrugging his shoulders at the strong currency and suggesting it would probably go higher than 80 cents versus the USD.

Next RBNZ Meeting: December 8

Alternative scenario: the kiwi could be dragged higher still if this environment of ever upward spiralling risk appetite continues. The key test for this trade comes with the US election and FOMC meeting November 2 and 3rd, respectively.

NOK



The Norwegian krone is at its lowest level in a long time as the leadership changes at the helm of the Norges Bank. The forward rate expectations are stagnant and the Norwegian economy has underperformed. Not much focus here, but the currency is getting too cheap.

The Norwegian krone is generally very weak against the rest of the G-10 currencies and is at the weaker end of the recent range against the Euro as well. Since our last report, the Norwegian finance ministry appointed Oeystein Olsen to replace Svein Gjedrem at the helm of the Norges Bank on January 1, 2011. The news is relatively bearish for NOK in that Mr. Olsen has said that the krone's strength will be an important indicator in determining monetary policy. Since Mr. Olsen's appointment, the NOK was generally weaker and interest rate expectations remain very low for the bank. While the consumption side of the Norwegian economy remains rather strong, the market sees little reason for expecting the bank to resume its tightening as housing prices were unchanged in the most recent quarter, inflation looks far from threatening with core inflation close to the lowest level in four years, and the NOK was relatively strong versus the Euro recently (EURNOK was at generally low level below 8.00 for most of August and September). Now, we also have a strong sell-off in crude prices in mid November that seals the deal on the Norges Bank standing pat for some time and has international investors looking elsewhere for interest.

Outlook

The outlook for NOK is not particularly inspiring. Crude oil needs to make a sustainable comeback if we are to get interested in a strong NOK story, and considering our rather dour outlook for the major developed countries, this looks like a low odds proposition. As for the Norges Bank, it is hard to see what will sway its decision making in the medium term, as there is little to get worked up about in the Norwegian economy.

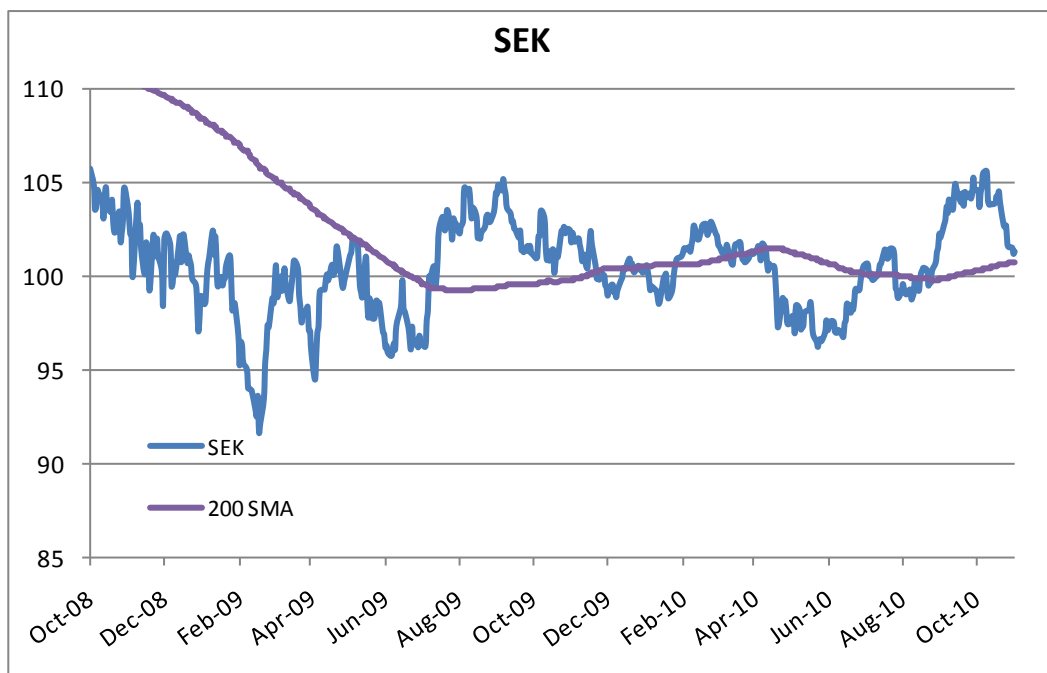
The interesting scenario for NOK is an investment environment in which the market worries about sovereign credit ratings again, in which case NOK has few peers. At the extreme, an out-and-out global sovereign debt crisis could mean that JPY and NOK become the two poles of the G-10 universe - NOK on the strong side and JPY on the weak.

If risk aversion is here to stay for a while sans sovereign debt worries, then the NOK is likely to remain somewhat on the weak side. So while NOK may weaken in the initial phases of a new sell-off in risk, particularly versus the USD, we wouldn't expect for the currency to show quite the high-beta behaviour it exhibited in the financial crisis days since it has fallen to extremely cheap levels since the equity market lows of 2009 versus the more obviously pro-risk currencies like AUD and NZD, levels that will look even cheaper if China sees a hitch in its growth story. In general, long NOK against the overvalued corners of the market is an intriguing value play.

Next Norges Bank Meeting: December 15.

Alternative scenario: consider the NOK upside potential whenever serious sovereign debt worries surface. It is hard to find any scenario that sees NOK falling much further than it has already.

SEK



The krona really turned tail over the last month because of the leveraged exposure of its economy to the EuroZone economies and on the reversal in risk appetite, as the krona tends to be a pro-cyclical currency.

The krona has beat a hasty retreat after pushing to a brief post-Lehman bankruptcy high since our last report. The krona seems to serve as a high beta version of the Euro at times, which makes some sense considering the degree to which its economy is leveraged to exports to Europe and the rest of the world. The krona often generally follows the trajectory of risk appetite as well, and risk suddenly soured in mid-November for several days while the USD made a comeback. That has made USDSEK upside one of the highest beta plays over the last couple of weeks as we almost reached our inferred USDSEK target for the 1-month period since our last publication. (7.05 – the recent high was 7.00 versus approximately 6.65 when we published our October report.)

The SEK upside was clearly overdone recently, just as the speculative move in risk markets in general was also overdone. In general, we are concerned about the economic prospects for the EuroZone going forward, and although Sweden has put in significant efforts to diversify its export destinations, Sweden would never be able to entirely escape fallout from a general Euro area malaise. Sweden's domestic number still appear rather strong and the Riksbank is expected to tighten the policy rate another 50 bps in the coming months, but this situation could quickly reverse in the months ahead as Europe faces strong headwinds.

Outlook

Sweden is one of a handful of G-10 currencies in which the economy is suffering a housing bubble that is soon likely to unwind now that the central bank is removing accommodation. If the major developed countries are all headed for a soft patch or worse, those countries with overheated housing markets could possibly fare worse because of the extra burden on the domestic market that asset bubble unwinds cause (think of the US, which has already been neck deep in the aftermath of its housing bubble for three years).

Still, SEK is starting from a relatively cheap valuation – certainly versus the Euro and it also generally has its fiscal house in order relative to most of the rest of the world. So if we are headed for a bit of turmoil in risk markets, SEK could see a bit more downside, but its valuation would quickly get too cheap if the market decides to take the sell-off too far.

Next Riksbank Meeting: December 15.

Alternative scenario: *a stronger than expected extension in the European economic recovery and/or an initial positive reception to Irish bailout attempts could see SEK charging stronger than we expect in the near term.*

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