

# Forex Weekly

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### ■ G10 FX Editorial

**Policymakers' event risks loom for FX.** Last week's increased risk appetite phase is likely to be short lived. We expect this week's rash of major policy events to once again alert markets to recession and credit crunch risks. Tuesday's Fed minutes offer the first test for risk appetite. This should be followed by what we think will be a rate cutting BOE. The ECB meeting will also be closely watched for signs of a thaw in the hitherto hawkish rhetoric.

### ■ G10 FX Trade Summary

**Risk appetite recovers, but we are still cautious.** Last week's recovery in risk appetite notwithstanding, we hold our current recommendations and position ourselves for further risk aversion and USD weakness. We stay short the "pro-cyclicals" in favour of the low yield and increase short USD risk with a long EUR/USD position targeting 1.61.

### ■ G10 FX Focus

**Will the G7 finally pipe up?** Recent USD resilience notwithstanding, this week's G7 meeting is likely to attract attention with speculation that policymakers may flag official concern over USD weakness. We do not think a change is likely in the official G7 communiqué.

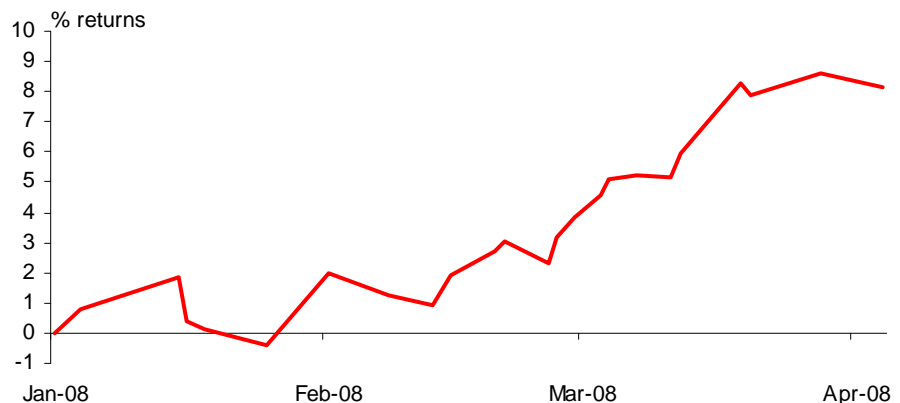
### ■ EM FX Trade Summary

**The recovery in EMFX is suspicious** and we believe that the tightening in global credit conditions will inevitably impact emerging markets in the coming weeks. Risk premiums on emerging assets are already on the rise and further increases likely. As a result we stay short TRY, HUF and RON.

### ■ FX Technical Analysis

**The consolidation of last week's USD decline is probably over.** EUR/USD should challenge 1.59/1.60 in the near future. Our USD/JPY call for a return to the 95.00/75 zone is on hold. Indeed, given the unexpected break above the 101.25/102.00 resistance area, we cannot rule out a rise to 106.60 (or even 108.60) before it re-targets lower.

### SG cumulative FX trading returns since the start of the year



Source: SG Forex Research

Note: This series denotes the cumulative gains from our trade recommendations since January 2008.

## View & Trade summary

### Market Trends and SG Views

	28/03/08	04/04/08	Coming week	Coming month
EUR/USD	1.5759	1.5722	↗	↗
EUR/JPY	157.13	160.36	↘	↘
GBP/USD	1.9890	1.9958	↗	↗
EUR/GBP	0.7923	0.7876	↗	↗
USD/JPY	99.71	102.00	↘	↘
USD/CAD	1.0180	1.0051	↘	→
AUD/USD	0.9186	0.9189	→	→

Source: SG Forex Research

### G10 trade recommendation update

**Risk appetite recovers, but we are still cautious. The improvement in market sentiment** did not bode well for our trade recommendations given that we have been positioned for further risk aversion. Our long exposure to the yen, which has underperformed, has been one factor. Pro-cyclical currencies (AUD, NZD, GBP and USD) have also shined. Last week's recovery in risk appetite notwithstanding, we are comfortable holding our current recommendations given that we expect further bad news. We stay short the "pro-cyclicals" in favour of the low yield and increase short USD risk following last week's drier payroll employment report.

■ **Basket 1. Long JPY, NOK, CHF & CAD (25% each) vs. short AUD, NZD, GBP & USD (25% each).** Performance has been hampered by the recovery in risk sentiment. However, we judge that the "pro-cyclical currencies" are likely to come under pressure. Given the recessionary readings in US data we stick with our bearish USD stance. We also hold short GBP exposure ahead of the BOE meeting this week. Upside surprises in Australia's employment report could boost AUD but we hold short (NZD too) given the increasingly dovish comments from the RBA and commodity market weakness.

■ **Basket 2. Long SEK and NOK (50% each) vs. short AUD, NZD & CAD (33% each).** The Scandic currencies did not perform as well as expected. However, we feel comfortable holding short exposure to the commodity currencies for now. Positive indications regarding the domestic economy (watch this week's industrial output reports) should provide support to NOK and SEK. Although AUD could receive a boost from a positive employment report, the dollar bloc is likely to be vulnerable to further correction in commodity prices.

■ **Hold long EUR/GBP.** We continue to see upside in the EUR/GBP cross. Our bias is to hold short exposure to GBP ahead of the BOE meeting this week given the prospect that the MPC will cut rates and strike a dovish tone. The prospect of further credit tightening (as was evidenced in last week's net lending and consumer credit data) and a slower UK economy is likely to keep GBP on the back foot in relation to the euro. Although eurozone data has started to weaken, the general economic resilience should hold EUR in good stead.

■ **Enter long EUR/USD.** With the USD showing some resilience, EUR/USD is the cross particularly vulnerable to downside risk. However, with long positioning in EUR relatively light, the ECB sticking to the script of containing inflation and a succession of US recession readings (including last Friday's lacklustre payroll employment report), our judgement is that the euro is poised to test new highs. We enter a long EUR/USD position and target 1.61.

### Trade recommendations

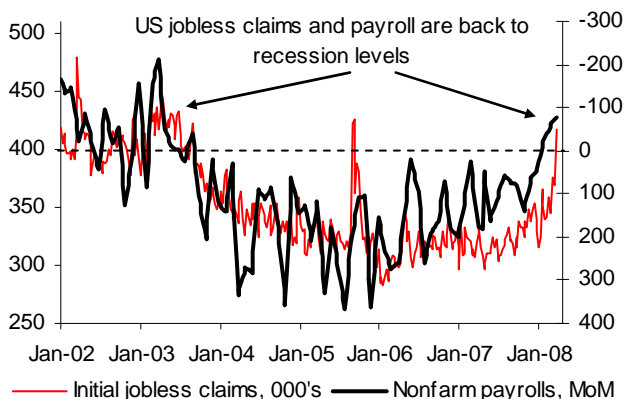
Cross	Position	Date	Entry	Target	Stop	Current	P/L week **	P/L total
<b>New positions this week</b>								
EUR/USD	Long	04-Apr	1.5700	1.6100	1.5500			
<b>Existing positions</b>								
EUR/GBP	Long	28-Mar	0.7923	0.8000	0.7750	0.7942	-0.72%	-0.72%
Basket		28-Mar		3%	-1%		-0.49%	-0.49%
<b>Long JPY, NOK, CHF &amp; CAD (25% each), Short AUD, NZD, GBP &amp; USD (25% each)</b>								
Basket		28-Mar		3%	-1%		0.11%	0.11%
<b>Long SEK, NOK (50% each), Short AUD, NZD, CAD (33% each)</b>								
<b>Positions closed this week</b>								
<b>Total</b>							<b>-1.09%</b>	<b>-1.09%</b>
** since last Friday								

## Policymaker event risks loom for FX

An eerie calm descended on financial markets last week. Bolstered by the global banks' recapitalisation plans, risk aversion turned to risk accumulation and the VIX index sunk as equity prices and US money market rates surged. The FX markets' response was to sell the JPY and CHF rather than the USD. The rest of G10 FX was sandwiched in between, with the GBP and CAD slightly outperforming the rest on M&A flows. But we think that last week's positive risk appetite phase will be short-lived, and we expect that this week's rash of major policymaker events will again alert markets to recession and credit crunch risks. Tuesday's Fed minutes offer the first test for risk appetite, with the markets set to scrutinise the March FOMC minutes for policy-easing clues. The BoE follows with what we think will be a rate-cutting MPC. The ECB meeting too will be closely watched for any signs of a thaw in the hitherto hawkish rhetoric. We stick with our risk-averse trading views for the week ahead (see trade summary) and the only position we add is a long EUR/USD spot position targeting 1.61.

■ **Will the USD downdraft continue? Yes, we think so.** An eerie calm descended on financial markets last week. Bolstered by recapitalisation plans from some major global banks, risk aversion turned to risk accumulation and the VIX index sunk as equity prices and US money market rates surged. All this came despite Fed Chairman Bernanke's acknowledgement that the US could see negative growth in H1 2008. His view was repeated by other FOMC members such as Yellen and Mishkin and was fully supported by bleak US ISM and labour news showing that employment is contracting rapidly (see Graph 1). The currency markets' response was to sell the JPY and CHF rather than the USD. The rest of G10 FX was sandwiched in between, with the GBP and CAD slightly outperforming the rest on M&A flows. But we think that last week's positive risk appetite phase will be short-lived, and the week ahead promises very different pressures and FX performances.

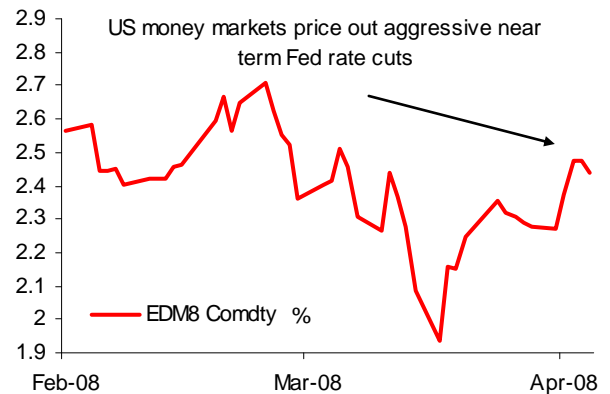
**Graph 1: US labour market is in recession**



Source: SG Forex Research

In contrast to last week's mishmash of month/quarter end-flows, banking recapitalisation news and US payroll climax, the focus will now return with a more secure anchor: monetary policy events. We think these events will again

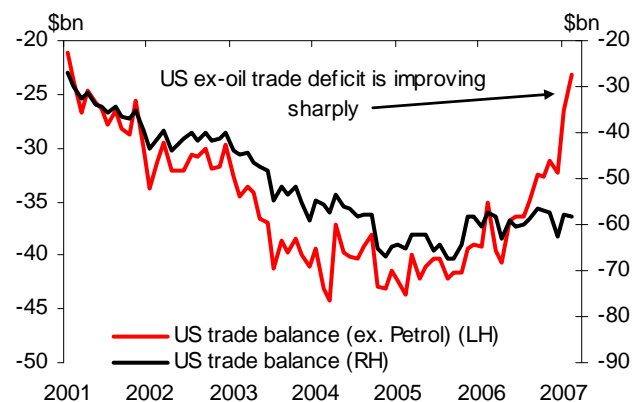
**Graph 2: US money markets price out aggressive easing**



Source: SG Forex Research

alert markets to recession and credit crunch risks. With the BoJ policy meeting unlikely to signal any changes, the Fed minutes from the March FOMC represent the first key policymaker event focus for the FX market. This meeting followed the Bear Stearns crisis and the markets will scrutinise its minutes for policy-easing clues for the 30 April FOMC. Interestingly, during the past week the USD has traded relatively firmly, despite the onslaught of recessionary news from the ISM surveys and the US labour market. Clearly, this move has in part followed the decline in risk aversion driven by the positive equity market response to bank recapitalisation. But the USD recovery also reflects the fact that US money market rates have soared on optimism that liquidity provision may reduce the need for the Fed to conduct further aggressive policy easing. Indeed, while a month ago money markets were pricing in rate cuts below 1.50% by summer, the market has now priced out Fed cuts below 1.85% for the rest of this year. The front end of the money market has also seen rate cut expectations crumble, as 3-month June future rates jumped 50bp from the March nadir (see Graph 2).

**Graph 3: US ex-oil trade imbalances are improving sharply**



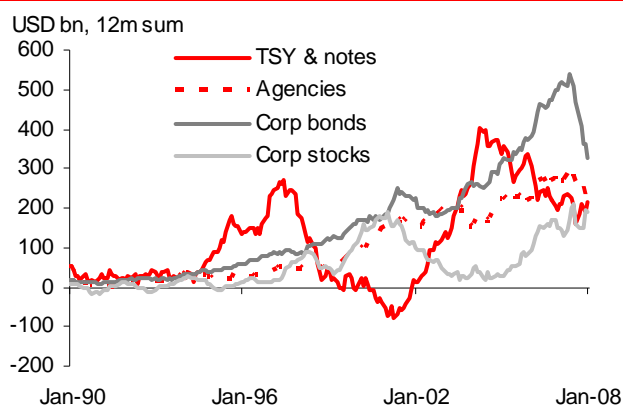
Source: SG Forex Research

We don't share the market view that the Fed is poised to take its foot off the rate-cutting pedal. Instead, we see credit conditions and the darkening growth outlook encouraging 1% Fed funds by summer. We also continue to see the USD weakening along with its relative growth dynamic versus the rest of the G10 into the year-end.

Fixed Income & Forex Research

From a longer-term valuation perspective, one of the few USD bright spots has been the receding of trade imbalances. Although the nominal trade deficit remains wide, the ex-oil balance has shrunk sharply in the past few months (See Graph 3). We think that this signals that any near-term decline in oil prices could lead to an improvement in US terms of trade and encourage a sharp correction in the frustratingly wide nominal trade deficit. Energy prices however remain stubbornly high, and with BRIC growth plus OPEC inertia providing a floor to prices, this medium-term correction could be slow in providing support for the USD. In addition, the scope for recycling of the US current and trade balance deficits by the US capital account is being heavily reduced by a lack of investor confidence in purchasing USD-denominated securities. The most recent TIC data shows an ongoing slide in net demand for US corporate debt, as well as sluggish demand for Treasuries and equities. We think that a meaningful improvement in the USD's fortunes will not come until the US deficit can be fully recycled by capital flows, a process which still seems some way off.

**Graph 4: US trade deficit improvement continues this week**



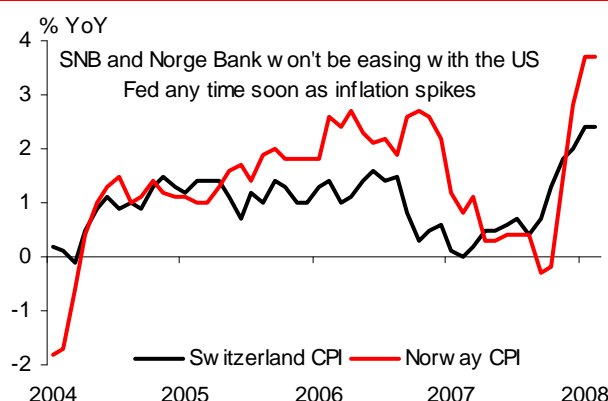
Source: SG Forex Research

■ **GBP storm clouds gather as BoE easing path speeds up to head off credit crunch.** The past week has seen a marked worsening in UK credit conditions. This was initially signalled by the likes of Nationwide hiking rates to cut mortgage demand and HSBC closing its doors to new mortgage borrowing. It was then followed up with the latest BoE credit conditions survey, which suggested that both mortgage and wider credit conditions would be significantly tightened in the months ahead. Last week, MPC member Paul Tucker noted that monetary policy would take account of the worsening liquidity situation. We believe that the UK mortgage market is freezing up fast and with the BoE's own survey showing this up, we now look for the BoE to cut rates this week instead of waiting until May. We already predict a steady series of quarterly rate cuts for the rest of the year and expect UK rates to hit 4.25% by Q1 2009. This backdrop is negative for the GBP, especially against the EUR and JPY, and we advise holding short GBP risk against the EUR and the basket of long JPY, CHF, NOK and CAD that are existing trade recommendations.

■ **Will ECB hawks still hold sway?** The ECB meeting too will be closely watched for any signs of a thaw in the hitherto hawkish rhetoric. There have been pockets of weakness in EU PMI reports and dark credit clouds are

gathering in Spain to push the service sector towards recession. But unlike the dovish policy shift we expect from the BoE, we are not holding our breath for the ECB. The past week has seen further hawkish commentaries from a cluster of senior ECB members and with the rump of EU data still holding up firmly, we believe that the elevated CPI and money supply growth rates, plus still solid labour and export markets will keep Trichet, Weber and co. on the hawkish trail. As a result of this, we favour further EUR upside in the week ahead both against the USD and the GBP. We already hold a long EUR/GBP position which is still targeting a run up through 0.80. We add to this a long EUR/USD trading position targeting 1.61.

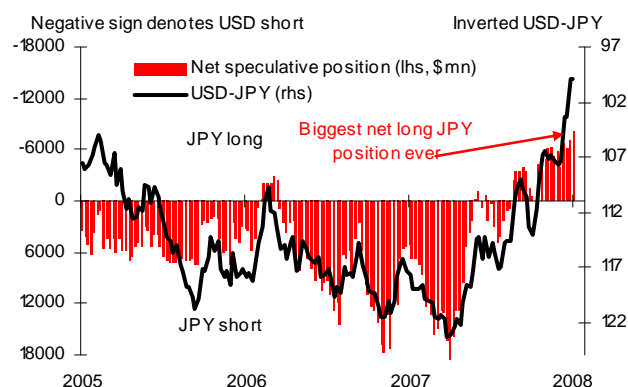
**Graph 5: SNB/ Norges Bank won't be easing any time soon**



Source: SG Forex Research, Bloomberg

**Risk aversion and decoupling bets still complimentary.** We continue to see USD and GBP underperformance as being our main views in the near term; we also remain short AUD and NZD and recommend funding these with longs in CHF, NOK and JPY, in addition to being long SEK and EUR. The latest data rounds for Switzerland and Norway have backed our bullish views, with inflation rates still policymakers' major issues. Meanwhile, the JPY is still a favoured long bet. We think gathering risk aversion flows will push USD/JPY back under 100 in the near term, despite the recent impediments of rising risk appetite and a record nominal net long JPY position on the IMM.

**Graph 6: JPY positioning obstacle is not insurmountable**



Source: SG Forex Research

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## G10 FX Focus<sup>1</sup>

### Will the G7 finally pipe up?

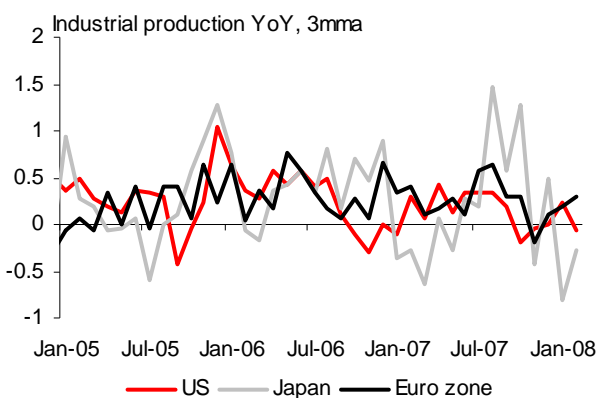
**Recent USD resilience notwithstanding, this week's G7 meeting is likely to attract attention with speculation that policymakers may flag official concern over USD weakness. We do not think a change is likely.**

This week's G7 meeting will be the most interesting for some time now. Though the dollar reversed some of its losses last week, the euro and the yen are at uncomfortably high levels for some policymakers. And, what's more is that some of the euro area and Japanese data are starting to show cracks. A raft of European policy makers – predominantly from France – continue to flag concern. Although European policymakers are likely to voice concern about euro strength at this week's G7 meeting (as is likely to have been the case in the past few), the G7 as a whole is unlikely to change its official stance this week and put a floor under the dollar. We think this, and official intervention by central banks for that matter, is unlikely to materialise for a number of reasons.

#### ■ US growth looks worse than the rest of the G10

Admittedly, the G7 has not spoken up about developments in the G10 FX sphere for some time now. The dollar has now declined significantly since the start of the year – predominantly against the euro and the yen respectively. Although comments calling for official intervention have popped up, there has been no official change of stance save for what has been a hands off approach to the US strong dollar policy – in both the US and Europe. With European growth data (the Ifo survey the most recent example) holding up well and Japan not far behind in terms of its performance (Graph 1), we doubt that the current exchange rate configuration will prompt a shift in the G7 FX policy stance this week.

**Graph 1. Industrial growth trends in the G3**



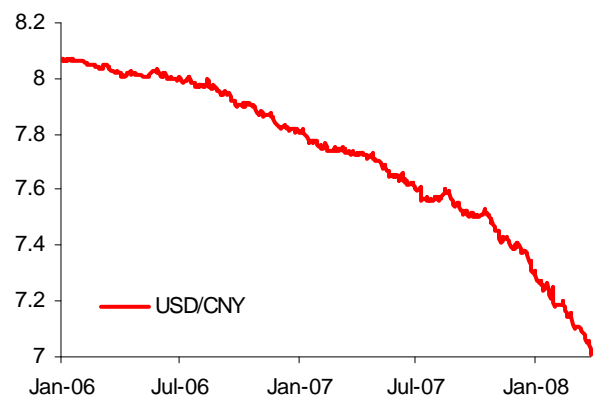
Source: SG Forex Research

<sup>1</sup> This focus article is partly excerpted from the April edition of the SG FX Monthly

#### ■ USD is in a period of natural adjustment

More fundamentally, our suspicion is that absent a disorderly decline in the USD, and one which is a reflection of risk aversion pertaining to US assets, it is likely that policymakers will view the trade-weighted adjustment in USD as part of a (long-awaited and necessary) natural re-balancing in the global economy. One where domestic demand in Europe and Asia fare relatively better than in the US (despite the appreciation of the euro and the yen) and the US rids itself of its unsustainably large current account deficit. If anything, there is still some scope to ratchet up the rhetoric with respect to Renminbi appreciation too, despite its relentless rise (Graph 2).

**Graph 2. The drop in USD/CNY has been pronounced**



Source: SG Forex Research

#### ■ Official intervention now would not necessarily work

Admittedly, FX intervention in support of the USD would not necessarily work at a time when the FOMC is cutting its policy rate and the ECB is not. In this sense, a stubbornly (and excessively) high euro *despite* weaker euro area growth (and an ECB that is easing policy) would be the first prerequisite for official intervention in our view. If anything, the current exchange rate configuration does not seem out of whack with the current macroeconomic or relative monetary policy backdrop. Additionally, with USD sentiment still predominantly negative, it would likely be more difficult for policymakers to “lean against the wind”.

However, something to watch out for would be increased discomfort on the part of the US administration in relation to the weaker dollar. Or indeed, significant concern on the part of the FOMC regarding upside inflation risks from the weaker dollar. In the euro area, with inflation remaining a concern for the governing council (and money and lending growth showing no sign of let-up), it is unlikely that the ECB will concede to coordinated intervention to weaken the euro exchange rate. Were growth to take a turn significantly for the worse, it would be a different story. For now, intervention is likely to be limited to verbal intervention by European politicians and, perhaps, as has been talked about, coordinated action to boost liquidity in the financial system – though we doubt that the latter will be enough to decisively stabilise the USD or risk appetite.

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## FX Trends – Majors

### The uptrend of EUR/USD is all but over

■ **The dollar took only a very quick breath.** Sentiment regarding risk has improved and equity markets tried to stabilise, allowing the dollar to drift up from its recent lows at the beginning of last week. The dollar traded particularly higher against JPY and CHF. It also outperformed the commodity currencies on the back of dropping oil prices. The dollar however gave up all its gains after another very poor NFP.

■ **Stay short on the greenback.** The US economic situation remains worrying. For instance, although the ISM indices stabilised they are still below the level of 50. The initial claims reached the critical area of 400K, corresponding to a potential recession level. Another disappointing NFP on Friday was confirmation that the US 'black hole' scenario is still top on the agenda. The Confidence Index of the University of Michigan should drop this week suggesting that the consumer is now affected. This will fuel Fed rate cut expectations during the FOMC of 30 April. The market fully anticipates a 25bp rate cut and is even considering a 50bp cut. The SG economists expect a 50bp cut. As long as economic indicators do not show signs of long-lasting improvement and risk aversion does not rise further, we will not adopt a bullish stance on the dollar. In addition to the above developments, the US stock markets are still struggling to post a clear trend, which is not good for risk sentiment.

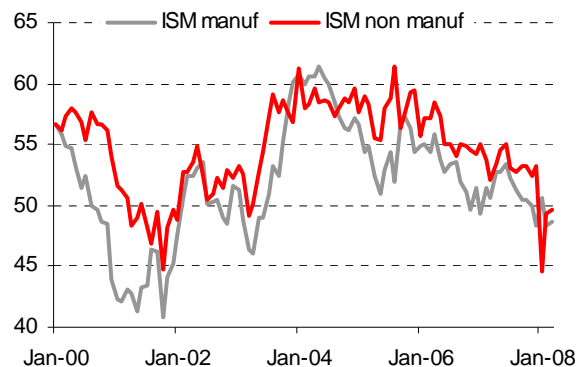
■ **The G7 meeting should not fundamentally influence market developments.** The FX market could be nervous this week as participants will bet on the tone of the G7 *communiqué* this week. A lot of noise for nothing? We do not believe that the tone will be different from last time. Only a disorderly drag on the greenback could encourage international authorities to be more aggressive and even intervene on the FX market. But we are far from it (see previous section).

■ **The euro remains firm.** The euro traded slightly lower against the G10 currencies last week, except for the CAD which nudged lower against all G10 currencies. We remain, however, confident in the bullish outlook for the euro in the short and medium term. The industrial production data in France and Germany could show signs of a slowdown in both economies, which have held up particularly well since the beginning of the year. Above all, market participants will closely watch the ECB meeting (status quo expected), and in particular the press conference of J.C. Trichet. Given the recent results of the confidence indices, the CPI and M3, Trichet is not expected to prepare the markets for a rate cut. The euro should remain firm, particularly against USD and GBP. Note that in terms of positioning, the euro is far from extreme levels.

#### Trade recommendation

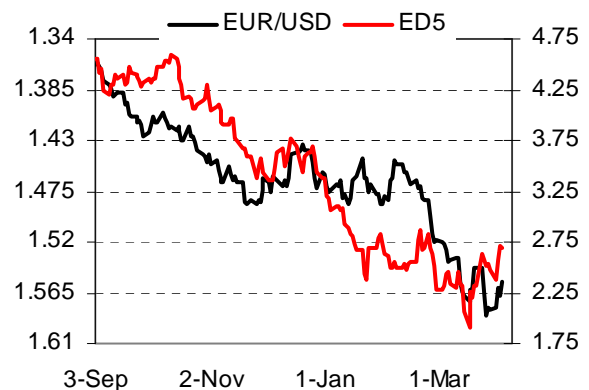
Set up long EUR/USD positions at 1.57, with a target of 1.61 and stops at 1.55

Graph 1. ISM indices



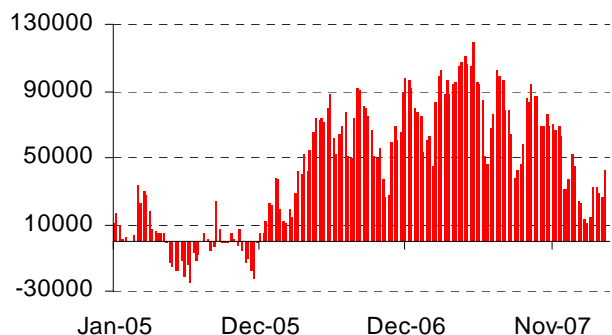
Source: SG Forex Research

Graph 2. EUR/USD and Euribor/Eurodollar spread (5th contract)



Source: SG Forex Research

Graph 3. IMM net speculative positioning in EUR (nber of contracts)



Source: SG Forex Research

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## JPY: mixed fortunes of late

The yen seems to have suffered mixed fortunes of late. This is largely due to the recovery in risk appetite which has followed bank recapitalisation and to policy moves by the US treasury and Federal Reserve to support the US financial system and housing market. We do not think that the worst is over yet and expect credit tightening to fuel both a continued slowdown in the global economy and further bouts of risk aversion. Although our long yen exposure has meant our trade recommendations have suffered, we think it likely that the yen will outperform in the near term.

### ■ BOJ rate decision unlikely to be a big mover

Admittedly with market sentiment rather than country-specific factors the dominant factor behind the yen's performance, data flow continues to take a back seat. The weaker-than-expected indications revealed in the Tankan report suggest that downside risks to the outlook (particularly for investment spending) are ever-present in the Japanese economy. The BOJ could very well take on a more dovish tone at its meeting this week. Should this be the case, or if there were any downgrade to its growth outlook, the yen could weaken further if risk appetite continues to improve next week. However, our underlying expectation is that the yen will strengthen to year-end.

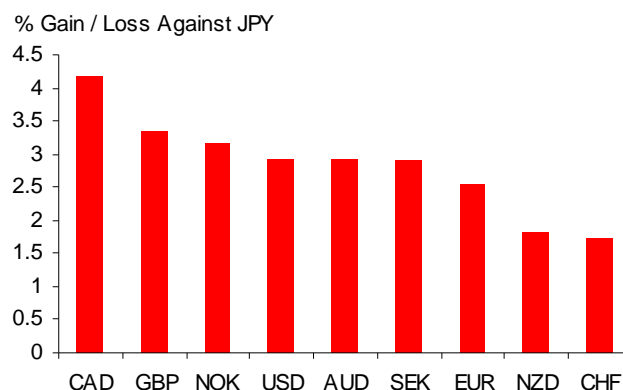
### ■ Will record longs in JPY be unwound?

If positioning data are anything to go by, positive sentiment towards the Japanese yen continues to build in the speculative community. As we mention in the recently-released *FX Monthly*, it has reached a four-year high (Graph 2). The positioning data reflect that from a market perspective, the yen has continued to benefit from the generalised environment of adverse risk conditions and heightened volatility. Our risk indicator in the G10 FX scorecard remains in triple negative territory. Of interest in the coming week will be whether – and to what extent – JPY longs are reduced if risk appetite improves this week. With the G7 unlikely to voice concern regarding USD weakness and risk appetite unlikely to hold its ground given the likelihood of bad news, we stay long JPY.

### ■ Don't forget valuation...

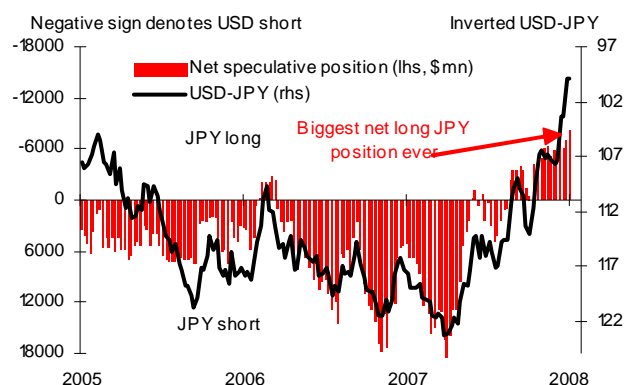
The yen's strengthening in the past month has eliminated a lot of our models' "undervaluation gaps", with valuation signals turning into negative territory. However, Japan's larger-than-sustainable current account surplus (and larger than is justified by the capital outflow from the economy) still points to an undervaluation - see our SGEER estimates in Graph 3. A key caveat to this "undervaluation" gap is that Japan's high frequency capital flow dynamics continue to indicate an appetite for foreign (rather than Japanese) assets – and demand for foreign equities has accelerated significantly in 2008 compared to past years. A further shift towards foreign rather than domestic assets is a risk for JPY, given that it suggests Japan's undervaluation gap will persist for some time - or, worse, that the equilibrium "anchor" for USD/JPY could start to trend higher.

Graph 1: The yen has underperformed of late



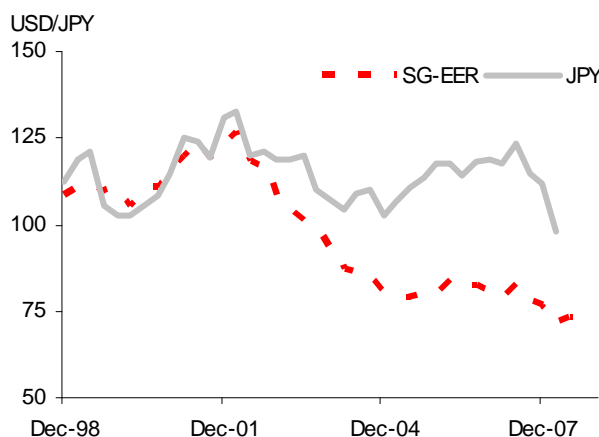
Source: SG Forex Research

Graph 2: 4-year high in long JPY speculative positioning



Source: SG Forex Research

Graph 3: SGEER estimates for USD/JPY



Source: SG Forex Research

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## Other majors

<b>USD/CHF</b>	<b>1 week trend</b> ↘	<b>1 month trend</b> ↘
<b>EUR/CHF</b>	<b>1 week trend</b> ↘	<b>1 month trend</b> ↘
<b>CHF correction will be short-lived. Stay long.</b>	<p>Last week, the CHF was down almost across the board due to slightly higher risk appetite. Only NZD and JPY posted larger underperformances against USD. However, we do not believe market optimism will last as both the US economy and financial markets remain in difficulty. So risk aversion will pick up again as will the performance of anti-carry trades. All in all, we remain bullish CHF. Swiss indicators will remain in the background this week, especially as only the unemployment rate is on the economic agenda (expected to remain stable at 2.5% sa).</p> <p><b>Recommendation : Stay long JPY, CHF, NOK and CAD (25% each) vs. short AUD, NZD, GBP &amp; USD (25% each)</b></p>	
<b>GBP/USD</b>	<b>1 week trend</b> ↗	<b>1 month trend</b> ↗
<b>We stay short GBP ahead of BOE decision</b>	<p>Sterling continues on its general downward trend both against the dollar and the euro. Although it showed some resilience of late – owing in part to patches of strength in the UK data – we judge that it will continue to remain under pressure. With the chances of an April rate cut gaining momentum (our economists have brought forward their expectation of a rate cut and now expect the BOE to cut this week) GBP's performance will be hampered. And, on the activity front, the manufacturing and industrial output figures will give an indication about how the UK economy fared in the first quarter.</p> <p>Trading-wise, our preference is to stay short GBP in both our 4X4 basket and against the euro. The deteriorating cyclical dynamic as well as the prospect of further easing by the BOE will mean the GBP underperforms within the G10. And, as we have highlighted in the past, the deteriorating current account deficit is unlikely to hold it in good stead during times of risk aversion. Upcoming February trade balance figures will also be of interest in this respect.</p> <p><b>Recommendation: We stay short in our 4X4 Basket and against the euro</b></p>	
<b>USD/CAD</b>	<b>1 week trend</b> ↘	<b>1 month trend</b> →
<b>The CAD has clocked up gains</b>	<p>The Canadian dollar has clocked up gains relative to the rest of the G10 in the past week. Admittedly, CAD is relatively more exposed to a downturn in the US economy. And, in terms of its own monetary policy dynamic, according to comments made by the BOC's Jenkins risks surrounding the Canadian economy are still skewed to the downside and further monetary stimulus is likely to be required in near term. The scope for further cuts in the policy rate is a downside risk for the CAD (watch the Bank of Canada meeting on 22 April). We stay short in our long Scandies basket. However, we think that it is more likely than not that the strength in domestic demand could trigger a shift of monetary policy stance by the BOC which would lend support to CAD when compared to the USD in particular.</p> <p><b>Recommendation: We stay short in our long Scandies basket but long in our 4x4 basket</b></p>	
<b>AUD/USD</b>	<b>1 week trend</b> →	<b>1 month trend</b> →
<b>As anticipated, the RBA finally recognises the risks associated with the situation in the financial sector</b>	<p>The AUD has been trading within a range for two weeks now. This trend may last for some time as many key drivers deliver contradictory messages. Overall, we recommend staying neutral or negative because the positioning makes the currency vulnerable to the current global uncertainty. Like the NZD, the Australian dollar suffers from a drop in commodity prices and from uncertainties weighing on the domestic financial sector. In contrast, the bounce-back of the equity markets brought some respite. Last week's figures did not bring anything new and the RBA decided to leave its rates unchanged at 7.25%. The RBA was remarkably less <i>hawkish</i> than previously. Indeed, we have been underlining for several weeks (see our FX Weekly as of 10 March) that the deterioration of funding conditions would weigh on the availability of credit in the economy. Finally, the RBA decided to take into account this situation. The minutes were clear: "The Australian financial intermediaries are experiencing increases in funding costs, which are being passed on to borrowers." Moreover, the minutes state that "some tightening in credit</p>	

standards for more risky borrowers is occurring". Globally, "the overall tightening in financial conditions since the middle of 2007 has been substantial". We believe that this theme will continue to weigh on the AUD even if there is a more pronounced rebound in equity markets. Closely watch the job report to be published on Thursday.

**NZD/USD**

**1 week trend** →

**1 month trend** ↗

**We advise remaining bearish (or neutral) in the short term**

**The main risk to our view would be a sharp recovery on stock markets**

The NZD is increasingly faced with conflicting forces. While it could benefit from improved market sentiment following the attempt of global equity recovery, the NZD is still structurally weakened by domestic financial concerns and the sharp sell-off on commodity markets. So, we advise keeping a bearish to neutral bias in the short term.

Two key figures were released last week in New Zealand. First, the NBNZ's business confidence index for March plunged from -43.9 to -57.9, a record low since February 2006. Second, M3 money supply growth fell to a low since July 2005, at +6.0% y/y (a peak was reached at +16.6% y/y in December 2006). Therefore, last week's figures were poor overall and pointed to slower growth.

The NZD is handicapped by weakness in its financial sector as it threatens the funding of its large current account deficit. Last week, S&P maintained its ratings on the financial sector but said that local market conditions and global uncertainty did put a downside risk on them.

The sharp sell-off on global commodity markets is also very bad news for the NZD. Grain prices fell the most with wheat down 31% between March 11 and April 1st before recovering slightly.

All those factors are clearly NZD-negative but, if the equity recovery continues, the improved market sentiment will limit the currency's downside.

**EUR/NOK**

**1 week trend** ↘

**1 month trend** ↘

**Stay long NOK**

The NOK eventually resumed its uptrend late last week thanks to renewed risk appetite, stronger-than-expected retail sales and, above all, a stabilisation in oil prices.

We remain bullish NOK as it should benefit from stronger manufacturing production figures this week. However, a slightly lower CPI may weigh on the currency, with the headline index for March expected down to 3.5% from 3.7% and the core figure to 2.1% from 2.2%. However, this will not challenge the ongoing monetary tightening cycle and oil prices will eventually pick up again, supporting the NOK. SG commodity analysts see the WTI contract back at 107.50 USD/b in late Q2.

**EUR/SEK**

**1 week trend** →

**1 month trend** ↘

**Stay long SEK but watch out for renewed equity weakness in the short term**

The SEK recovered last week, showing that stock markets remain a significant driver for the currency. While the publication of improved manufacturing and household confidence figures may have contributed to the rise, we believe it has more to do with lower risk aversion.

We remain bullish SEK overall. Caution is advised, as the Swedish Finance minister said last week that growth risks were to the downside, but we believe the Riksbank remains concerned by price pressures and will hike rates further. This should be confirmed this week by stronger industrial production and, above all, a lower AMV unemployment rate.

The SEK should resume its uptrend in the coming weeks, although this move could be delayed by revived equity weakness.

**Recommendation: stay long SEK and NOK (50% each) vs. short AUD, NZD & CAD (33% each)**

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## FX Trends - Emerging

### A rate hike to counter rising “second round” effects

■ **The South African central bank meets next week.** Contrary to the last meeting when the MPC voted unanimously to keep the repo rate at 11.00%, the outcome this time is more uncertain. The SARB is facing an extremely difficult decision with on one side weakening economic growth and on the other an inflation rate running persistently above target. However, the balance of risks is skewed towards the inflation side and the SARB will have no choice but to raise rates by 50bp next Thursday.

**The economy is slowing down.** Despite unexpectedly strong GDP growth in Q4 2007, there is no doubt that the economy has entered a significant deceleration phase. The manufacturing output posted an increase of only 1.4% y/y in January and the leading business confidence survey does not point to an improvement anytime soon. On the household front, demand is extremely weak. Retail sales in volume terms contracted -0.2% y/y in January. And, according to association of auto manufacturers, car sales posted their biggest drop in six years in March (-17.5% y/y). Even if the pace remains high, credit growth seems to have started a lasting downward move. In February, credit to the private sector slowed to 20.8% y/y from 23.1% in January suggesting weaker domestic demand in the coming quarters.

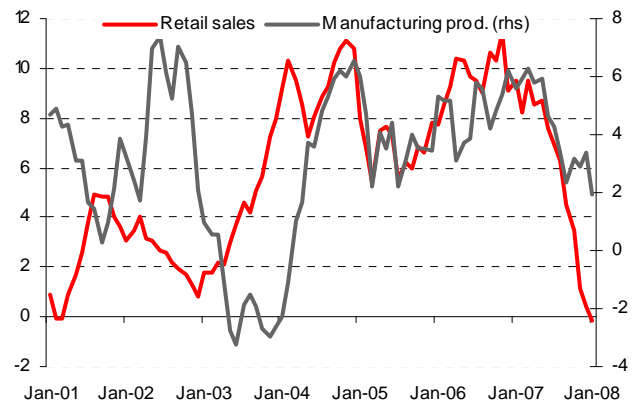
**Appearance of “second round” effects.** The deterioration in economic prospects still presents a lower risk to that posed by the deteriorating inflationary picture. The CPIX has been running above the tolerance range of 3-6% for almost a year now. If the initial surge in inflation stems from energy & food prices, the SARB notes that signs of second round effects have appeared. In other words, the steep rise in food & energy prices has started to contaminate a larger range of good & services. The price setting behaviour is changing and with it inflation expectations are moving higher.

**A rate hike to protect the ZAR.** The situation on the FX front is also a reason for the SARB to raise rates. The weakness of the currency is not only a source of imported inflationary pressures but also of potential instability given the high level of the current account deficit. The need to be competitive to capture capital flows in the current global environment is extremely important. South Africa is very dependent on portfolio flows and higher rates are one of the tools to attract them. The SARB will be tempted to raise rates because of the FX issue. The reaction of the ZAR will largely depend on market sentiment next week. A positive reaction is possible, as the market does not fully price a rate hike.

#### Recommendations

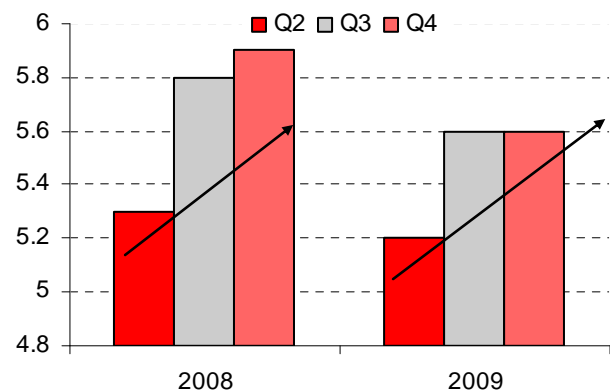
We have decided to close our long USD/ZAR position and will open a short one ahead of the MPC meeting. This position is purely tactical and event-driven as directionally we still expect a lower ZAR in the coming weeks. The combination of weak growth, high inflation, large financing needs and tensions in credit markets are not ZAR-positive. We are still seeing USD/ZAR going to the 8.30-35 area.

**Graph 1 Economic growth is decelerating (y/y, 3-mth mav)**



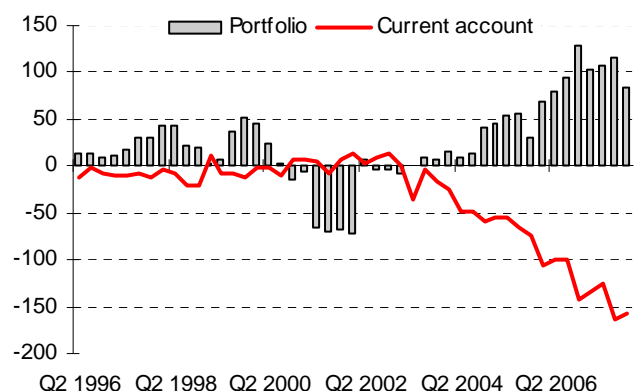
Source: SG Forex Research, Bloomberg

**Graph 2 Inflation expectations (quarterly survey)**



Source: SG Forex Research, Datastream

**Graph 3. High dependence on portfolio flows**



Source: SG Forex Research

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## Other Emerging Currencies

### EUR/PLN

1 week trend →

1 month trend ↘

EUR/PLN broke through 3.50 this week and almost reached 3.47, its strongest performance since January 2002. The PLN was supported by the comeback of risk appetite on global markets and by prospects of further monetary tightening in coming months. Indeed, comments made by central bank's MPC members since last week's decision to raise rates by 25bp have been mostly hawkish. One member is even pushing for another hike as soon as this month to avoid inflation expectations trending upward. Another tightening move at the end of the month, or in May, is not a done deal though. The MPC may want to wait for the next Inflation Report in June before acting. The release of March CPI and wage growth data on 15 April will provide more clues about the timing of the next rate move. Another significant factor will be the evolution of EUR/PLN, as the current downward trend contributes to the tightening in monetary conditions. To this extent, the Finance Ministry appeared rather at ease with the zloty's strengthening, saying that Polish exporters were so far coping well with the stronger currency.

In this context, our target on EUR/PLN remains 3.45, and we stay long PLN/HUF with a target at 76.00.

### EUR/HUF

1 week trend ↗

1 month trend ↗

The central bank opted for an aggressive tightening of monetary policy last week. The NBH raised its base rate by 50bp to 8.50% in order to avoid "second round" effects, notably via acceleration in wage growth. Persistently high levels of inflation continue to bother the monetary authorities and another 50bp rate hike may be necessary by the end of the month. FX market sentiment will again be decisive during the next MPC meeting on 28 April. The HUF has gained ground in recent sessions, but the rate increase only played a minor role in the EUR/HUF move from a 260-261 range to 256-257. This decline reflected a more general trend as resurgent risk appetite helped many emerging currencies to bounce back. Those offering high yields, such as the HUF, performed very well in this type of environment, as usual.

We do not believe that the decline in the EUR/HUF cross last week is a sign of a sustainable trend reversal. Indeed, rate hikes are not a factor protecting the currency in the current context, characterised by a global tightening of credit conditions. Moreover, the macroeconomic situation remains HUF-unfriendly with a flat GDP growth and high inflation levels (i.e. stagflation). The deteriorating political situation is another negative factor. The end of the coalition between the Socialist party and the Free Democrats is expected to lead to a minority government led by the socialists and by a prime minister politically weakened. Structural reforms will probably be put on hold until the next legislative elections planned for 2010. This political inertia could lead to a deterioration of the financial budget in the coming quarters.

To be released this week: The CPI for the month of March which will be important for the market. The inflation rate is expected to be stable at 6.9%. However, a higher-than-expected rise will be negative for the HUF.

**Recommendation: stay long EUR/HUF with a target at 269.**

### EUR/RON

1 week trend ↗

1 month trend ↗

The economic agenda will be busy in Romania next week, with March CPI, February net wages, industry output and retail sales due for release. Activity was strong in Q4 and there have been no significant signs of a slowdown so far in Q1. Industrial output growth accelerated in January after having slowed since last summer and, business confidence is holding up well, especially in the retail trade and construction sectors. Retail sales growth has been solid (+16.6% y/y in January) and though consumer confidence has been trending down since last summer, household consumption should remain supported by high wage and credit growth.

February net wage growth, due on April 11, will be the most important data of the week. It surged by 30.7% y/y in January and is a key factor in the central bank's monetary policy decisions. The statement released after the 50bp rate hike on 26 March highlighted the NBR's concern over the outlook for wages and inflation. The central bank is also on alert about the expansion of credit to households, which has been accelerating since the summer, especially credit denominated in foreign currencies. The more the central bank is

raising interest rates, the more households turn to foreign currency borrowing to benefit from better financing conditions. Housing loans in EUR rose by 67% y/y at the end of 2007, while those denominated in leu were up only 27% y/y. Foreign currency loans make up half of total loans to households (the bulk of it being in EUR with about 8% in CHF or JPY). Regulatory measures aimed at limiting this trend have proved ineffective so far.

Price data are still on the upside, with this week's February PPI up by 14.5% y/y after 13.0% in January. March CPI is expected to reach 8.4% y/y, up from 8.0% in February. The central bank's latest statement left the door open for another 50bp rate hike at the next NBR meeting on 6 May. Strong data next week would support such a decision. However, this should not help the RON in our view, as global market conditions are adverse for countries with large current account deficits and dependence on foreign financing. We thus keep our long EUR/RON position with a target of 3.82.

**USD/TRY**

**1 week trend** ↗

**1 month trend** ↗

USD/TRY and EUR/TRY have plunged from the very high levels reached at the end of March. These corrections are due to revived risk appetite in the markets and constitute, in our view, good opportunities to rebuild long positions. After having closed our long USD/TRY position - when the cross flirted with the 1.35 level - we took advantage of the bearish phase. We did this by reinitiating long positions ahead of the CPI data being published. The current levels of USD/TRY and EUR/TRY are still attractive and more upward moves are likely.

**The plunge of the USD/TRY & EUR/TRY offers great buying opportunities**

The international context remains fundamentally adverse and revived risk appetite last week was, in our view, a brief respite. On the domestic front, the situation deteriorates. The political outlook remains tense and a long period of uncertainty has started since the constitutional court accepted a prosecutor's request to open a case against the party in power. The AKP is accused of threatening the secular regime in Turkey. On the economic front, the rising inflation trend becomes a major factor of worry. Contrary to market expectations, inflation did not drop in March. Instead, it slightly rose to 9.2% y/y. More importantly, the components of the CPI (excluding energy and food) show signs of tensions, suggesting possible "second round" effects. The deterioration of inflation is not favourable in the current environment in which risk premia of emerging countries are heading up. The downgrade of S&P last week illustrates the risks weighing on Turkish assets. The TRY is in the front line. We thus remain short.

**Recommendation: stay long USD/TRY and EUR/TRY, targets at 1.3460 and 2.1230.**

**USD/CNY**

**1 week view** →

**1 month view** →↘

Official fixing rates for USD/CNY have been kept flat during the last week, with spot indicated just above 7.00. That level is considered a psychological barrier and may take some effort to be conclusively broken. When spot traded toward 8.00 in early April 2006, it was another month before spot traded under 8.00 and a further six weeks before that level was clearly broken. The Chinese monetary authorities' engineering of a stronger CNY has moved on since early-mid 2006. Still, we believe there is an ongoing desire to introduce two-way market risk at regular intervals. Thus, the current approach to 7.00 might be an appropriate time for that to be introduced.

As spot has traded lower since mid-March from 7.10 to just above 7.00, the non-deliverable forwards markets have traded sideways. In part this reflects expectations that the recent accelerated pace of CNY appreciation might pause, even if only temporarily.

We maintain our spread trade, short the 6-month and long the 12-month USD/CNY NDF, on the basis that pricing for ongoing appreciation was too aggressive (we expect a faster pace now and a more moderate one later). The trade was entered at 0.27 or 3.8% and we target a move to 2.0% with a stop loss at 4.5%.

**Short 6-month USD/CNY NDF at 6.8200, long 12-month NDF at 6.5500 (spread entered at -0.27, last -0.31)**

**USD/TWD**

**1 week view** →↘

**1 month view** ↘

The TWD remains a big outperformer amongst Asian currencies year-to-date having gained 6.7% against the USD. As we previously noted, part of its strength is attributable to a reversal of previous underperformance. But a great deal of the improvement has to do with strong economic fundamentals versus its regional peers, plus refreshed demand from investors for Taiwanese assets following the victory of the Nationalist Party in the 22 March

presidential election.

Most regional equity indices are in deep negative territory for the year and of the major markets, only Taiwan shows a net inflow from foreign investors. The Taiwan Taiex is also the only market in positive territory so far this year. Value will undoubtedly be found across the region in months to come, but we are not confident that the best buying is going to be during the next weeks. To be sure, economic data across the region remains resilient so far, but ongoing softness in US consumer demand is yet to filter through and we expect this to have a more significant impact than initially expected. It may not be too exciting, but caution needs to remain the watchword regarding Asia at the present time. Even if the global economy was to make a turn for the better, or if investors were to begin pricing beyond the eventual low point of global economic growth, being a few days or a couple of weeks late in re-setting a full complement of trades could still be too early.

For the last few months we have been interested in holding or building long north versus short Asia trades and long of TWD/SGD is favoured on the back of relative outperformance of the Taiwan market and economy vis-à-vis Singapore. The Singapore economy retains a greater leverage to the US and global consumer demand than Taiwan. The development of the financial services sector in Singapore during the last years also leaves the Singaporean economy at a disadvantage, especially if reports from major financial institutions that are detailing net outflows from asset management during Q1 precedes slowing returns from the sector in 2008.

**Long TWD/SGD from 4.56, target 4.70, stop loss 4.52.**

**Closed long USD/SGD from 1.3815 at 1.3790 stop loss.**

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**USD/KRW**

**1 week view →↗**

**1 month view →**

South Korean trade data for March released last week was stronger than expected but not sufficiently so to prevent the trade account recording its fourth consecutive monthly deficit. Exports expanded 19.1% and imports 25.9% yoy, producing a deficit of \$668m. The resilience of exports is encouraging, though the impact of high oil prices continues to dominate the import side of the ledger. Recent weakening of the KRW can aid the export account but will not help imports when oil payments are denominated in USD.

KRW underperformance since early March has not only been due to the trade account but was also driven by offshore borrowers' capitulation on JPY exposure. The blowout in USD/KRW to above 1030 and in JPY/KRW to 1075 probably marks some near term peaks for both pairs, though we are not yet confident of an early return to strength against the USD or JPY. However, upon some moderation or stabilisation in the oil price and coupled with ongoing resilience of the export sector, we anticipate there will be opportunities to add relative value long positions in KRW against south Asian currencies during the next quarter.

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## Technical analysis

► **EUR/USD** should challenge 1.59/1.60 in the near future.

The recovery initiated near the 1.5525/50 support area (\*) last Thursday suggests that the consolidation of the recent rally from the 1.5345 Fibonacci retracement is probably over. We therefore expect EUR/USD to challenge the 1.5895/1.6000 resistance area again in the near future.

Once this resistance zone is broken, the 1.6245 Fibonacci projection should be the main step on the way to the LT rising channel (underside of our LT target), coming at 1.6360 in April (+0.0067/month).

(\*) 3rd Fibonacci retracement of the rally from 1.5345 to 1.5895.

### EUR/USD: Consolidation of ST rally from 1.5345 probably over



3 <sup>rd</sup> support	2 <sup>nd</sup> support	1 <sup>st</sup> support	Last	1 <sup>st</sup> resistance	2 <sup>nd</sup> resistance	3 <sup>rd</sup> resistance
1.5145/70	1.5345	1.5525	1.5710	1.5895/1.6000	1.6160	1.6245

### EUR/JPY: MT outlook bullish

► **EUR/JPY** - 161.35 is the next major step on the way back to last year's highs at 167.70/168.95.

The upside breakout of the declining channel within which EUR/JPY had been moving since October 2007 means the downward consolidation initiated at 167.70 is over. We therefore expect EUR/JPY to break above the key resistance level at 161.35 (\*) and return to the 167.70/168.95 zone in the coming weeks.

In the meantime we cannot rule out an ST corrective setback towards the upper channel line, which should now act as a support line and comes at 1.5790 this week (-0.0059/week).

(\*) Neckline of the potential double bottom drawn at 151.85/152.10.



3 <sup>rd</sup> support	2 <sup>nd</sup> support	1 <sup>st</sup> support	Last	1 <sup>st</sup> resistance	2 <sup>nd</sup> resistance	3 <sup>rd</sup> resistance
156.05	157.90	159.10	160.85	161.35	164.05	166.65

## Short Rates

### United States

■ **Bernanke's Testimony basically suggests that future policy will be data dependent.** Looking into the details, the Fed Chairman did not include a key dovish statement from the directive: *"The Committee will act in a timely manner as needed to promote sustainable economic growth and price stability."* This suggests that the stabilisation we have witnessed in financial markets since March 17 allows the Fed to switch from risk management to standard monetary policy. What this means is that **the next move will most likely be smaller than 75bp**, which should come as no surprise given the fed funds target rate already stands at a low 2.25%. By most likely we mean barring another Bear-type accident. To this end, Bernanke confirmed last week that Bear Stearn's capital situation was in line with regulatory requirements, but its liquidity situation worsened dramatically and rapidly. In essence, this confirms that the Primary Dealer Credit Facility was created to avoid that another Dealer with a fundamentally sound situation (from a regulatory capital perspective) is brought to default by a market run on the institution. **With readily access to the Fed's liquidity, a collapse of another Broker/Dealer near-term thus appears almost impossible now to the extent it seems still relatively easy to attract capital.**

**To the extent risks to growth still lie on the downside according to the Fed's chief, rate cuts remain more likely than not down the road.** Moreover, Bernanke admitted growth could be negative over H1 (not only Q1), which suggests that **cuts all over Q2 are also more likely than not.** As we indeed pointed out last week, the recession is just beginning to show up in the data, so this is too soon for the Fed to switch to wait-and-see mode. Back in 2001, the Fed continued to ease policy at a rapid pace well after the first recession signals were sent.

**Table 1. OIS-implied fed funds target rate on FOMC dates**

FOMC date	OIS pricing (%)	Exp. cuts(-)/hike(+)
30-Apr-08	1.958	-29.2
25-Jun-08	1.888	-7.0
05-Aug-08	1.870	-1.7
16-Sep-08	1.911	4.1
29-Oct-08	1.955	4.4
16-Dec-08	2.001	4.7
28-Jan-09	2.051	5.0
17-Mar-09	2.171	11.9
06-May-09	2.292	12.1
24-Jun-09	2.415	12.3
04-Aug-09	2.538	12.3
22-Sep-09	2.661	12.3
29-Oct-09	2.790	13.0
16-Dec-09	2.929	13.9

Source: SG Fixed Income Research

To sum up, further policy easing is a near-certainty on April 30, but it is unclear whether it will be 25bp or 50bp. Similarly, it would be unwise to rule out a cut on June 25. However, the market has now come to the conclusion that it will be 25bp and done (see Table 1), and hence appears to be thinking that we're nearing the second leg of the V. We're not there yet in our opinion. So directional risks are strongly asymmetric (tilted on the upside bondwise)

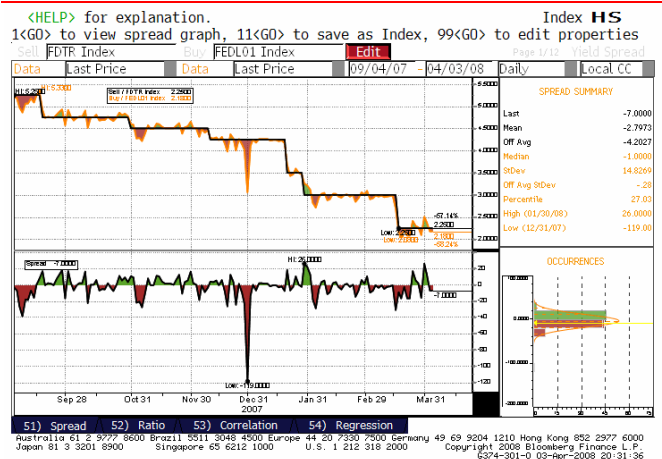
**Table 2. Binary-implied probabilities on FOMC dates**

	1.00	1.25	1.50	1.75	2.00	2.25	2.50
FOMC Date							
30-Apr	0.0%	0.0%	0.0%	15.4%	70.4%	14.2%	0.0%

Source: SG Fixed Income Research

**As we rule out a status quo at the April 30 FOMC, we see the May Fed Funds Futures at 1.95% in rates as a free option to play a 50bp cut.** Indeed, binary options imply a probability weighted outcome for April 30 at exactly 25bp (see Table 2). So Fed Funds Futures currently price a negative 5bp average miss on the fed funds effective rate relative to its target, which is quite large since the latter has come out only 2bp lower than target on average since the start of the year – 2.8bp lower than target since Sep. 07. Assuming a -3bp average miss and a 50bp cut on April 30, the May Fed Funds Future contract would fix at 98.28 at expiry. So, unless the NY Fed lets the fed funds effective rate drop significantly below target in May, which is most unlikely, the downside on a long FFK8 is virtually zero. On the other hand, there is a 28bp upside on this trade.

**Graph 1: -2.8bp average miss on the fed funds effective rate since Sep. 07**



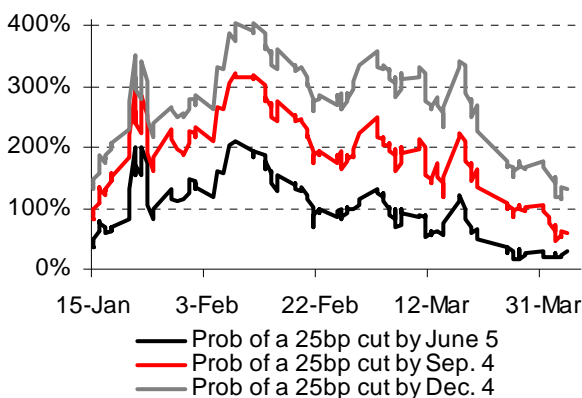
Source: SG Fixed Income Research

Finally, with only 10bp of cuts expected after the April 30 meeting, we continue to recommend putting on flatteners on the May/Oct. sector of the fed funds strip (@ -6bp). See last week's edition of our FI Weekly for more details.

## Europe

■ As we had envisioned last week, the market continued to remove rate cut expectations off the strip (see Graph 2), especially on September-and-after meetings. One bank's economists' team has already pushed its first expected cut back to Q4 (previously June). There is probably more to come, we fear, so **the trend of repricing the ECB on the upside is probably not over yet.** And this week's ECB Press Conference will hardly stand in front of the current trend if the latest ECB officials' comments are to be believed (e.g. Trichet, Garganas... see *ECB Watch*).

**Graph 2: Rate-cut expectations continue to be wiped off the strip**



Source: SG Fixed Income Research

**Eonias now assign very low chances for a cut in the next 4 meetings** (see Table 3). August is about evenly priced for 25bp, while September is now only 60%-priced for a 25bp cut (vs. about 100% last week). A second cut before the end of the year is now only assigned one-in-three chances, down from 64% last week. Finally, the trough of the cycle has broken above 3.50% (3.53% on ERU9 after taking into account the OIS/Euribor basis).

**Table 3. Implied market probabilities for the ECB refi rate based on forward starting Eonias on meeting dates**

ECB date	3.00%	3.25%	3.50%	3.75%	4.00%
7-Feb	-	-	-	-	-
6-Mar	-	-	-	-	-
10-Apr	-	-	-	10.0%	90.0%
8-May	-	-	-	19.2%	80.8%
5-Jun	-	-	-	22.0%	78.0%
3-Jul	-	-	-	30.0%	70.0%
7-Aug	-	-	-	44.0%	56.0%
4-Sep	-	-	-	96.0%	4.0%
2-Oct	-	-	20.0%	80.0%	-
6-Nov	-	-	44.0%	56.0%	-
4-Dec	-	-	64.0%	36.0%	-

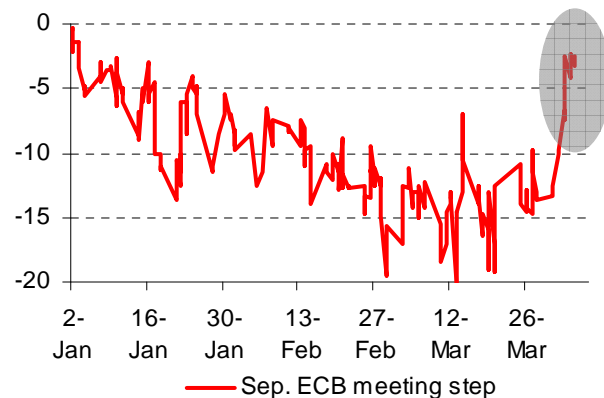
Source: SG Fixed Income Research

**Arguably, the residual potential for removing cuts off the strip is now very limited on the very front end (until July).** However, the trend could clearly extend further this week on back meetings (Q4 and after). Indeed, the risks are tilted on the hawkish side regarding the tone of the ECB Press Conference as the doves' position inside the Governing Council has been weakened by the seemingly low sensitivity of the European economy to the US slowdown and the appreciating euro.

**So, we would not be comfortable being short Eonias ahead of the ECB meeting, but remain ready to add to shorts on the July 3 meeting after Thursday's Press Conference, especially if the implied probability of a cut drops to 15-20% (30% now).** At this level, the risk/reward ratio would be overwhelmingly favourable to receiving July Eonia (4bp downside/21bp upside).

Finally, we recommended paying 1m Eonia starting on Sep. 10 @ 3.68% vs. receiving 1m Eonia starting on Aug. 13 @ 3.825% two weeks ago because the amount of cuts expected on the Sep. 4 ECB meeting had increased to 19bp. Our target spread @ -7bp was reached last week, and we currently stand as high as -3.3bp (see Graph 3). **So we continue to play the range and turn long Aug vs. Sep. on ECB meeting dates.** Indeed, unless Eonias start pricing rate hikes in Q3, the spread is capped at 0bp while the latter could drop as low as -20bp. The risk/reward ratio is hence very attractive (3bp of downside vs. 17bp of upside).

**Graph 3: The "step" on the September ECB meeting is too small**



Source: SG Fixed Income Research

## OIS/Libor spreads

■ **Liquidity strains ever more acute.** Demand was very strong at last week's 6m ECB auction. The Bank had announced on Friday, March 28, it would lend €25bn but demand turned out to be more than 4 times worth this amount (103.1bn). Usually, the bid/cover is around 2 and, at most, still below 3.

Reflecting the strength of bank's interest for 6m ECB liquidity, the marginal rate came out only 18.6bp below

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today's 6m Euribor fixing (4.55% vs. 4.736%), while the average rate came out at 4.61%, or 12.6bp below the fixing. As a matter of comparison, the March 26 three months auction was bid at a marginal rate 27.8bp lower than the 3m fixing (avg 18.8bp lower).

In sum **interbank confidence continues to suffer significantly after the Bear Stearns episode.** The fundamental difficulties of Lehman and UBS then only weighed further. **Banks are ever more reluctant to lend cash in the interbank market, effectively wondering who the next casualty will be.** Finally, there is basically no market in USD and STG, so funding in those currencies is being met by EUR borrowing, whatever the price (then swapped into USD or STG). Liquidity needs are especially strong in the morning, when the USD market is closed.

**Meanwhile, balance sheet-related needs remain strong.** So fixings remain high and the bases have not tightened despite the start of a new quarter and the lengthening of the average maturity of ECB repo operations – from 5 weeks to 11 weeks (see last week's edition of our *FI Weekly* for more details).

**The June 08 IMM forward Eonia/Euribor spread is the most affected by the situation** – the latter indeed widened by 11bp over the week (see Graph 4). With the 3m Euribor fixing never coming down, the Jun8 basis is left "running" after the spot value. Also, the basis showed the now-usual directionality, as Euribor futures continued to sell-off last week on the back of ever thinner hopes for ECB cuts. In particular, 6m EONIA is being capped by good interest to receive above 4%, as the risk-reward for this strategy is attractive given the non-zero risk of the ECB's hand being forced into cuts later in the year – although the level over which there is a free option on an ECB cut later this year is 4.066%, not 4% (because of a 2bp refi/Eonia basis built into the curve, plus a 4.6bp impact of compounding o/n rates at 4% over 6 months).

What is the near-term outlook for term spreads? Last week, we wrongly recommended turning short again on BOR/OIS bases (EUR and USD) on the June 08 sector. Indeed, we thought the combination of the start of Q2 and the lengthening of ECB repos' average maturity would ease liquidity strains. We clearly underestimated last month's blow to the confidence that banks have in each other. Hopefully we set the stop close to the entry point in EUR (57bp vs. 52.5bp).

That being said, there is a limit to the widening of OIS/Libor basis. First, it is reassuring that money is still available for financial institutions that need to boost their capital base.

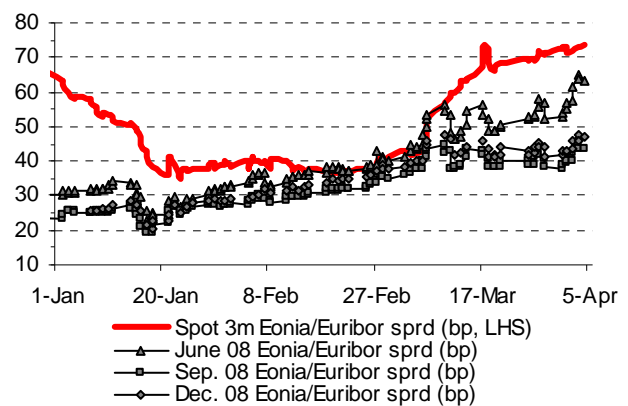
Second, the Fed has done a lot to prevent another large-size default (see *United States* section for more details). For example, the stigma associated to the use of the Fed's discount window seems to have weakened somewhat lately, as shows the sharp increase in primary credit to depository institutions between March 26 and April 2 – the outstanding amount indeed surged from \$0.58bn to \$10.3bn over the week, well above the \$5bn level reached going into the turn of 2007.

Third, Merrill's CEO said last week his securities firm doesn't need to raise more capital. "We have plenty of capital going forward and we don't need to come back into

the equity market," he said. Finally, new liquidity initiatives could well be announced at the forthcoming G7 meeting (Apr. 11-13) as we outlined in the *FI Dailies* last week. To this end, there was a JiJi report Friday about Central Banks considering new liquidity measures Friday.

Although we would certainly not try to fight the current widening trend again, we stand ready to jump in the tightening train when the latter starts rolling.

**Graph 4: With the 3m Euribor fixing never coming down, the Jun8 basis is left "running" after the spot**



Source: SG Fixed Income Research

**Recommendations**

**USD.** Go long FFK8 at 98.05. Target @ 98.155. Stop @ 97.95.

Hold flatteners on the May/Oct. sector of the fed funds strip (@ -6bp)

**EUR.** Receive 1m Eonia starting on Sep. 10 @ 3.86% and simultaneously pay 1m Eonia starting on Aug. 13 @ 3.92%. Target a spread @ -15bp. Stop @ 0bp.

Remain ready to add to shorts on 1m Eonia starting on July 9 @ 3.96%.

**OIS/Libor spreads.** Although we would certainly not try to fight the current widening trend again, we stand ready to jump in the tightening train when the latter starts rolling.

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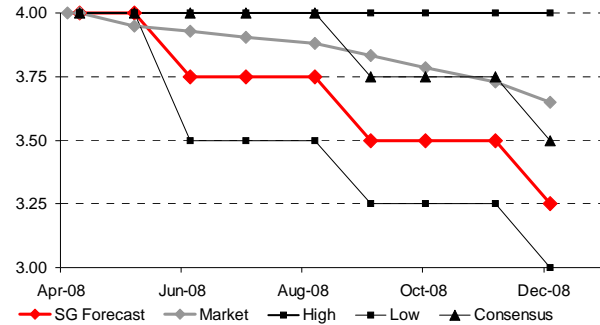
## Central Banks' key rate monitor \*

\* Market rates extracted from OIS as of 4 April 2008, 15.00 GMT

### ECB refi rate: SG forecast vs market and consensus expectations

Gov Council date	SG Forecast	Market	High	Low	Consensus
-	-	4.000	-	-	-
10-Apr-08	4.000	4.000	4.00	4.00	4.00
8-May-08	4.000	3.948	4.00	4.00	4.00
5-Jun-08	3.750	3.927	4.00	3.50	4.00
3-Jul-08	3.750	3.906	4.00	3.50	4.00
7-Aug-08	3.750	3.881	4.00	3.50	4.00
4-Sep-08	3.500	3.833	4.00	3.25	3.75
2-Oct-08	3.500	3.783	4.00	3.25	3.75
6-Nov-08	3.500	3.728	4.00	3.25	3.75
4-Dec-08	3.250	3.648	4.00	3.00	3.50

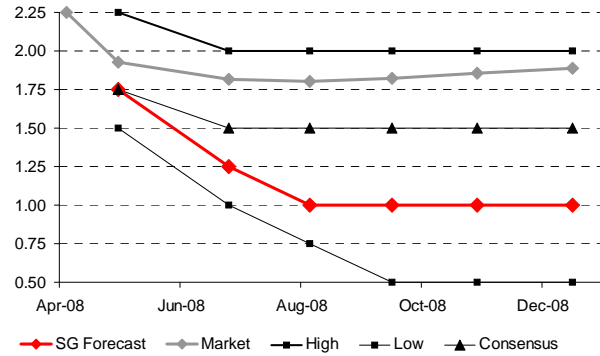
Source: SG Fixed Income Research, Reuters survey on ECB refi rate forecasts



### Fed funds target rate: SG forecast vs market and consensus expectations

FOMC date	SG Forecast	Market	High	Low	Consensus
-	-	2.250	-	-	-
30-Apr-08	1.750	1.930	2.25	1.50	1.75
25-Jun-08	1.250	1.818	2.00	1.00	1.50
5-Aug-08	1.000	1.800	2.00	0.75	1.50
16-Sep-08	1.000	1.824	2.00	0.50	1.50
29-Oct-08	1.000	1.853	2.00	0.50	1.50
16-Dec-08	1.000	1.888	2.00	0.50	1.50

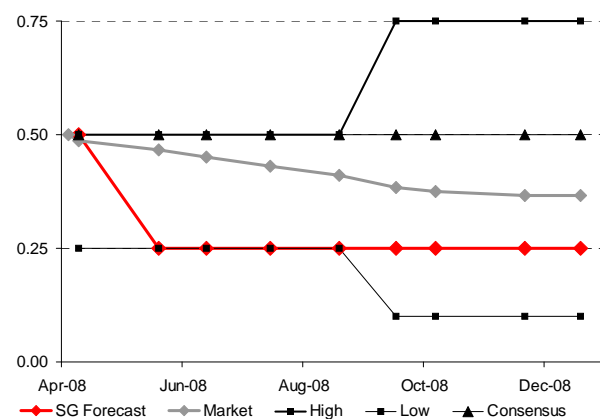
Source: SG Fixed Income Research, Reuters survey on fed funds target rate forecasts



### BoJ's OCR: SG forecast vs market and consensus expectations

MPM date	SG Forecast	Market	High	Low	Consensus
-	-	0.500	-	-	-
9-Apr-08	0.500	0.488	0.50	0.25	0.50
20-May-08	0.250	0.468	0.50	0.25	0.50
13-Jun-08	0.250	0.450	0.50	0.25	0.50
15-Jul-08	0.250	0.430	0.50	0.25	0.50
19-Aug-08	0.250	0.410	0.50	0.25	0.50
17-Sep-08	0.250	0.385	0.75	0.10	0.50
7-Oct-08	0.250	0.375	0.75	0.10	0.50
21-Nov-08	0.250	0.365	0.75	0.10	0.50
19-Dec-08	0.250	0.365	0.75	0.10	0.50

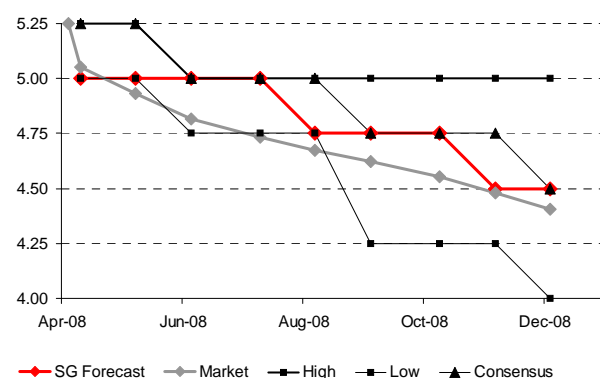
Source: SG Fixed Income Research, Reuters survey on BoJ's OCR forecasts



### BoE's official rate: SG forecast vs market and consensus expectations

MPC date	SG Forecast	Market	High	Low	Consensus
-	-	5.250	-	-	-
10-Apr-08	5.00	5.050	5.25	5.00	5.25
8-May-08	5.00	4.930	5.25	5.00	5.25
5-Jun-08	5.00	4.815	5.00	4.75	5.00
10-Jul-08	5.00	4.735	5.00	4.75	5.00
7-Aug-08	4.75	4.675	5.00	4.75	5.00
4-Sep-08	4.75	4.625	5.00	4.25	4.75
9-Oct-08	4.75	4.551	5.00	4.25	4.75
6-Nov-08	4.50	4.478	5.00	4.25	4.75
4-Dec-08	4.50	4.404	5.00	4.00	4.50

Source: SG Fixed Income Research, Reuters survey on BoE's official rate forecasts



## SG Exchange Rate and Interest Rate Forecasts

### Exchange Rates (end quarter)

	4 Apr 08	Jun 08	Sep 08	Dec 08	Mar 09
EUR/USD	1.5759	1.62	1.58	1.60	1.55
USD/JPY	99.71	90	95	90	95
GBP/USD	1.989	2.03	2.03	2.05	2.04
USD/CHF	1.0051	0.93	0.97	0.94	0.98
USD/NOK	5.0835	4.69	4.81	4.81	5.03
USD/SEK	5.9662	5.71	5.70	5.59	5.74
USD/CAD	1.018	0.96	0.98	1.00	1.07
AUD/USD	0.9186	0.94	0.97	0.93	0.90
NZD/USD	0.7886	0.82	0.83	0.79	0.76
USD/CNY	7.0158	6.90	6.80	6.75	6.70
EUR/JPY	160.18	146	150	144	147
EUR/GBP	0.7882	0.80	0.78	0.78	0.76
EUR/CHF	1.5790	1.51	1.53	1.51	1.52
EUR/NOK	7.9958	7.60	7.60	7.70	7.80
EUR/SEK	9.3842	9.25	9.00	8.95	8.90
EUR/CAD	1.5813	1.56	1.55	1.60	1.66
EUR/AUD	1.7062	1.72	1.63	1.72	1.72
EUR/CNY	11.03	11.18	10.74	10.80	10.39

### Key central bank rates (end quarter)

	4 Apr 08	Jun 08	Sep 08	Dec 08	Mar 09
USA	2.25	1.25	1.00	1.00	1.00
Euro area	4.00	3.75	3.50	3.25	3.25
Japan	0.50	0.25	0.25	0.25	0.25
UK	5.25	5.00	4.75	4.50	4.25

### 10-yr yield

	4 Apr 08	Jun 08	Sep 08	Dec 08	Mar 09
USA	4.319	3.20	3.50	3.75	3.75
Euro area	3.930	3.50	3.60	3.70	3.70
Japan	1.320	1.15	1.00	1.10	1.20
UK	4.419	4.00	4.10	4.20	4.15

Source: SG FX Research



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