Saxo Bank FX Monthly – October 2010

John J. Hardy, Consulting FX Strategist, October 18, 2010

FX month in review:

The last month has been a dramatic one for all asset classes. Here are a few highlights of the goings-on in teh currency market since our last publication:

- **Competitive Devaluation Strikes.** The Brazilian Finance Minister recently declared that the world is engaging in "currency wars" as nations fight to prevent their currencies from appreciating in order to remain competitive in the global marketplace and reap what they can of insufficient world demand. On the one side of this war, we have the rapidly weakening currencies from low-growth developed nations led by the US that are devaluing their currency through ZIRP and QE aimed at boosting growth and preventing deflation. Japan and the UK are the other two major developed countries current either actively intervening (Japan) or threatening renewed QE (the UK.). This is triggering massive capital flows to the higher yielding emerging markets, which can't absorb the flows without tremendous currency strengthening effects (they also boost the economy and become a self-fulfilling yield enhancer as higher growth rates mean policy must be kept relatively tight as well). In response, highly export-dependent countries like Korea and Brazil have enacted various capital controls and other policies aimed at punishing inflows and stemming currency strength. Above all nations fighting currency strength stands China, which accumulated an astounding USD 100 billion in reserves in September alone. Currently, the easy money policies of the Fed are triggering wild speculation in all major risk assets, but we still wonder whether this is sustainable – see more below in Cognitive Dissonance an in our Outlook section.
- **The Euro finally gets respect.** So far, despite street protests in Greece and a new bank bailout in Ireland that will mean an astonishing 30% of GDP shortfall in that country's budget deficit, the EuroZone has managed to keep a lid on the sovereign debt and default fear situation as the ECB has bought sovereign bond debt (and as large European banks have front-run this buying). At the same time, the sudden realization that ECB policy is extremely tight relative to the more aggressive "QE" troika of the Fed, BoE and BoJ in a world of competitive devaluation, drove the Euro sharply higher after it had clearly become oversold versus the broader market. Short rates in Europe have dramatically risen vs. the other G-4 currencies as the ECB's sovereign bond buying operations are sterilized and as it remains clear that the ECB is not interested in changing its overnight rate, further aggravating the liquidity at the short end of the curve. Is there more to squeeze out of this trade? Versus the USD, we're not so sure.

- **AUDUSD nips at parity**. Just after Bernanke's October 15 speech in which he outlined some of the tools the fed could use to fulfil the Fed's mandate in a "low inflation environment", AUDUSD pipped parity before falling later in the day, and AUD vs. the rest of the G-10 has eked out new highs for the cycle as risk appetite marched ever higher globally on the anticipation of endless easy liquidity from the US Fed and as commodities prices also rose sharply as a corollary of the competitive devaluation theme. But is the AUD rally overdone once again? – see below in our Outlook section for an in-depth look.

Cognitive Dissonance: Not all asset classes can rise forever

It would be easy to accept the US dollar devaluation premise if this premise didn't entail such a bizarre set of circumstances that we have a hard time contemplating without shaking our heads in confusion and despair at the market's logic here. The market tells us that the Fed is very determined to devalue the dollar by keeping US interest rates artificially low. That is all fine as a starting proposition, but the resulting "Everything Up" trade this market has played since the heavy hints from the last FOMC meeting on imminent QE2 doesn't sit well with us if we sort through where this logic takes us. If the market believes that the Fed will be successful in destroying the USD, then why would anyone want to own not only the US currency, but also US sovereign debt? A sufficient buyer's strike would easily overwhelm any Fed attempt to buy bonds and the political fallout would quickly be a self-limiting factor for the Fed as well, one would imagine. So the market's enthusiasm for gaming the Fed is then the driver here rather than the Fed's actual ability to prop up all asset markets simultaneously. (There is that, and there may be an element of forced Treasury buying by Asian and other central banks interested in preventing their currencies from appreciating too rapidly. We saw north of 40% of indirect bidding in the most recent 10-year Treasury auction, for example.)

Another highly risk-negative implication to the market's anticipation of what the Fed wants to do here that is not evident at all in the market's unsustainable speculative frenzy: the speculative fervor is beginning to strongly drive commodity prices higher – and this risks creating the "wrong kind" of inflation (cost push), which would only crowd out already anemic demand and/or squeeze margins for companies – bad for growth and bad for the economy (and one would suppose bad for riskier corporate credit and equities). Everyone is suddenly talking about hyperinflation as a serious risk again, but to take the German hyperinflation example from the 1920's and even the UK high inflation episode of the 1970's, both inflationary episodes had as one of their hallmarks a wage-price spiral as union and public sector workers demanded – and received - higher and higher wages as inflation expectations increased. If we look at what is going on at the state and even national level in the US (not to mention elsewhere) with wage freezes, pension reductions and freeze on the US Social Security cost of living for 2011, there's not much to build a spiral on just yet. Yes, if sufficient numbers of foreign central banks went on strike on buying US treasury bonds, we could get a different dynamic started, but so far these countries have not decided to press that particular gun barrel to their (and our) collective temple.

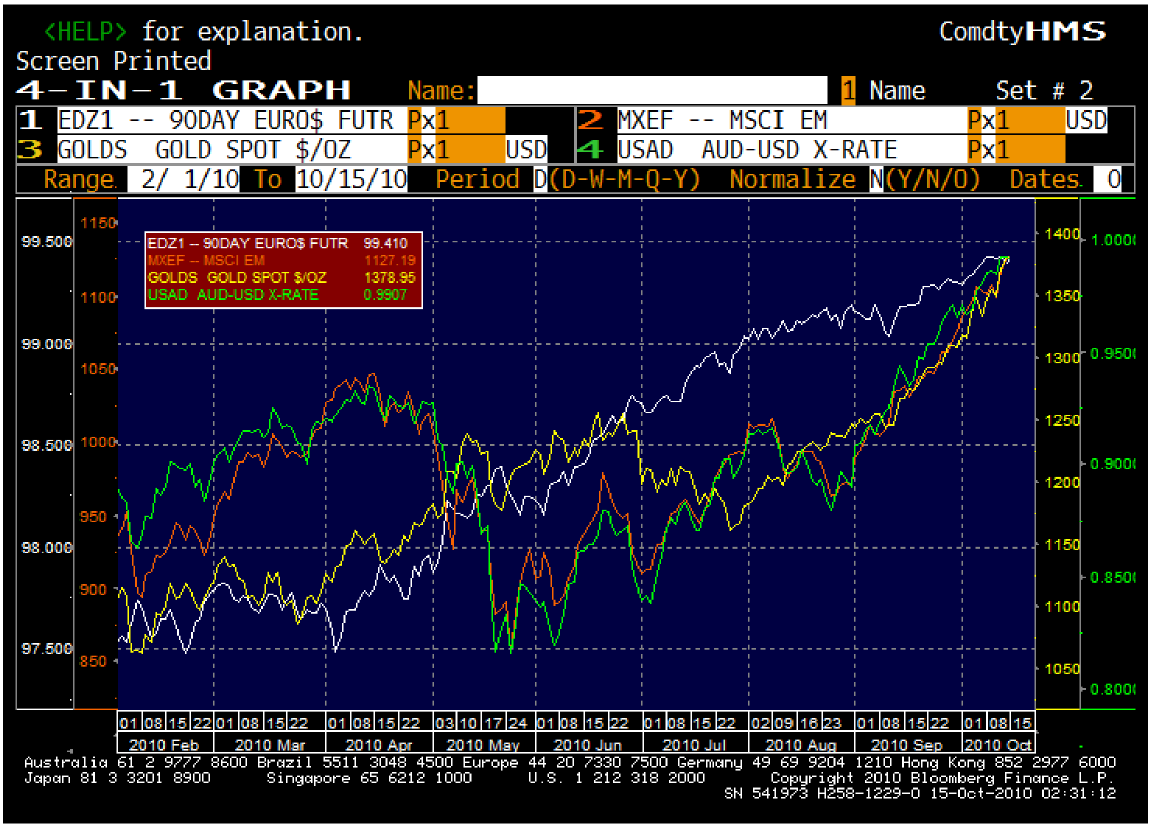


Chart: The Chart above of the December 2011 US Fed STIR, which shows the market in recent months taking more and more out of the forward expectations for the Fed while the speculative fervor on expectations of a new round of QE from the US Fed is evident in the almost inexorable rise in risk appetite and hard assets - here represented by emerging market stocks (red), AUDUSD (green) and Gold (yellow). (Chart and Data courtesy of Bloomberg)

So at present, we are in a kind of reflexive liquidity bubble that suggests the lower US rates go, the more it feeds the liquidity (possibly aided by Fed operations allowing the big US banks to speculate with open market operations money) that feeds the Everything Up bubble in emerging market equities, commodities and pro-risk currencies (and the Euro for not stooping to the competitive devaluation theme). It's more than tough to speculate what eventual trigger gets the ball rolling for ending the Everything Up trade – and obviously our timing has been so far off in expecting a return to risk aversion and USD strength that we are even doubting at times whether this will ever play out as we expect. Potential triggers for an end to the current market paradigm include a batch of especially poor corporate outlooks for Q4, further deceleration in US data, strong deceleration in data elsewhere in the world (particularly Europe and/or China), a new mortgage-related crisis from the new foreclosure mess in the US, or the move simply collapsing under its own speculative overweight when it is finally revealed that the Fed's next QE move is far more modest than the market has priced in.

The key question when the Everything Up trade comes to an end is whether it also spells the end of the USD Down trade. Speculative positioning suggests that this could be the case as USD shorting has been particularly aggressive of late. This new competitive devaluation story has been most compelling because of the combination of the Fed's move and the apparent decoupling of a weak US economy from the rest of the world economy. But part of the strength of the rest of the world's economy is being driven by easy liquidity conditions from the US and other major developed countries that are generating enormous capital flows to emerging markets that are driving and aggravating the decoupling trend. So the really key test of whether we have a longer term USD devaluation story only comes if and when we see the USD falling even in a general environment of strong risk aversion. Until then, we'll look for some measure of resilience.

Carry Trade Model – USD carry trade gone wild

In the past, we noted the degree to which the USD carry trade had overtaken the JPY carry trade as the market's obvious focus for a pro-risk trade, due to the US' vulnerable external position and the trajectory of the Fed. Interestingly, although Japan has effectively leapfrogged the Fed in coming out with a new QE program (unsterilized currency intervention plus the new lending facility announced at its most recent meeting) and the JPY should arguably be punished on the competitive devaluation theme, the USD remains the focus, fairly or not. Instead, the market has put the JPY in limbo, refusing to take a stand on the JPY, and has focused all of its efforts on selling the greenback – even as underlying risk measure suggest that the enthusiasm has taken on a life of its own beyond the formerly tight correlation of risk appetite and the greenback.

Carry Trade Outlook

The carry trade performance has rocketed higher with the advent – or intensification, at least – of the competitive devaluation theme, particularly in the case of the USD and the British pound, which has almost become a sidekick of the USD (or low beta version thereof) to the similarity of the two country's fiscal dilemmas, trade deficits and central bank policy. Going forward, we are curious to see whether the USD carry trade has taken on a life of its own and become the leading indicator for risk, or if the other risk measures represented by our carry trade index will prove prescient. As things stand, we believe that the USD and risk are reflexive, so it may be tough in this cycle to find the kind of predictive divergence we found in cycles past, though we will certainly keep our eye out for such a development. Also, one might look at other factors in this market to suggest that the competitive devaluation/risk appetite theme in currencies is weakening, like the relative performance of the British pound, which at times lately has changed direction a bit ahead of the USD. Stay tuned...

Saxo Bank Carry Trade Model Charts

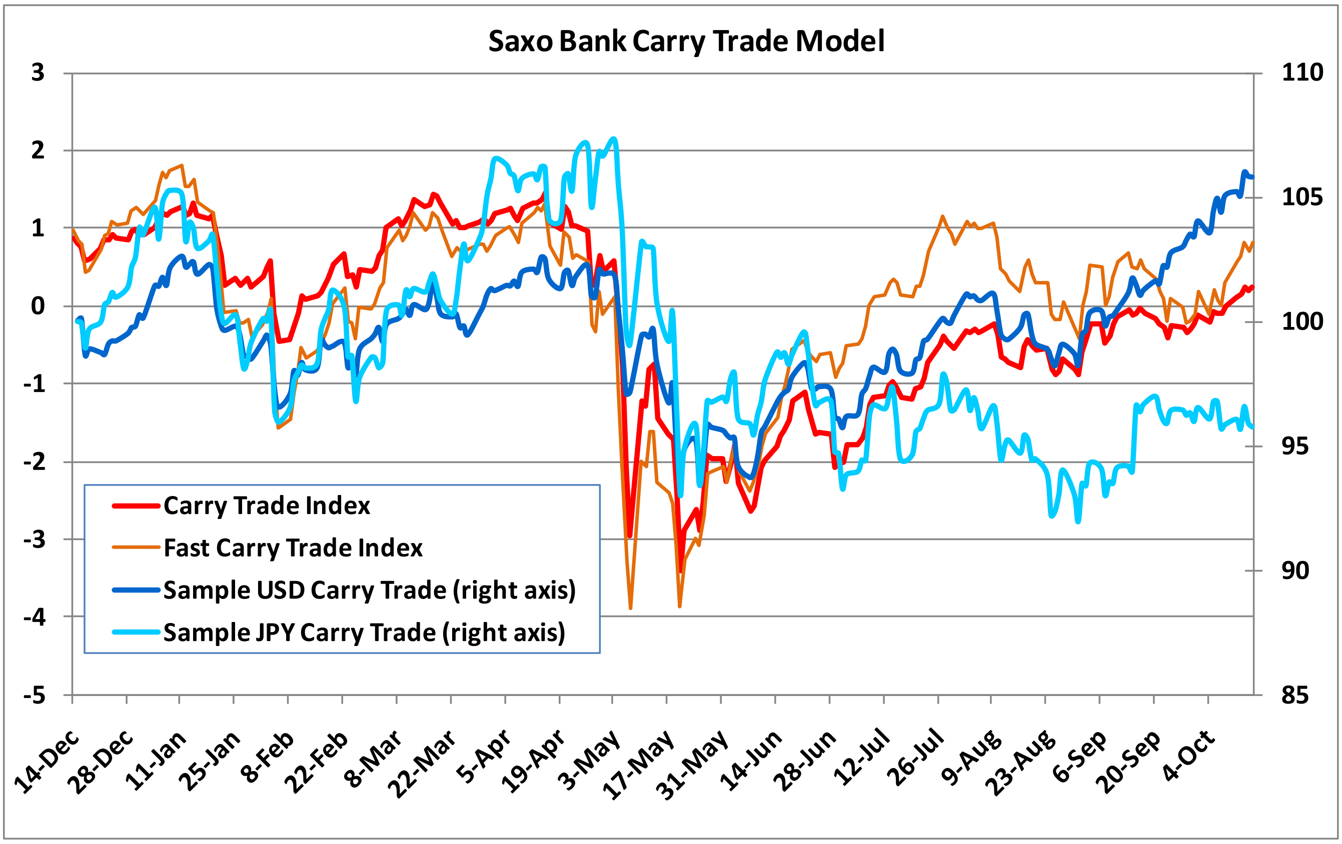


Chart: Saxo Bank Carry Trade Model.

Note the continued divergence in the JPY relative to the USD despite the advent of BoJ intervention, which only caused a one-off weakening in the JPY. The USD weakness has diverged rather sharply from our overall carry trade *index, which is what leads us to believe that the USD weakness has become a more sentiment-driven speculative frenzy that has taken on a life of its own. The risk arises in such situations that the reversal, when it arrives, could be particularly violent. (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).

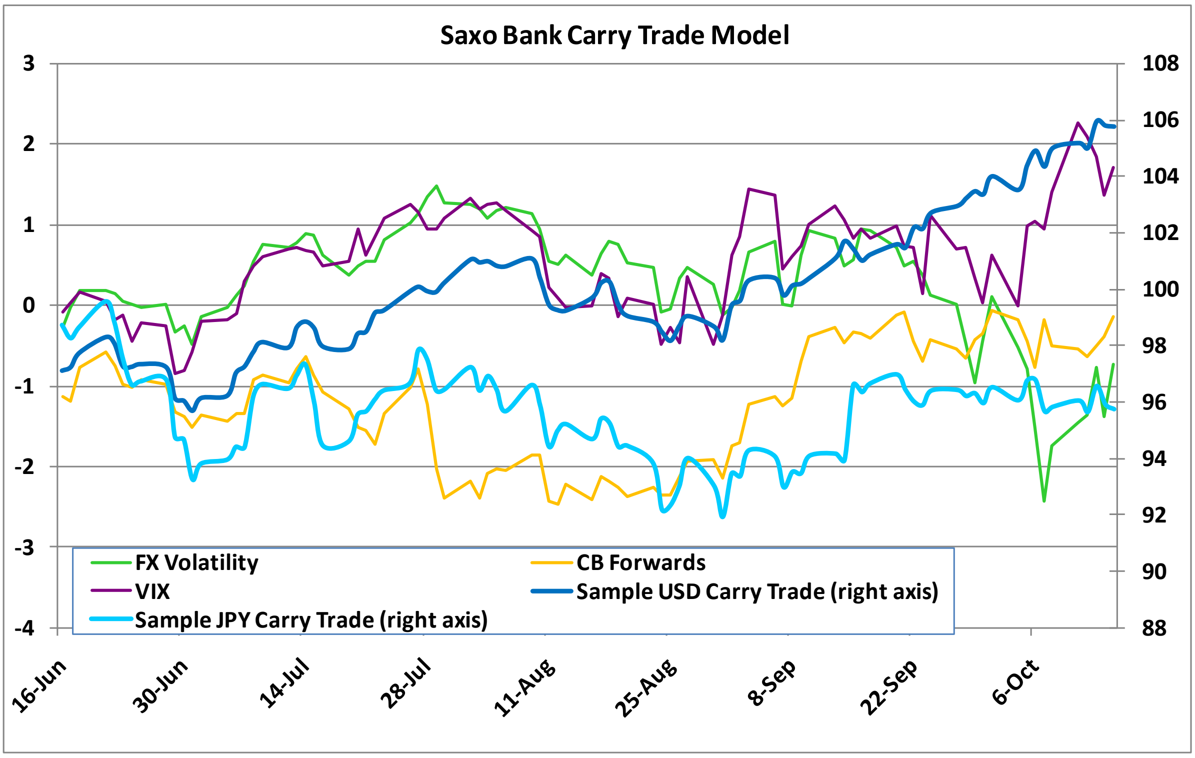


Chart: Fast Carry Trade Index Components 1

The central bank forward expectations has been flat, but note the extensive divergence in the VIX (supportive of risk as it falls with rising equity prices) while the USD selling has become so heated at times that overall FX volatility has risen – something that normally is not risk supportive. Chart derived from data from Bloomberg

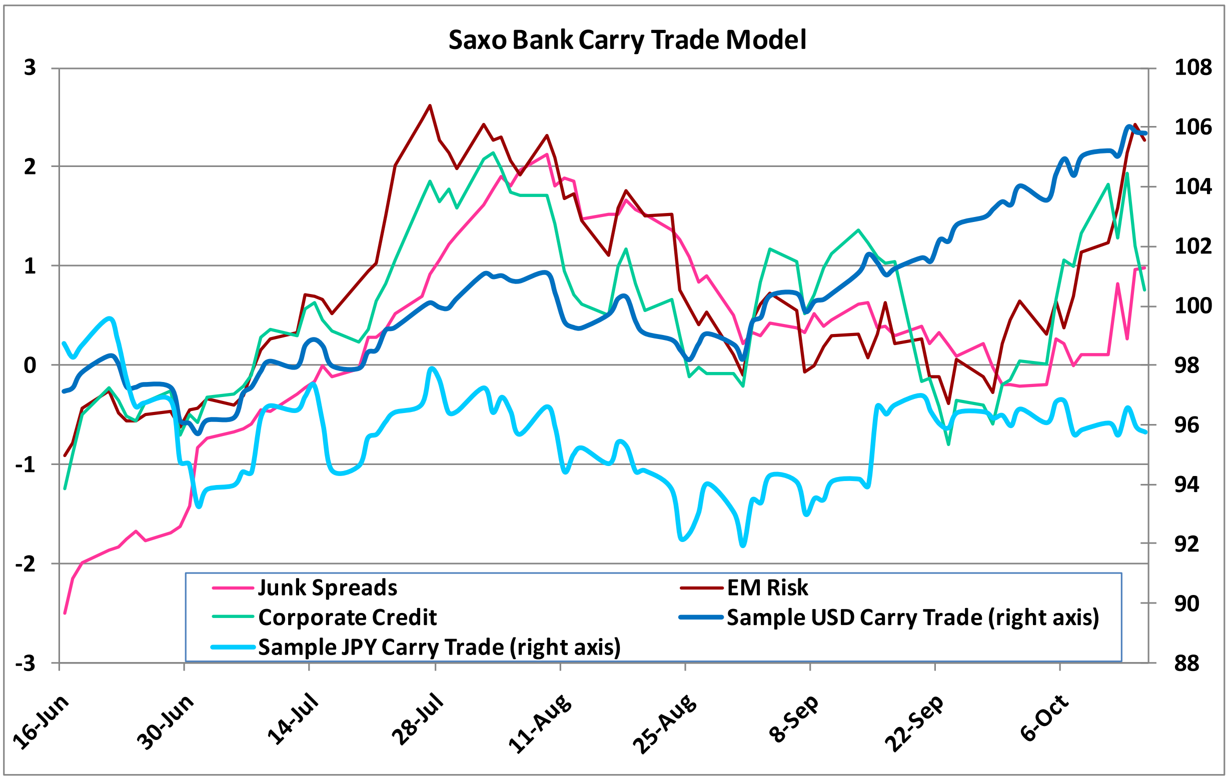


Chart: Fast Carry Trade index Components 2 (previous page3)

Remaining components show Junk bond risk spreads to be generally supportive, while there has been an interesting reversal just before we publish this report in the corporate default swap indices. Note the extreme strength in the EM bond market driving EM spreads lower – and EM currencies higher. Chart derived from data from Bloomberg

Central Bank Watch: A bump in CB expectations

Our latest look at where things stand for G-10 Central bank expectations

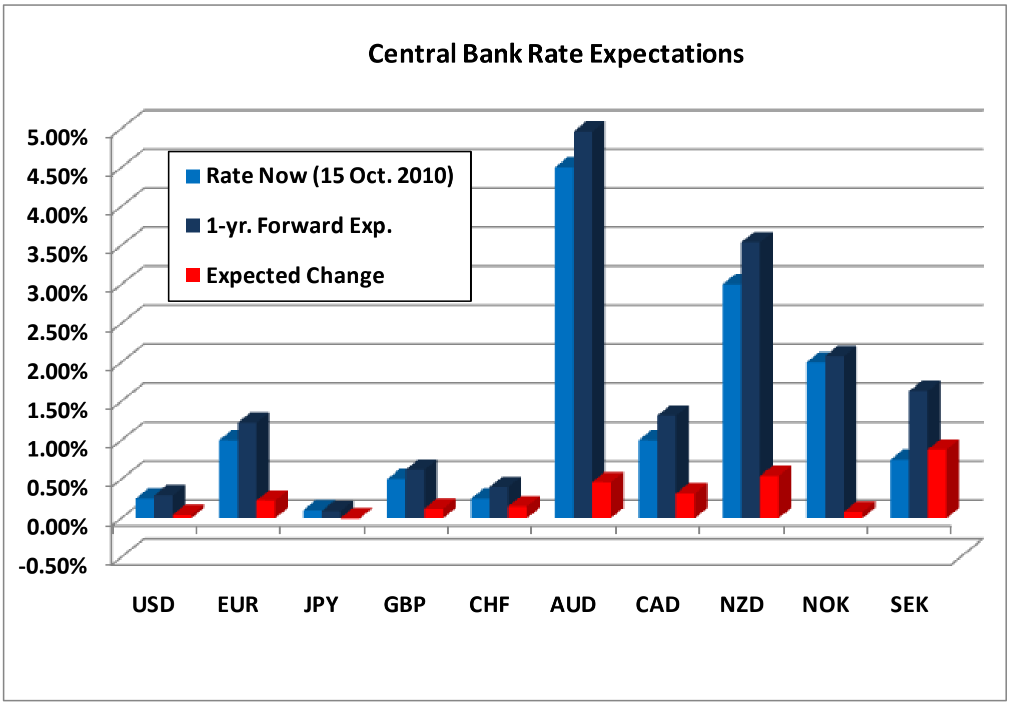


Chart: Central Bank expectations still very low. *Central bank expectations remain largely moribund, though they have inched higher for the RBA again and remain relatively high relative to current rates for the Riksbank. It's clear where the risk lies for a strong reversal in rate expectations if we see a significant reversal in the markets global growth expectations. Chart derived from data from Bloomberg*

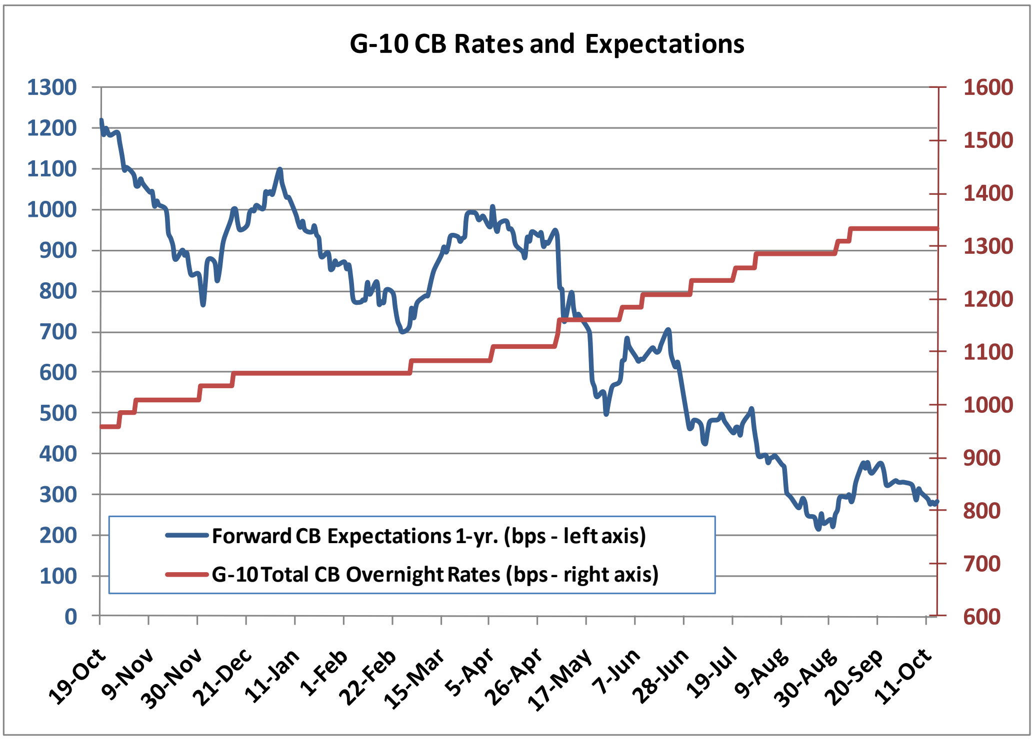


Chart: A look at G-10 CB rates and rate expectations in aggregate: *Central bank expectations are generally headed lower again, though they are still off their lows for the cycle. We still wonder if expectations eventually move to negative territory in aggregate in the coming three months or so. Chart derived from data from Bloomberg*

Saxo Bank G-10 FX Forecasts

Base Case: Our base case scenario has proven far off the mark yet again as this market has become so enamoured with the competitive devaluation theme and front-running the Fed over the last six to eight weeks that our old short to medium term USD targets are now miles away from market prices. While we still believe that a moment of recognition awaits for this market (the moment when the market realizes that speculative bubble blowing on anticipated Fed liquidity will not end well for risk appetite or for USD bears in the medium term), the shorter term market action has gone so radically against our base scenario that we have lost some faith in predicting the timing of a return to sanity. If we use the 2007 example as a model for a potential repeat here, we note that the risk appetite rally back then started when the Fed dropped a hint about a coming rate cut in August – and then risk appetite topped out in October. Of course, the USD didn't bottom out until the following summer. This time around, we suspect that the USD is more closely linked to the overall market for risk appetite, due to their recent very strongly negative correlation and the reflexive nature of the USD vs. emerging market equities, commodities, name-your-favourite-asset-class-here trade. The trick will be finding the Eureka moment or event that makes this market change its mind. The risk is also mounting that the reversal, when it comes, will be a rather violent one, due to signs of extreme correlation across markets.

Alternative Scenario: The alternative scenario is a continuation of the current market paradigm: a continued spiralling in risk asset prices upward as the market tries to front run anticipated further easing from the US Fed and as flows to emerging markets and stagnant US data reinforce the impression of a decoupling world economy. In the shorter term, the key test for a continuation of this scenario comes on November 2 & 3 with the mid-term US elections and the next FOMC meeting. Is the rally over-pricing the ability of the Fed to support asset prices or are we seeing the USD devaluation endgame as the entire foundation of our economies, fiat currencies, are seeing their ultimate test? The fall-out from a true loss of faith in fiat currencies is a true black swan.

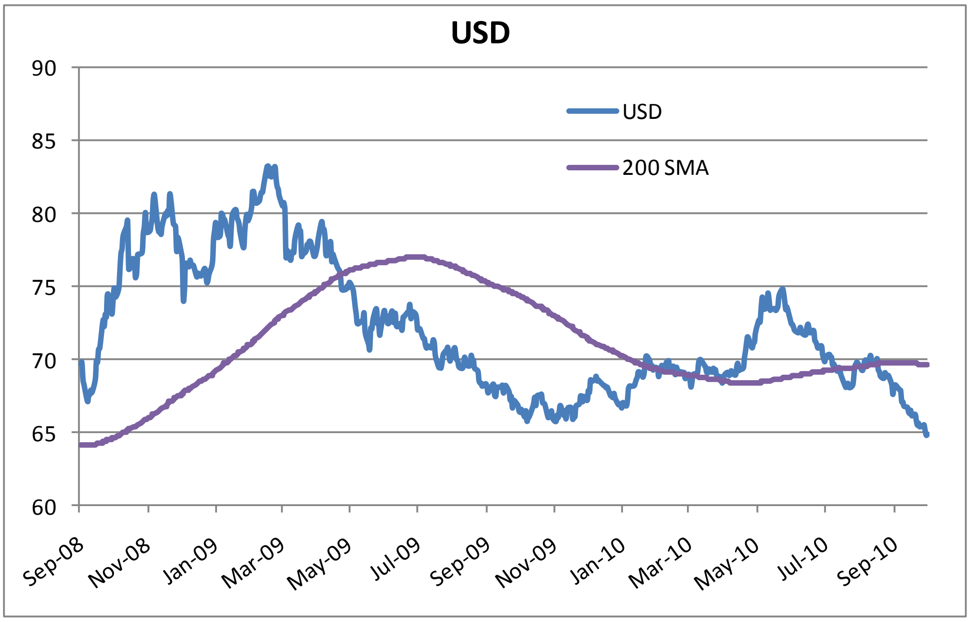
Table: Saxo Bank G-10 FX Forecasts

Currency Pair	1M	3M	12M	Alternative (1-2M)
EURUSD	1.3200	1.1800	1.1200	1.4500
USDJPY	84.00	88.00	102.00	76.00
EURJPY	111.00	104.00	114.00	110.00
EURGBP	0.8700	0.8100	0.7700	0.9000
GBPUSD	1.5200	1.4600	1.4500	1.6200
EURCHF	1.3500	1.3600	1.4200	1.3000
USDCHF	1.0200	1.1500	1.2700	0.9000
AUDUSD	0.9000	0.8000	0.7000	1.0200
AUDJPY	76.00	70.00	71.00	78.00
AUDNZD	1.2900	1.2500	1.2100	1.3100
NZDUSD	0.7000	0.6400	0.5800	0.7800
USDCAD	1.0600	1.1400	1.2000	0.9900
EURNOK	8.10	8.25	7.75	7.75
EURSEK	9.30	9.60	9.00	9.10
EURPLN	4.00	4.50	4.75	3.80
USDZAR	7.10	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 is trading at its lowest levels since before the financial crisis began in the fall of 2008 as the world speculates that the Fed is bent on devaluing the US currency and as investors buy risk assets as the flipside of USD short trades.

Key Issues

The US currency is at the epicenter of global market developments in recent weeks as every asset class and currency seems to be trading in one way or another off the Feds much ballyhooed QE2 and the theme of competitive devaluation. So far this has meant a one way street higher for risk assets and a one way street to the cellar for the greenback. As we discuss in the article at the beginning of this publication, however, the logic makes some sense as long as the US continues to look shaky and the rest of the world appears to be doing fine.

But eventually, the current risk bubble that is inflating as the world thinks it is front-running the Fed has to hit a brick wall: whether on the unsustainable logic of "Everything Up that we discuss in the Cognitive Dissonance" article or due to an as yet unidentified trigger. But what form will that trigger take? Poor corporate earnings outlooks as margins are squeezed due to rising cost push inflation and insufficient end demand? Signs of a real slowdown in China? Financial crisis part 2 on the new US Mortgage crisis? The future QE from the Fed turning out to be far more limited and less forceful than expected?

Outlook

We don't have the answers to our own question above, but we do feel that all of these risk factors are possible hurdles to the current market paradigm, though timing is very uncertain. Of them, the most potentially pressing in the near term is this new US mortgage debacle, which is rapidly gathering steam. It is easy to argue from a legal standpoint that a sufficiently large number of these mortgages and foreclosures could be called into question to require that most of the biggest US banks will be rendered bankrupt and have to be unwound according to the Frank-Dodd legislation. However, whether US politicians care more about the constitution and contract law or bailing out the banks (AKA, the hand that feeds them) once again determines whether this is allowed to transpire.

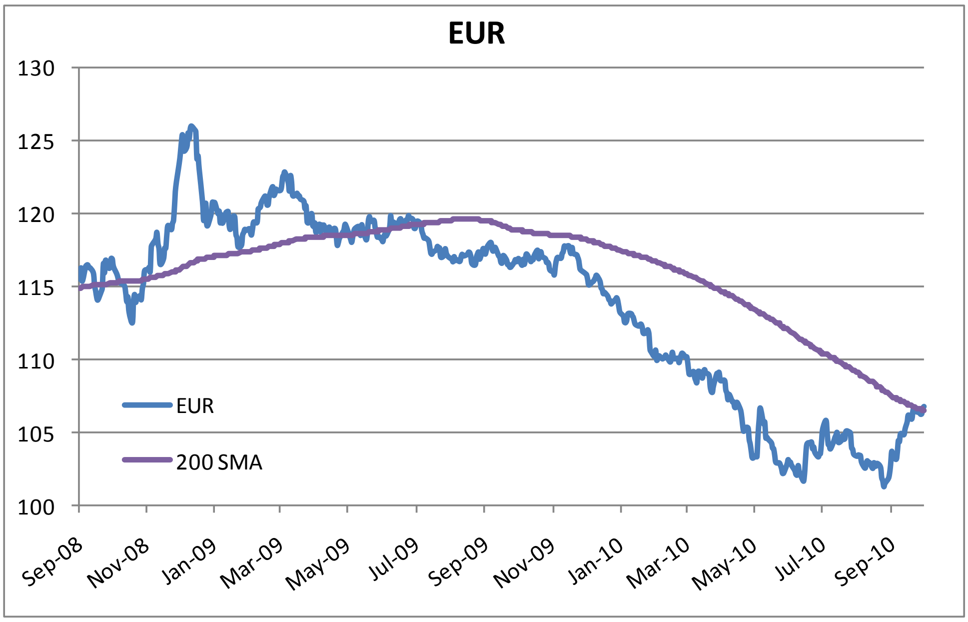
We trudge masochistically on with the view that "this cannot end well" and that the market's current hopes for a risk positive outcome to a renewed move by the Fed into QE will fail to justify asset prices at their current level, much less any hope that the US economic outlook is bright when the consumer 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!*

At this stage, our patience is wearing thin for our long standing view that a bear market for risk will return and that this will provide a boost for the greenback, though the signs are that the drivers that have taken risk appetite to such heights are unhealthy ones that could spell a very ugly and precipitous unwind in the market's current paradigm.

Next FOMC Meeting: November 3.

Alternative scenario*: a continuation of the current devaluing dollar/everything else up trade is our basic alternative scenario, but the real alternative scenario of interest would be one in which the USD continues to sell-off despite an end of the positive risk appetite trade. That is certainly not anticipated –but if it comes to pass, it is a scenario that would require us to revisit our entire set of assumptions about what is driving this market.*

EUR



The Euro has made a sharp comeback since our last report as the focus has shifted from the risks of sovereign default at the EuroZone periphery to the virtuously tight ECB relative to the profligate devaluers of the remainder of the G-4 central banks.

The Euro has suddenly gone from goat to hero in recent weeks. First, since the summer months, the ECB's debt buying program in the troubled PIIGS countries has sufficiently shut up the Euroskeptics for now as the sovereign default trade has been put on hold. Then, in recent weeks, speculative Euro shorts are turning into outright longs as the dominant market theme has switched to one of competitive devaluation. Here, the ECB is easily the most credible G4 central bank in maintaining the value of its currency, as it has refused to entertain the idea of lower its interest rate any further, much less go the QE route that the BoJ, BoE and the Fed all seem happy to tread. The Bundesbank perma-hawk Weber, one of the favourites for taking over the ECB helm late next year, was even out talking out against the buying of PIIGS debt and in favour of increasing interest rates. Still, Mr. Weber is a bit of a loose cannon and this view is in conflict with what other ECB members have said.

Another support for the Euro has been a still strong Chinese market that has kept the German export machine humming, meaning that economic malaise has failed to materialize at the European core to the degree it has in the US (even while Ireland tipped into outright recession in Q2). And bond buying operations and the expiration of various liquidity ECB liquidity facilities have sopped up shorter-dated liquidity, meaning that interest rates at the short end in Europe have risen sharply while they have fallen elsewhere. This has all added up to an impressive reversal in EURUSD, EURGBP and to a lesser degree EURJPY in recent weeks.

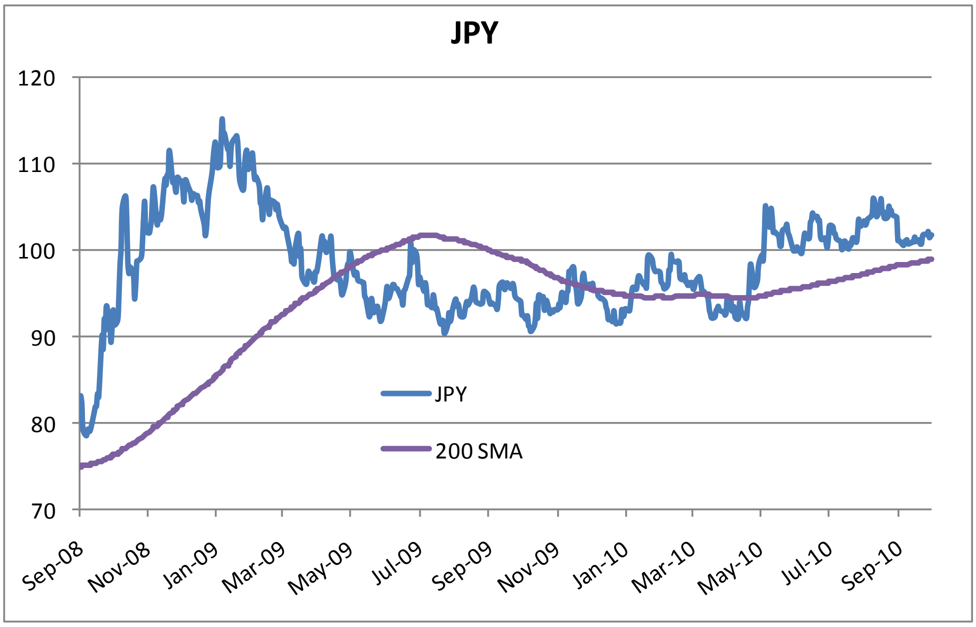
Outlook

While we can't rule out another leg up for the Euro on the themes we mention above, we estimate that most of the potential upside from absolute rate differentials at the short end of the curve has been realized in the EuroZone. Key risks going forward are the strength in the Euro currency itself and a potential drag this could exert on the European economy. As well, we're not convinced the European sovereign debt situation and risks to the European banking system have been resolved just because a lid has been kept on this issue for a time. So, while the Euro may have bottomed now against the G-10 more broadly speaking, it could yet unwind some of the excesses of strength against the USD once this speculative mini-bubble on Fed front-running has run its course. But regardless of the USD view, trades like EURNZD and EURAUD longs are a way to look for a reversal in the "all risk trades up" department in coming weeks and months if one has a more positive Euro view.

Next ECB Meeting: November 4

Alternative scenario: *a continuation of the competitive devaluation scenario and a the USD selling turning into a blowoff USD panic could see aggravated further upside in the Euro, since the Euro is the only credible reserve currency alternative to the USD. But eventually, if the world questions the value of all fiat currencies, it will find that the Euro has its blemishes as well.*

JPY



The JPY has gone virtually nowhere recently as the negative implications of BoJ interventionism and new QE threats make it a "loser" (or is it a winner?) in this competitive devaluation environment. Still, against the USD, the currency managed to post a new 1-year low on the market's more heated anticipation of QE2 from the Fed.

Broadly speaking, the JPY hasn't gone much of anywhere over the last several weeks – a relatively strong performance considering the markets current focus on competitive devaluation and the fact that the BoJ is practicing unsterilized intervention (a flavour of QE) and announced a program of asset purchases at its most recent meeting. But the focus is on the USDJPY more than the broader JPY picture, and in that cross, the US is "winning" the devaluation race as US interest rates have fallen faster and owing to the US trade deficit as compared with Japan's still large trade surplus and exposure to Asian economic strength. As well, Japanese economic data - outside of further deflation – looks relatively stronger of late, though the trajectory isn't particularly encouraging in some areas like PMI's and actual production figures.

Outlook

The initial efforts by the BoJ to intervene have failed to bear the hoped for fruit of a weaker JPY – at least in the all-important USDJPY pair. But further out, we wonder if something is finally afoot here with the market's longer term assessment of Japan's creditworthiness. Namely, while short rates have stayed very low to lower in the US and Japan, we have begun to see a strong steepening at the longest end of the yield curve in both the US and Japan – a place the government bond investor is loathe to go - even regardless of QE apparently - in countries where the debt overhang is so large and the where the central banks seem bent on reflating at all costs. Japan, with its world-beating public debt loads, should in fact prove the canary in the coal mine if the market every rekindles its fears of the long term implications of heavy public debt loads.

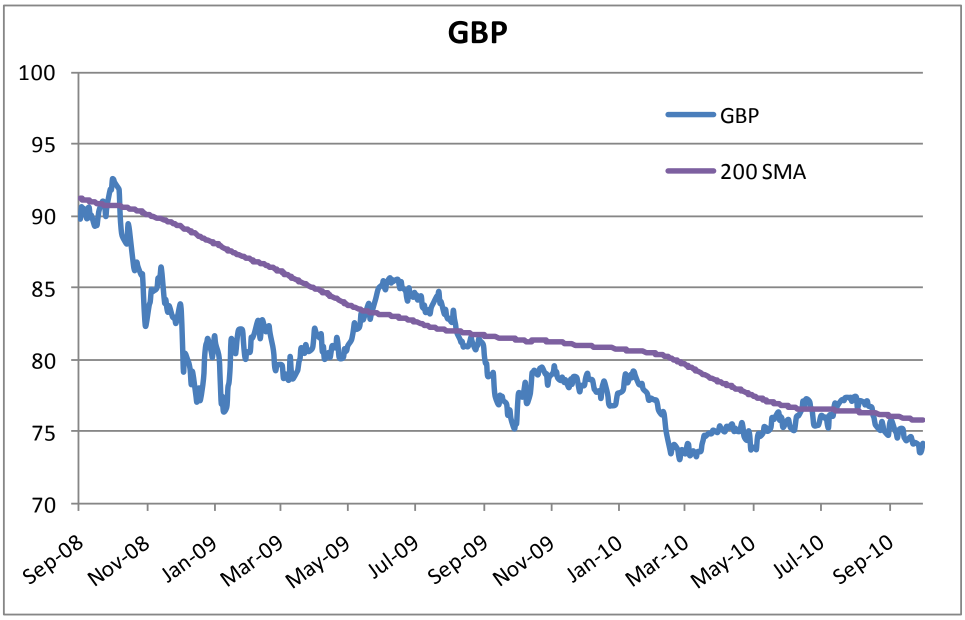
We continue to note that the speculative world is very short US dollars and very long the yen. While the current punishment of the USD could continue for some time, it is a bit hard to understand why the market shouldn't also be flogging the JPY on this theme. If interest rates rise, the spreads will move against Japan's favor and if Japanese rates rise sharply, it will only be because the world is afraid that the government there can't pay debt holders back. Lose-lose for the JPY. The only winning scenario for the JPY is a short to medium term one in which expectations for the higher growth countries contract rapidly and make the JPY less unattractive to hold for a time in crosses like NZDJPY and AUDJPY..

We understand the logic of those who say that USDJPY could easily trade toward 70 or lower in terms of PPP relative to historic inflation rates and the implications of the Fed's QE2, etc. – but the extreme speculative positioning and Japan's longer term debt picture makes us reluctant to entertain a bearish USDJPY view for now.

Next BoJ Meeting: October 28

Alternative scenario: *A large scale consolidation in the bond market could see the JPY weaker across the board in the near term as spreads would inevitably move against the JPY's favour.*

GBP



GBP has generally lost altitude on the competitive devaluation theme as the BoE is seen as one of the more likely banks to engage in QE in an effort to keep monetary conditions easy. This is an interesting idea in a country that is also launching strong fiscal austerity

measures at the same time.

Don't be too distracted with the pound's advance against the very weak USD of late – the pound is also relatively weak elsewhere and for largely the same reasons that the USD is weak: the competitive devaluation theme and fears that the BoE stands ready to expand its asset purchase target in order to boost growth much like the Fed appears on the cusp of launching QE2.

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 are making new historic shortfalls recently while the US is a good deal off its all time lows) 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, which really must come down in line with the BoE's projections if the central bank is to maintain any credibility at all. As well, any new QE moves from the BoE will come after the UK government has launched its impressive austerity initiatives, which promise to slow economic growth in the UK in the months to come.

Outlook

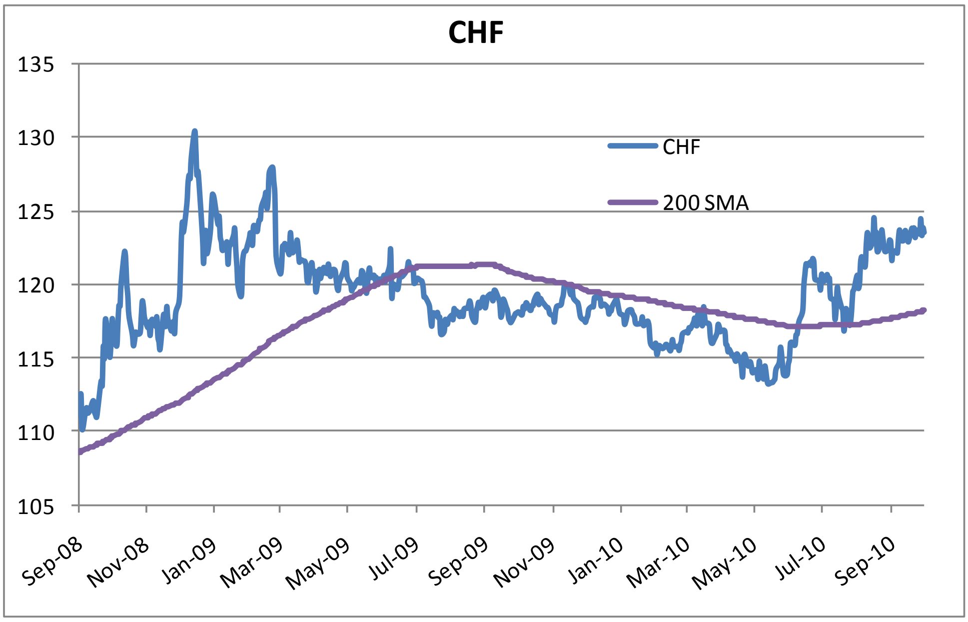
We assume that the pound will continue to trade more or less in correlation with the USD due to the similar themes the two currencies face, even if the relative strength could vary at times, as the pound could tend to be a bit stronger than the greenback when risk appetite is strong and weaker when risk is on the defensive. (We've not changed this last paragraph by a single word since last month as this is precisely what happened over the last few weeks and all signs are that it will continue to be the case.)

The housing market in the UK seems on the way into steep retreat, a development that, combined with all of the austerity measures in the pipeline, should help the CPI fall in line with the BoE's expectations. If not, we should all worry about the pound's value. If the pro-risk trade in the rest of the world hits a rough patch, the pounds relative value across the G-10 (outside of the USD as we note above) could make some solid gains in the months ahead on a retrenchment in the competitive devaluation trade.

Next BoE Meeting: November 4

Alternative scenario: *The GBP would likely continue to weaken if austerity bites in the UK without helping easing inflation and if risk appetite remains healthy elsewhere.*

CHF



The Swiss Franc continues to perform relatively well on the competitive devaluation theme as its

central bank has not even nodded in the direction of quantitative easing and after its currency intervention efforts failed. But is Switzerland the safe haven it once was?

The EURCHF short trade has finally shown signs of bottoming out with the Euro's newfound respect on tight ECB policy. But the relative franc weakness has been stemmed somewhat by the relatively tight SNB policy, which has not even begun to nod in the direction of QE and kept the franc relatively elevated versus the rest of the G-10 currencies and particularly against the trio of devaluing sinners, the Fed, BoJ and BoE. Continued economic strength in Switzerland has offered another boost to the currency.

Still, the franc' relative strength is a risk to the country's export sector and the recent rise in risk appetite has glossed over the continued risks to Switzerland stemming from the overbearing size of the country's financial services sector. There may be skeletons yet in the closets of the Swiss banks if financial markets experience a renewed disturbance in the months to come – something we see as increasingly likely since the markets have become an almost outright three-ring circus of speculation and attempts of Fed front-running. As well, we are seeing a few signs of slowing improvement in Swiss economic fundamentals, as the previous intervention may have boosted domestic economic strength as it served as a kind of policy easing, an effect that is fast fading since the SNB gave up on its intervention policy more than three months ago.

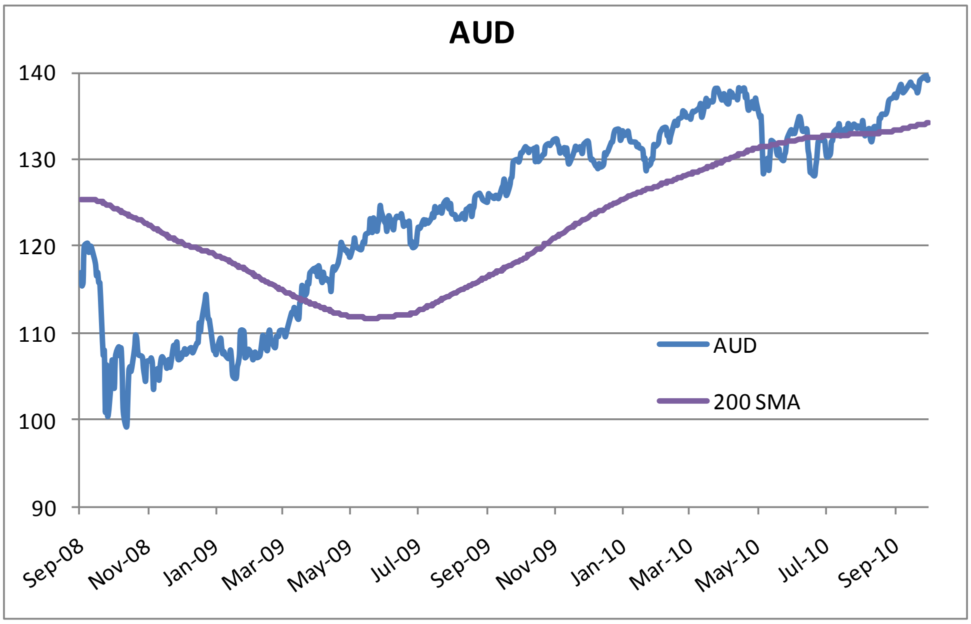
Outlook

The USD fell to a remarkable level of well below parity (0.9500, in fact) vs. the franc, a development we didn't anticipate on the strength of the competitive devaluation theme. A further panicky blowoff conclusion of the USD sell-off could see lower levels still, but we're most interested to see how the franc behaves on a new round of risk aversion, as all indications are that pairs like USDCHF and GBPCHF are trading purely as a function of the competitive devaluation theme – which is in turn an expression of risk appetite and the direction in emerging market equities – so the franc may not exactly be a safe haven currency when the going gets rough if this correlation holds true.

Next SNB Meeting: December 16

Alternate scenario: *USDCHF trades to 0.90 on a blow-off run of the competitive devaluation theme before reversing just as sharply in the opposite direction*

AUD



The Aussie has eked out new highs for the cycle on the implications for commodities prices stemming from the competitive devaluation theme and as the RBA seems far from joining the

devaluation choru. As well, Australia's exposure to the Chinese growth has made it a favourite in this environment and AUD has managed to pull to new all time highs for the cycle.

AUD remains the biggest gainer within the G-10 on the general implications of the competitive devaluation theme, but also as the RBA still seems primed for another rate hike or more aimed at keeping a lid on a supposedly strong economy even though it somewhat surprisingly balked at taking the cash target higher in September.

We have noted recently that strength in the Australian economy is increasingly limited to the mining sector, a development that has only been underlined over the last month as commodity prices have begun rallying more broadly. Meanwhile, most indications outside of the mining sector point to a rapidly cooling economy. Construction activity is in rapid contraction, the services side of the economy is also clearly contracting now, and credit growth looks to be at a tipping point. The imbalances in the Australian economy represent a tremendous risk to the Australian economy going forward on a potential shock if the all important resource prices fall– and for the Australian currency, which is priced at extraordinarily overvalued levels.

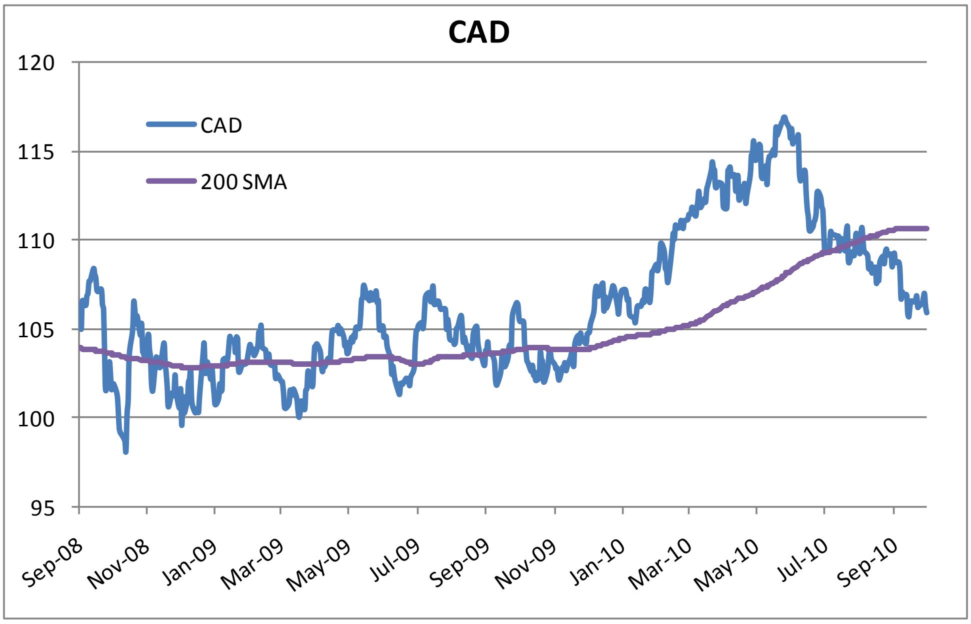
Outlook

While a blow-off rally in commodities and the competitive devaluation theme could see the Australian dollar reach ever more dizzying heights of success in the near term, we feel that the erosion of fundamentals outside of the mining-related sectors in the Australian economy is a significant cause for concern. Of particular import on that front is the trajectory of Chinese demand, to which Australia exports such a significant portion of its resources. A slowing China might be a necessary precipitator for the bout of Aussie weakness we expect will eventually arrive. This latter is the main risk to any Aussie-negative view like ours, since predicting the trajectory of a command economy is a futile exercise in the short to medium run since the regime in these economies can continue pursuing more and more grotesque distortions of economic reality for political ends.

Next RBA Meeting: November 2

Alternative scenario: *As long as the competitive devaluation theme continue to see risk assets and commodities spiralling ever-upward, the Australian currency will maintain its strength as well, meaning that AUDUSD could move significantly higher than parity in the near term.*

CAD



CAD has been dragged through the mud by the still very weak US economy, a focus that has outweighed the relatively positive implications of its precious metal-heavy equity market and

important natural resources in a world of competitive devaluation.

CAD remains on the weak side versus the G-10, even as it has moved somewhat stronger versus the hapless USD on the competitive devaluation theme. While the BoC did hike in early September, one wonders why the market continues to look for another rate hike from the Bank when the administration and the Bank are now clearly very worried about the strength of the currency against its all important neighbour to the south. Several signs now point to the risks of a slowing Canadian economy and a continuation in deteriorating terms of trade with the US as the currency remains at the stronger end of the range versus the greenback.

Outlook.

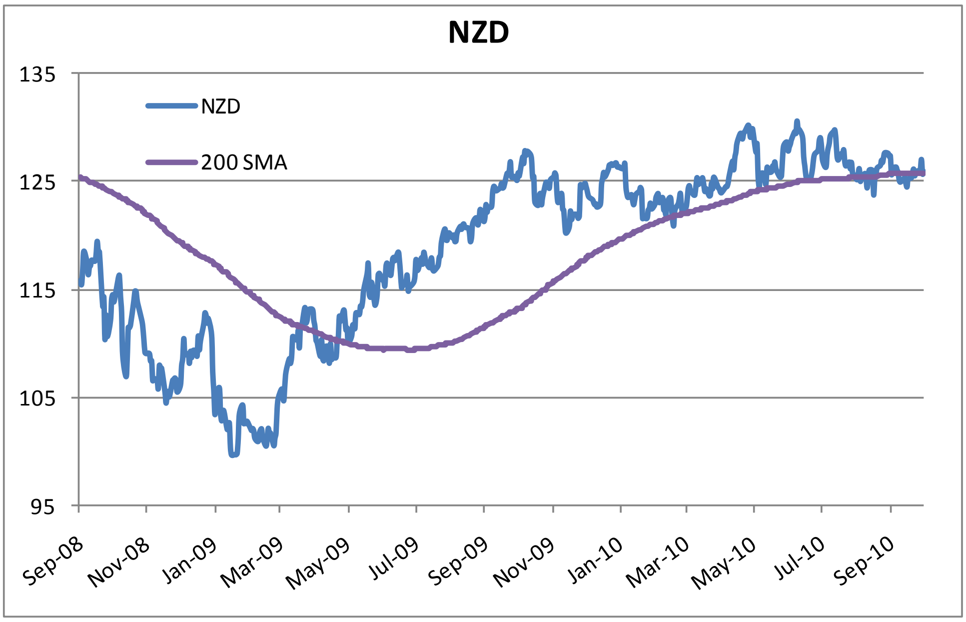
CAD is too strong versus the US dollar, and if the upward spiral in commodity prices and risk appetite comes to an end in the weeks to come, this may rapidly become evident. The BoC is going nowhere at all in the coming year and probably wishes that it could take back its last hike from September 8 considering what has unfolded in global markets since that date. Further risks to the Canadian economy include a more rapid unwind of the country's housing bubble – as the Canadian housing market is where the US housing market was in early 2007 – only without the amplifying effects of securitization/sub-prime, etc.. Still, a bubble is a bubble, and signs are that we are rapidly transitioning to implosion mode. Inflation also remains very low and Retail Sales over the summer looked awful.

Still, the Canadian dollar is unlikely to trade as a particularly high beta currency in the cycle ahead if we see a significant correction in USD strength since it has already been dragged south by its bigger neighbour to the south, so one might consider whether NZDCAD or AUDCAD shorts are an interesting way to express the view that the competitive devaluation/risk asset spiral are overdone without having to trade the US currency.

Next BoC Meeting: October 19

Alternative scenario: *the longer the precious metals rally continues in the near term, and in particular, if energy market prices also burst through higher if the world continues to fret the implications of further Fed easing, this could add further pressure on CAD to appreciate versus the USD.*

NZD



NZD has gone nowhere in particular against the rest of the G-10 over the last month. It has been dragged higher versus the USD on the competitive devaluation theme, but lacklustre numbers in the domestic economy have kept it relatively anonymous in recent months otherwise.

Considering the all-encompassing focus of the competitive devaluation theme and pro-risk stance in global markets over the last several weeks, the kiwi's performance is actually relatively underwhelming. Some of the weakness is understandable, considering the RBNZ's more cautious stance from its mid-September meeting, in which it made clear that it would like to pause for a time to assess the situation, particularly from the Christchurch earthquake, the worst natural disaster in the country's history.

Still, the assumption on the part of kiwi bulls is that strong Asian growth will remain the norm, and rising commodity prices – which are now broadening with the competitive devaluation theme and the huge rise in grain prices on supply issues - will support New Zealand's key food-related exports. Still, the picture is not rosy for the New Zealand economy at the moment as we try to determine whether the slowdown over the summer in business activity and consumption will deepen later this fall. One significant further risk to the New Zealand economy is the housing market, which never really corrected from its bubble state and in which activity is strongly contracting again – perhaps anticipating falling prices.

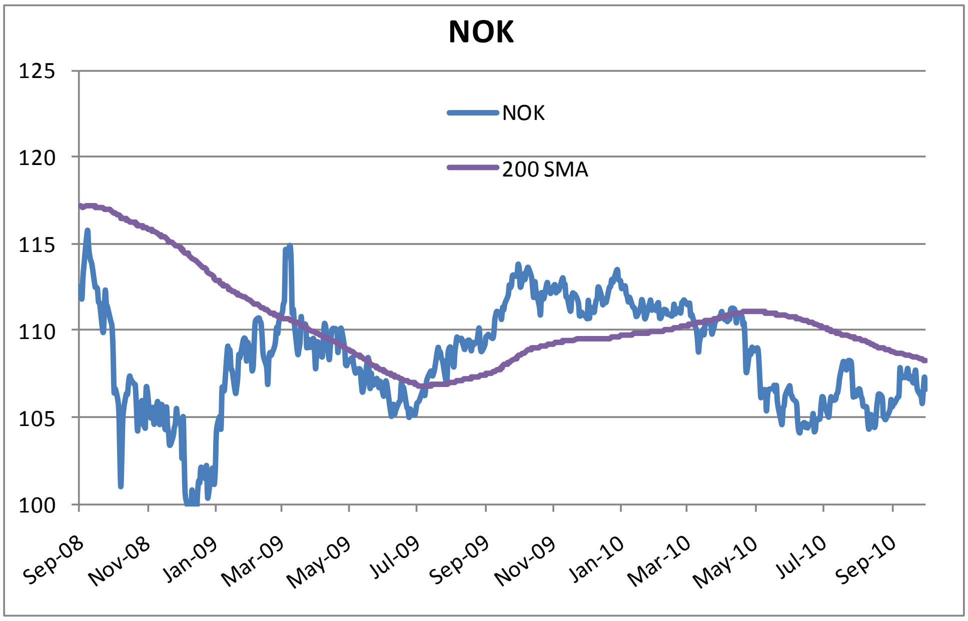
Outlook

NZD will most likely perform in close correlation with the strength of the competitive devaluation theme, if somewhat passively. It 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 country's risk a double dip in their economies.

Next RBNZ Meeting: October 27.

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 has received little focus over the last month- weaker versus the very strong Euro, but perhaps keeping some modicum of resilience on firming in energy prices. .

The Norwegian krone has on the defensive versus the resurgent Euro – mostly due to the latter's strength rather than anything particularly noteworthy happening in Norway lately. NOK managed to remain relatively resilient more broadly speaking as the most recent Norges Bank meeting saw the bank continuing to express the desire for further normalization (raising) of rates, despite a very lacklustre set of economic numbers and very low inflation data. Also supportive of NOK has been a 10 dollar rally in crude oil on the competitive devaluation theme. But in general, there has been very little focus on the currency if late, which may continue to be the case until/unless sovereign creditworthiness comes into question, in which case the krone should shine due to the country's unmatched fiscal balance and large current account surplus.

Outlook

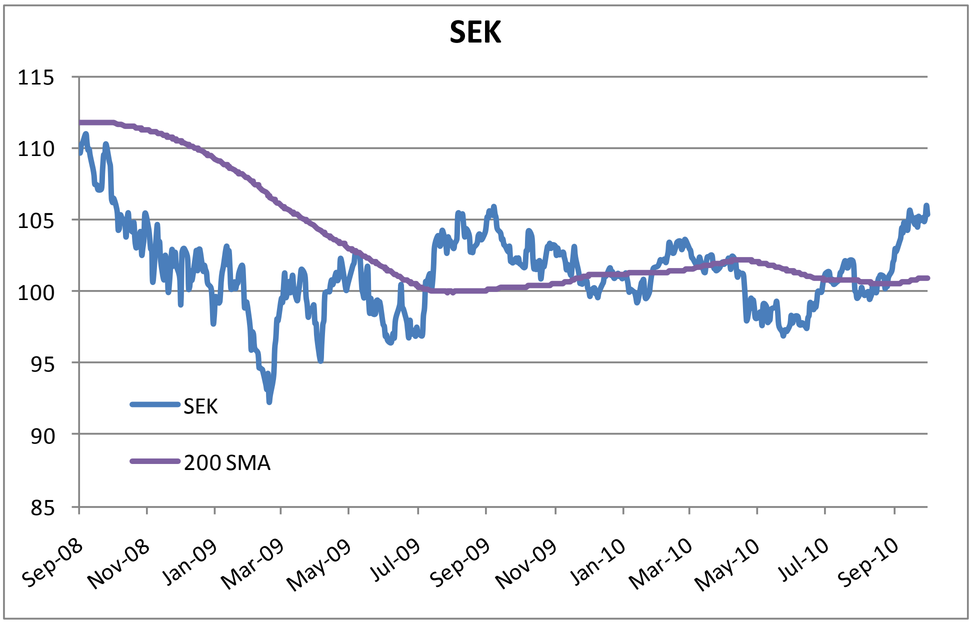
NOK is a very curious creature within the G-10 and we suspect that, while it may perform poorly initially if global risk appetite sours once again as we suspect, it also contains the potential for enormous strength in the right kind of environment – particularly one in which the government bond yields rise because of the fear of bleeding defaults through inflation rather than for pro-cyclical reasons. That would be a sweet spot for the NOK, though that is not currently a part of our baseline scenario, just something to keep in the corner of our mind for returning to in the right conditions. At the extreme, an out-and-out 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. Again – just a scenario to consider.

So NOK may weaken in the initial phases of a new sell-off in risk, particularly versus the USD, but 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 CAD, levels that will look even cheaper if China sees a hitch in its growth story.

Next Norges Bank Meeting: October 27.

Alternative scenario: *consider the NOK potential whenever serious sovereign debt worries surface. Even with a significant extension of the current focus on competitive devaluation, the NOK could get more respect than it is currently receiving.*

SEK



The krona is reaching its highest levels versus the G-10 on the competitive devaluation theme as its central bank continues to look to hike and as its export economy continues to hum.

The krona rally more broadly speaking has continued with the latest extension in risk appetite – though the focus on the competitive devaluation theme and sudden respect for the Euro due to tight policy there has meant that the EURSEK rally has finally eased over the last month.

Outlook

The SEK upside argument is understandable as the country clearly thrives whenever its export markets are thriving, and high exports and low interest rates have confidence and the economy humming in Sweden. SEK strength could have a bit further to run as long as equity markets remain robust and the Chinese growth engine continues to hum. The market is also looking for the Riksbank to hike more than any other G-10 central bank in the coming year.

But there are three major risks to further upside to the Swedish krona from these levels. First, of course, is the umbrella risk of a less robust outlook for the world economy. If economic growth expectations ease and if China's outlook in particular dims, this will almost inevitably hurt the krona as the Swedish economy is very leveraged to its export markets. As well, the latest trade balance number for August was actually negative and even if this was a spike, the country's terms of trade have been heading sharply in the wrong direction over the last couple of years.

Second, 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 possible 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).

Finally, the Swedish National Debt Office has announced that it will unwind its long SEK exposure built up over the course of the financial crisis as it intervened during that period in an effort to keep markets orderly. The position apparently measures some SEK 50 billion, a "noticeable" amount to unwind. One imagines that the office would like to unwind the position slowly and only at favourable levels, but this still could provide some headwind to further SEK appreciation.

Further out, Sweden may perform reasonably well (far less downside than during the financial crisis) as its fiscal house is in relative order compared to most of the rest of the developed world and on basic valuation.

Next Riksbank Meeting: October 26.

Alternative scenario: *a continued spiral higher in risk appetite and the competitive devaluation theme would likely generally favour the krona beyond our base scenario expectations.*

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