

1Q 2010 MARKET OUTLOOK

Muddling Through: Growth Divergences to Drive FX

Highlights

- Review of 4Q Predictions

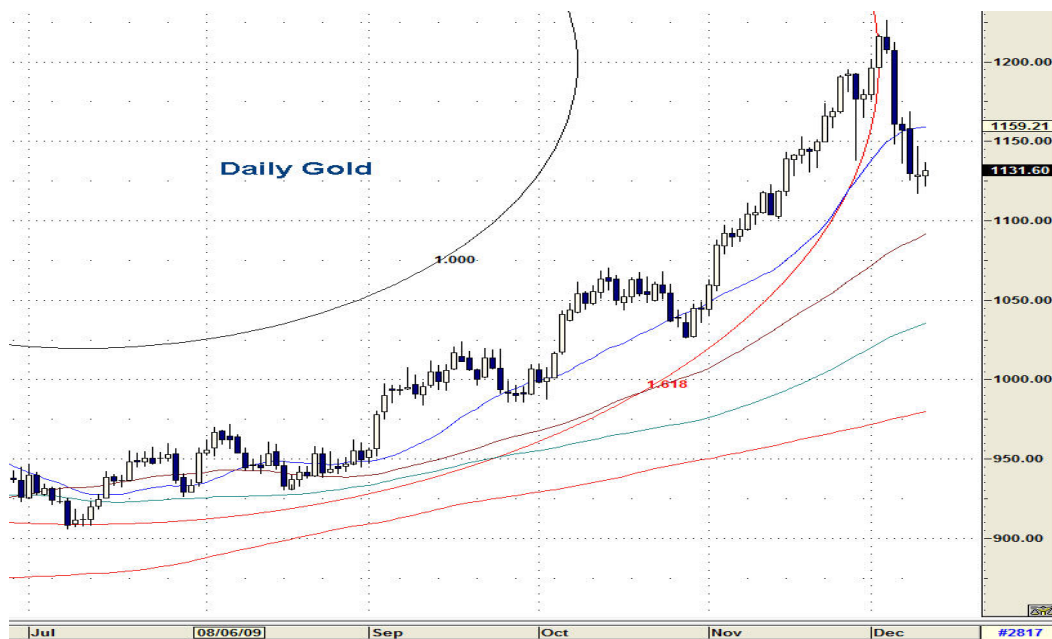
Overall ranges did prevail--EUR/USD today is nearly exactly where it was on Oct. 6, and USD/JPY is about 1 yen lower. The USD remained weak, but we never got the recovery we expected. The USD did experience additional weakness, but it never became especially extreme. Lastly, inter-market correlations actually intensified in the 4Q, with many moving above 90% at the peak. Our major short-coming was in not anticipating the additional USD weakness that unfolded during this period, but to be fair, our price expectations were quite aggressive at the time, effectively forecasting a USD bottom at the then-current market levels.

- 4Q Trading Strategies Reviewed

In terms of our trading strategies, our underestimation of USD weakness caused us to be stopped out by small margins in GBP and JPY, while our EUR/USD strategy remains in play. Where we completely missed the mark was in our commodity calls. We completely underestimated the speculative frenzy that unfolded in metals and energy, but we still think the fundamentals do not support the moves seen in 4Q. Still, we are mindful that markets can remain irrational for longer than we can stay.

- Gold's Parabolic Rally and Bust

In case you have any doubts about the speculative nature of the rally in gold in particular, this chart shows a classic parabolic acceleration in gold prices during the 4Q, culminating in a final surge, followed by a nearly 10% collapse in the course of a week.



- Key Market Themes for 1Q 2010

Turning to our outlook for the 1Q of 2010, we think the primary driving theme in FX will continue to be risk appetite. The global recovery is underway, anemic and uneven as it, but with most G7 rates to remain near zero for the quarter, investors will continue to seek returns in risky assets like stocks and commodities.

So far in December, we've had a minor correction lower in stocks and commodities, and a small rebound in the USD. Some of this is due to European credit concerns and a rise in short-term US rates, but we think the bulk of the pullback is due to excessive 'risk-on' positioning and USD short-covering. We expect European credit concerns to fade into the New Year and for investors to embrace risk again at the start of 2010.

We think risk sentiment will mostly be in the 'on' position throughout the 1Q, but obviously subject to hiccups on data disappointments or credit surprises. 4Q corporate earnings reports are likely to sustain risk gains into late February, but from then on, risk sentiment is likely in greater jeopardy as concerns grow about the outlook as stimulus efforts wind down and interest rate hikes loom on the horizon in 2H of 2010.

High unemployment will continue to restrain consumer activity throughout the G7, resulting in further uneven economic data overall. Throw in residential housing market weakness, commercial real estate fears, and financial sector travails, and a smooth trajectory toward sustained growth seems highly unlikely. Additionally, the winding down of stimulus packages will likely undermine corporate and consumer confidence.

Taken together, we think these factors are likely to lead to a continuation of relatively range-bound, sideways trading conditions in most key currency pairs. USD weakness is likely to fade as a driving theme, as US data may prove slightly more upbeat than reports out of Europe, the UK and Japan. Additionally, marginally higher US market rates may induce further unwinding of short-USD positioning. Overall, we think trading conditions will favor short-term, mini-trends and anticipate another target-rich environment as market correlations remain high.

- Currency Themes for 1Q

While we can envision some further USD recovery, primarily as short-USD positioning is unwound, the USD is likely to continue to trade on the weak side as the Fed will maintain a near-zero interest rate policy into the 2H of the year. Fed comments have made it abundantly clear that a solid, self-sustaining recovery is needed before the Fed will move to tighten. We don't think those conditions will be met in 1Q by any stretch. However, a recent back-up in US yields has moved the USD out of the rate cellar, and it should be less of a clear-cut funding currency.

The Japanese government's new fiscal stimulus and the BOJ's additional liquidity measures are likely to keep JPY rates the lowest of the major currencies and restore the JPY to its role as the primary funding currency for carry trades. Additionally, MOF threats to intervene should be taken seriously, given the damage JPY strength has caused the economy. Together, these factors should work to keep the JPY generally weaker. On the flip side, corporate JPY repatriation may wane at the start of the Japanese 4Q, allowing the JPY to weaken further. Repatriation flows will become more pronounced into March as the fiscal year draws to a close.

The pound is at risk on several fronts and should remain on the weak side against both the USD and EUR. The BOE is likely to maintain 0.50% benchmark rates through the 1Q at least, and the end of QE may lead to a relapse in UK credit markets and a fresh strain on a still weak economy. A further expansion of QE in February may aggravate concerns over the pound's value and heighten fiscal sustainability worries. Debt fears will continue to hang over the pound.

The currencies that are most likely to outperform are those where growth has returned most solidly and where interest rates are being raised. AUD is the standout here, followed closely by the NOK. Both central banks are expected to raise rates at least one more time in the 1Q. Kiwi is also expected to do better than most, but the timing of the first rate hike may only be in 2Q at the earliest. The CAD is also likely to do well, but Bank of Canada opposition to further CAD strength and its pledge to hold rates steady until June may limit 1Q CAD strength.

The recent drop in Japanese short-term rates has seen the JPY return as the primary carry trade funding currency. This is most evident in JPY-crosses re-establishing high positive correlations to risk assets over the last two weeks, similar to the situation that prevailed up to the end of 3Q. We think BOJ extra-credit measures will continue to weigh on short-term rates and this will keep the JPY-crosses trading in tandem with risk assets.

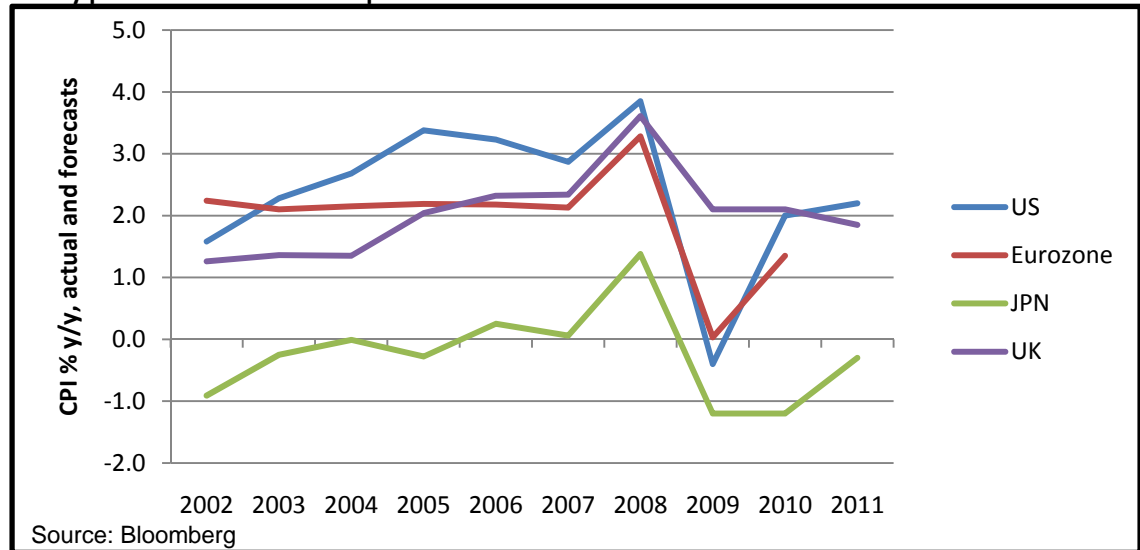
- Expected ranges for key pairs in 1Q

EUR/USD:	1.4300/1.5000; risk to 1.3800 if below 1.4300
GBP/USD:	1.5700/1.6500; risk to 1.5300 if below 1.5700
USD/JPY:	87.00/95.00; risk to 100.00 if above 95.00
USD/CHF:	1.0100/1.1000; risk to 1.1500 if above 1.1000
AUD/USD:	0.8800/1.000; risk to 1.0400 if above 1.0000
NZD/USD:	0.7000/0.7800; risk to 0.8300 if above 0.7800
USD/CAD:	0.9700/1.0700; risk to 1.1100 if above 1.0700
EUR/GBP:	0.8800/0.9500; risk to 1.0000 if above 0.9500
EUR/JPY:	128.00/140.00; risk to 146.00 if above 140.00
Gold:	1050/1150; risk to 1250 if above 1150/70
Brent crude:	65.00/77.00; risk to 83.00 if above 77.00

Inflation outlook still subdued

- High levels of spare capacity in much of the G-10, unemployment rates will still trend higher in many countries
- US and UK will have to make efforts to reduce budget deficits
- Slow wage growth, higher savings rates suggest lessened pricing power on Main St.

Survey points to low inflation expectations



Central bank outlook

- Risk of 'w' shaped recession has receded though as impact of fiscal stimulus tapers off growth in 2010 likely to be slow in many parts of G-10
- Rhetoric of most G-10 central banks recognizes economic improvement but cautious on path of recovery
- Fed, ECB, BoE rates likely to be on hold at least until Q3 2010
- UK inflation to spike higher in the spring due to higher energy and VAT. However, low underlying inflation suggests BoE rates to remain low.
- Growth has returned to most countries suggesting that Q1 will bring more unwinding of emergency measures.
- The laggards: The BoE has left the door open for further QE. The BoJ under pressures from the Jpn Gov't to take further action.
- The leaders: the RBA have hiked three times already, the Norges Bank has also hiked.

Will 1Q bring signs of a potential double-dip?

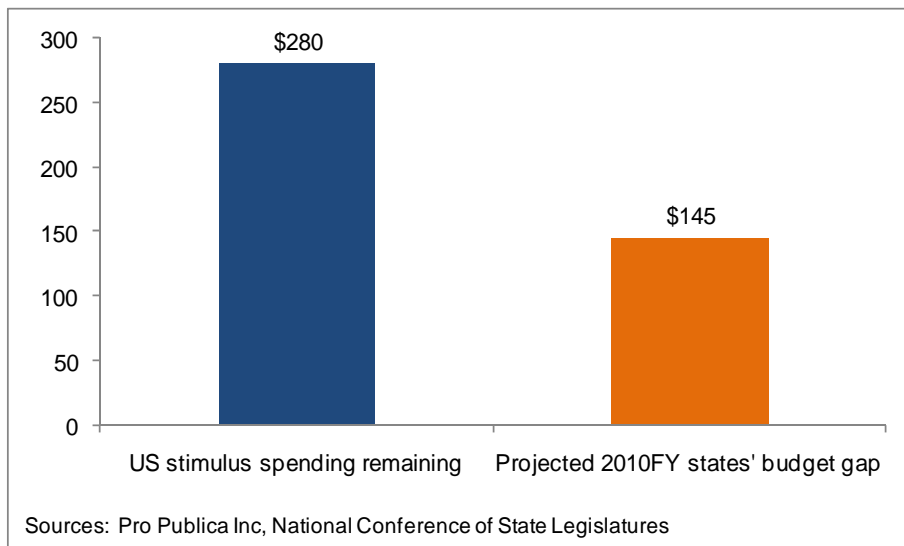
We think the risk of a double-dip in economic activity is high of enough that it should not be ignored or tossed aside. First, it does not look as if the US fiscal stimulus in the pipeline will be enough to generate significant growth. Second, there looks to be little doubt that this will be the mother of all jobless recoveries. Finally, a relapse in what is seemingly an improving US housing market would nip the nascent global recovery in the bud.

US stimulus to come up short

Most of the US government's \$790 billion stimulus package will have been spoken for as we enter 2010. There is currently \$280 billion in spending that has yet to be allocated and about \$128 billion in tax cuts that have yet to be distributed. Most of the spending portion is at risk of being absorbed by troubled state budgets, while the majority of the tax incentives are unlikely to be put back into the economy any time soon.

State deficits to hinder stimulus impact

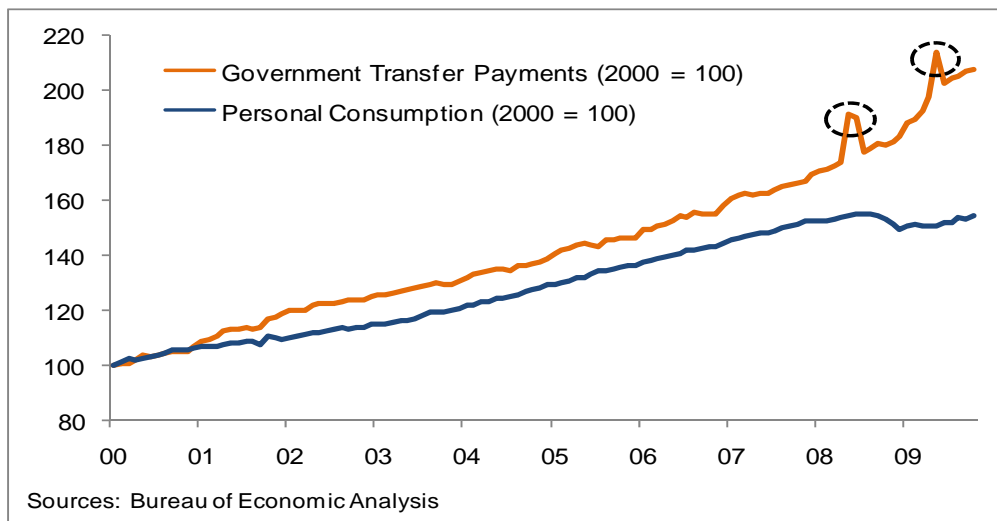
According to the National Conference of State Legislatures, the projected budget gap for states in FY2010 is about \$145 billion. Should most of the remaining stimulus monies be needed to plug these gaps (as was the case in 2009), the overall impact to economic growth will be significantly diminished. Siphoning \$145 billion to the states for budget purposes would put the impact to US gross domestic product from the remaining amount of stimulus at around 1%. This is assuming that we get a 1-1 impact on every dollar spent (which is debatable) and that state budgets do not deteriorate further (which is obviously a risk).



Remaining tax cuts unlikely to help

In terms of the remaining tax cuts, permanent income hypothesis and recent observed trends suggest little of this will be put back into the economy. Permanent income hypothesis states that the choices made by consumers regarding their consumption patterns are determined not by current income but by their longer-term income expectations. This theory has been proven true once again very recently. Government transfers were increased markedly in early 2009, averaging a whopping 3.2% monthly increase from January through May. During this time, personal consumption increased a paltry 0.2% per month on average. In other words, a \$322 billion increase (annual rate) in handouts only managed to elicit a measly \$80 billion in spending. A similar spending pattern for the remaining \$128 billion in tax cuts would see about \$32 billion put back into the economy, or a measly 0.2% of gross domestic product.

In the United States, recent growth has been all government induced. If not for cash for clunkers and the first-time homebuyer tax credit, growth in the third quarter would have been just about non-existent compared to the actual near-3.0% results. Little in the way of growth contribution from remaining stimulus coupled with what is likely to be negligible organic growth should bring a very weak US economy as we kick off 2010.



Mother of all jobless recoveries

Weak headlines from the employment front will continue to stifle confidence and spending in the year-ahead. The recent turn lower in the unemployment rate notwithstanding (which by the way was very inconsistent in terms of what all of the other employment data for the month of November were telling us), we expect this metric to remain in double digits for the foreseeable future, potentially peaking as high as 11% in the first half of 2010. The negative headlines this is likely to generate, should continue to weigh on a consumer confidence metric which continues to plumb the depths. The consumer's outlook on the economy has remained broadly unchanged since June and at 68.5 remains considerably below the average of 92.5 seen since 1975. This metric leads real consumer spending and currently suggest that personal consumption will go no higher than 1.0-1.5% near-term. This component accounts for about 70% of US GDP and such modest growth here-in will make it very difficult for the economy as a whole to grow at potential.

Is US employment really recovering?

Furthermore, hiring intentions are moribund and not confirming a better job market. The National Federation of Independent Businesses releases a small business confidence survey and the component that shows hiring intentions dipped to -3 in November from -1 in October despite what was a massive improvement in headline nonfarm payrolls to -11K from -111K in that same span. Hiring intentions have trended sideways since June, despite a massive improvement in NFP from a decline of about -470K to the current near-0 read. The lack of follow-through in terms of future hiring suggests little in the way of momentum for the currently beleaguered jobs market – so while firms are likely done with most of their firing, the hiring looks unlikely to return anytime soon.

This should give those who believe the unemployment rate will grind down aggressively some pause. The historical statistical relationship between GDP and employment suggests we need to see real annual growth of 3.0% in order to bring down the unemployment rate by 1 percentage point. Paltry consumer spending coupled with government stimulus that is likely to contribute a mere 1% to annual growth suggests reaching that 3% benchmark will be a daunting task.

Looming US housing market relapse

The potential for a US housing market relapse is not trivial in our view and this would undoubtedly have very negative repercussions for the global economy. Signs of this will probably begin to emerge towards the end of 1Q when the Fed is expected to conclude its \$1.25 trillion MBS purchase program. We think the Fed MBS exit could be one of the triggers that send home prices lower once again.

Fed propping up MBS market

The Fed has absorbed about 95% of gross MBS issuance this year and their exit is widely expected to elicit about a 50 basis point increase in mortgage rates. Demand for MBS paper is unclear given that the Fed's massive participation masked real appetite. Thus, there could be more of a backup in mortgage yields than expected. This would hamper housing affordability and throw a wrench into the newly extended homebuyer tax credit scheme (set to expire in late April-June). In an environment with potentially another 5 million homes about to be foreclosed upon, a drying up of demand on the back of higher rates would be detrimental.

US home prices leading global growth

In terms of what this would mean for global growth, the recent cycle suggests another leg-down in US home prices would negatively impact world GDP. In recent years the US housing market and the global economy have gone hand-in-hand. US home price trends have led the global economy by about 1-2 years since 2004. As such, the risk of a US housing collapse 2.0 should not be taken lightly.

1Q Trading Strategies...

- Buy AUD/USD 0.8700/0.8900; stop 0.8450; target 0.9800
- Buy Gold 1050/1080; stop 1020; target 1250
- Buy EUR/USD 1.4000/1.4200; stop 1.3750; target 1.4800
- Sell USD/CAD 1.0600/1.0800; stop 1.1000; target 0.9900
- Buy EUR/GBP 0.8600/0.8800; stop 0.8450; target 0.9400
- Sell GBP/AUD 1.8200/1.8400; stop 1.8500; target 1.6500

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