

# QUARTERLY REVIEW

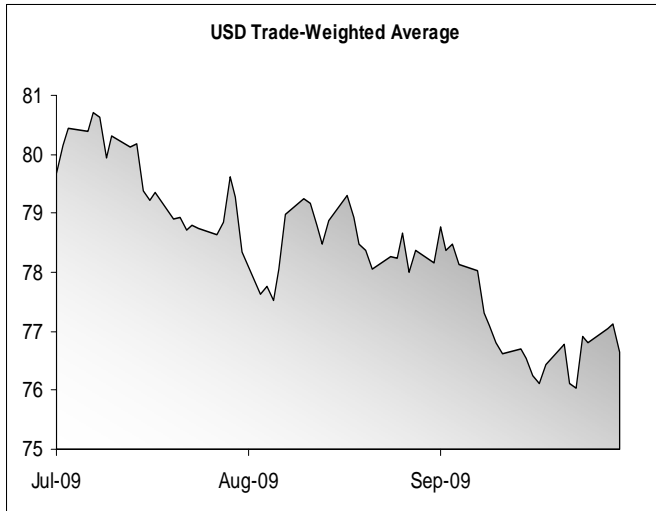
a quarterly market analysis from Travelex Global Business Payments

Posted: October 1, 2009



## USD Q3 Summary

Month: -2.21%    Quarter: -2.72%    YTD: -5.02%



The trade-weighted U.S. dollar index fell to its lowest level in a year in September, broadly weighed down by steadily improving sentiment throughout global financial markets. Upside surprises to economic data encouraged optimism that a global recovery is at hand and dampened demand for the traditional safe-haven USD. Mounting worries about America's soaring deficits and its ability to attract the capital needed to finance them also undermined the greenback's appeal.

Upside surprises to global economic data have signaled a marked stabilization in the economy and have fostered a sense of optimism that a recovery is taking hold. The subsequent rise in risk appetite continued to sap the greenback of safe-haven appeal. Rising equities, stronger commodities and broadly improved emerging market performance was consistent with investors' elevated risk appetite. Late in the quarter, momentum and technical selling as well as worries about the dollar's position as the world's reserve currency added to the USD's broadly heavier tone.

## USD Outlook

The U.S. dollar's broad selloff since the middle of the second quarter has been largely fueled by mounting signs that the worst of the crisis has passed. The improvement in risk appetite associated with the relief that a "Great Depression" type scenario had been averted prompted a broad unwinding of defensive long-USD

positions that had been accumulated during the height of the crisis. While encouraging, much of the recent signs of improvement in the global economy will eventually prove to be a result of unsustainable government stimulus and not from any organic improvement in underlying fundamentals. The resulting market disappointment in the actual pace of recovery should see risk assets underperform in favor of safe-havens like the greenback. Worries about soaring U.S. deficits and reserve diversification out of dollar assets will continue to limit the USD's upside.

### Positive Factors

- The U.S. dollar's status as the world's safe-haven asset still benefits it, especially during times of increasing risk aversion and concerns about the global economic outlook
- The steep rise in risk assets over recent months looks somewhat overstretched at current levels and could result in a flight back into safer assets if the pace of global recovery undershoots the market's elevated expectations
- Much of the perceived improvement in the global economy, a key driver of the rally in risk assets, has been fueled by transitory government stimulus spending, not a recovery in underlying fundamentals
- The unprecedented policy response from the Fed and the government in the early days of the financial crisis has helped many key sectors of the economy stabilize and even improve
- While the unemployment rate continues to rise, the pace of monthly job losses has fallen sharply from its peak last winter
- The Obama Administration's massive stimulus spending, while detrimental to America's fiscal position, is widely seen as contributing to positive, albeit short-term economic growth

### Negative Factors

- Mounting signs of stabilization in the global economy suggest that the worst of the crisis has passed. The resulting rise in risk appetite saps the greenback of key safe-haven appeal
- Zero percent interest rate policy and a flood of dollars into the financial system as a result of the Fed's quantitative easing are inherently USD-negative and markedly deteriorate the U.S.'s already dire fiscal position
- Soaring government spending and deficits and the required debt issuance to fund them threaten the U.S.'s fiscal outlook and weigh on foreign demand for USD-denominated assets
- Three-month LIBOR USD lending rates are now below three-month JPY rates for the first time in over a decade. The dollar's rock-bottom yield leaves it vulnerable to carry trade-related selling, especially during periods of improving market sentiment
- Rising unemployment, now at its highest level since 1983, threatens to keep aggregate demand in the economy under increasing pressure, even as other sectors recover
- Soaring commodities like gold and crude oil signal an improvement in the global economy and sap the USD of strength

- Home prices continue to fall, keeping the precipitous downward cycle of sliding prices, mounting defaults, troubled banks, tight credit conditions and depressed consumer spending in tact.
- Mounting talk of central bank reserve diversification out of dollar assets remains a key liability for the greenback

### Conclusion

The third quarter of 2009 marked a continuation in the greenback's downward trend that was initiated by its steep declines in Q2. Moderating risk aversion over the past two quarters has fueled the broad unwinding of defensive long-USD positions that had been accumulated during the height of the market chaos between Q3 2008 and Q1 2009. Global investors, who were shell-shocked by the collapse of America's subprime mortgage market and subsequent crisis throughout global financial markets, flocked to the relative safety of dollar-denominated assets like Treasury bonds in droves. The massive spike in aversion to any asset with even the narrowest risk profile saw the U.S. dollar index soar to its highest level in three years in early March 2009. Since then however, mounting signs of stabilization in the global economy triggered a relief rally in risk assets on the notion that a worst-case "Great Depression" type scenario had been averted. The subsequent unwinding of dollar-denominated positions in favor of higher yielding instruments like stocks, commodities and emerging market assets pushed the U.S. currency to a one-year low in mid-September.

Indeed, recent signs of stabilization in the world's largest economy have been encouraging. Nearly all gauges of consumer and business confidence have rebounded sharply in recent months, with the University of Michigan's consumer sentiment index currently near its highest level since February 2008. Manufacturing sector activity, as measured by the ISM, expanded for the first time since June 2008 in August, while the services sector put in its best performance since September 2008. Even the troubled housing market, suffering from its longest downturn since the 1930's, is showing signs of bottoming, with both new and existing home sales figures for July rising by 9.6%(m/m) and 7.2%(m/m) respectively. Employment remains a key area of concern for policymakers with the unemployment rate now at its highest level since June of 1983 and projected to continue rising even as the broader economy emerges from recession. However, the pace of job losses, which peaked at over 740,000 per month in January, has slowed markedly to just over 200,000 in August. The encouraging improvements have not been specific to the U.S. Both Germany and France, the euro zone's largest economies, surprisingly emerged from recession in the second quarter. China too, has shown surprisingly resilience, with its key manufacturing sector expanding at its fastest level in 12 months. Japan, the world's number two economy recovered from an 11.7% annualized decline in the first quarter to grow by 2.3% annually in Q2.

While the relative strength of recent data from the world's largest economies has been a clear sign of stabilization, it is not likely sustainable. To-date, the U.S. government has spent over \$800 billion on a stimulus package aimed at infrastructure spending and aid to state and local governments. The bill included \$287 billion in tax cuts. China spent roughly \$600 billion on its stimulus package with the bulk of those monies earmarked for infrastructure projects and consumer assistance. Japan pumped \$120 billion into its economy, Germany spent \$100 billion and the U.K. and Canada

anteed up \$30 billion each. The total of five trillion dollars in taxpayer dollars have been pumped into the global economy and are in addition to historic monetary easing which has pushed global interest rates to record low levels. The average benchmark lending rate of the G7 nations is currently under 0.50%. Moreover, quantitative easing schemes in the U.S., the U.K., the euro zone and Japan have add to flood of cheap money sloshing throughout the global financial system. The short-term stimulus spending around the world aimed at avoiding a complete collapse of the global economy has been successful in providing a backstop for growth. However, rising unemployment will ultimately keep final demand in the industrialized world under significant pressure for well into 2010. Household balance sheets have deleveraged significantly since the start of the recession and are expected to continue consolidating for the foreseeable future. The rising savings rate in the U.S. combined with stagnant wage growth will keep consumers entrenched for the foreseeable future and will ultimately keep the pace of global recovery very subdued. As the "sugar high" of government spending fades over the coming months, aggregate demand is unlikely to have improved to levels that will be able to maintain the current elevated pace of global output. The resulting drop in production is likely to yield another dip, or a "W" shaped recovery.

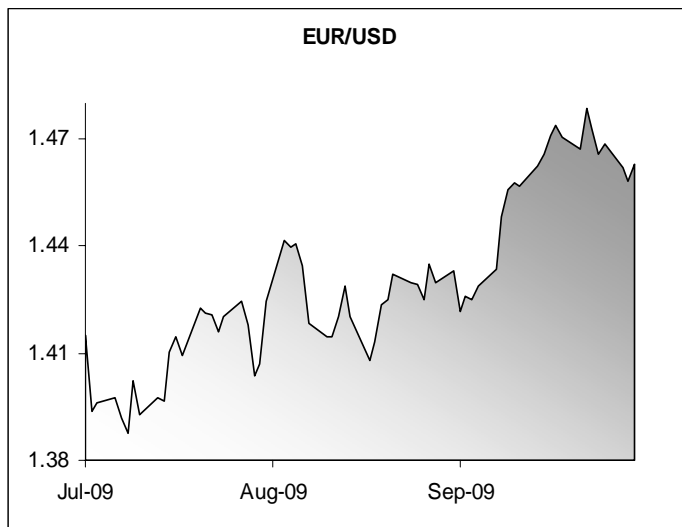
The U.S. dollar should benefit from the market's inevitable disappointment in the actual pace of recovery versus the elevated expectations that have been priced into assets. Global financial markets are currently pricing in a "V" shaped, robust recovery. The Dow Jones Industrial Average is up over 46% from its March lows. Japan's Nikkei has rallied by 44% since March, London's FTSE is up 52% and China's main SSE share index is 70% higher than its lows in the winter. Commodities too have enjoyed a sharp rally on hopes of a near-term global rebound. The Commodity Research Bureau's index is up 30% since its lows in the first quarter, with crude oil up almost \$40/barrel in recent months. The pace of recovery currently being priced in by financial markets will ultimately prove overoptimistic, resulting in a pullback in investors' exposure to risk- an outlook that favors a broad return to safer assets like the USD.

The medium-term outlook for a stronger dollar is not however, without considerable risk. The soaring levels of U.S. government debt continue to seriously undermine the outlook for the greenback. A key concern for the dollar's longer-term outlook remains the threat of soaring government deficits and the Federal Reserve's monetization of debt that could potentially result in a surge in inflation once a recovery begins to meaningfully gain traction. To allay market concerns, the Obama Administration has pledged to reign in government spending and reduce the deficit over time. The Federal Reserve has already begun to reduce the size of its balance sheet by allowing various credit easing facilities, including its \$300 billion Treasury purchase program to run off (Fed purchases of mortgage and consumer loans will likely continue well into 2010). In addition, worries about the U.S. dollar's status as the world's reserve currency and reserve diversification remain an Achilles heel for the greenback. However, key surplus nations like China and Japan remain net buyers of U.S. Treasury assets, despite some of the recent rhetoric suggesting otherwise. Consequently, the dollar will rebound from its current oversold levels as investors trim their exposure to risk assets as the pace of global recovery undershoots the markets overly optimistic expectations.



## EUR Q3 Summary

Month: +2.35%    Quarter: +2.73%    YTD: +4.12%



The single currency put in a generally positive performance during the third quarter of 2009, rising to a new one-year high against the beleaguered U.S. dollar, a five-month peak against the British pound and a two-month high against the Canadian dollar. The euro's broad strength was the result of the marked improvement in investor sentiment, which was fueled by a steady stream of signs that the worst of the financial crisis and recession had passed. Moderating risk aversion prompted further unwinding of defensive positions and capital flows back to the euro zone.

Euro zone economic data improved markedly in the third quarter, helping to alleviate concern that the 16-member economy will lag its major counterparts in recovery. While global trade remained subdued, demand for Germany's key exports rebounded. France and Germany surprisingly recovered from recession in the second quarter, but the rest of the bloc remained mired in recession.

## EUR Outlook

Because much of the single currency's rise since the second quarter of 2009 was based on the unwinding of safe-haven positions and U.S. dollar weakness, it remains vulnerable to a pull back if market sentiment fades. Investors are currently pricing in an aggressive pace of economic recovery, as evidenced by the steep run up in risk assets across the board. Global governments' stimulus spending, which is not likely to be sustained into the coming year, has led to the encouraging bounce in the global economy witnessed over recent months. As spending winds down, the pace of recovery will inevitably undershoot the market's

elevated expectations. The resulting disappointment will lead to a pullback in risk asset that will likely drag the euro down as well. Lingering concerns about euro zone banks' exposure to troubled Eastern European economies and the widening growth gap between Germany and France and the rest of the 16-member bloc will add to the EUR's heavier tone.

### Positive Factors

- While euro zone lending rates have fallen to a record low of just 1.00% in the wake of the worst financial crisis in generations, the euro still enjoys a healthy yield advantage over its G7 counterparts
- The ECB reluctantly followed the Federal Reserve and the Bank of England down the path of unconventional policy easing by implementing a 60 billion euro asset purchase plan. However, the size of the ECB's QE program remains substantially smaller than most of its counterparts'
- The broad improvement in investors' appetite for risk associated with signs of a global economic recovery benefits the euro as investors unwind defensive positions that were accumulated during the height of the financial crisis
- Germany and France, the euro zone's two largest economies surprisingly emerged from recession with very humble growth in the second quarter
- Fiscal restraint on the part of E.U. finance ministers contrasts the unprecedented pace of spending in the U.S. and U.K.
- Talk of central bank reserve diversification out of dollar assets benefits the euro

### Negative Factors

- The ECB was forced to cut its key lending rate to a record low of just 1.00% and to implement unconventional policy easing measures through the purchase of longer-term covered bonds. While signs of stabilization and even growth have emerged, rates are unlikely to rise in the foreseeable future
- The fact the ECB was late in responding to its economy's downturn with the needed policy stimulus has exacerbated its recession and made it more likely that any recovery will be very lackluster in nature
- The euro zone's exposure to struggling Eastern and Central emerging European economies remains a key liability. Rising defaults from emerging Europe threaten to further destabilize already shaky euro zone banks
- Because markets have become overoptimistic in pricing in a global economic recovery, the euro is vulnerable to losses as risk appetite falls back down to levels that are consistent with a more subdued pace of recovery
- The euro zone's exposure to struggling Eastern and Central emerging European economies remains a key liability. Rising defaults from emerging Europe threaten to further destabilize already shaky euro zone banks
- While France and Germany have shown signs of growth, the rest of the 16-member bloc has struggled to recover. The widening gap between euro zone nations could become source of stress within the bloc

## Conclusion

The single currency's recent gains against the greenback and the Japanese yen have been largely fueled by the broad improvement in risk appetite associated with an upgraded outlook for the global economy. Upside surprises to global economic data helped further the notion that the worst of the financial crisis and recession has passed and that a worst case "great depression" scenario had been averted. The resulting improvement in demand for riskier assets saw investors scale back defensive positions in safe-haven USD and JPY assets that were accumulated during the height of the market uncertainty. Domestic economic data that surprised to the upside was also broadly supportive of the single currency, especially against the weaker U.S. dollar. While encouraging, the good economic news is likely to prove unsustainable, given that much of the improvement was the result of short-term government spending and inventory restocking. The resulting disappointment in the actual pace of recovery versus the market's elevated expectations should see risk assets underperform in the coming months. Such a scenario suggests a high likelihood of a weaker euro, especially against safer asset classes.

The single currency soared to a new one-year peak against the broadly weaker U.S. dollar late in the quarter, buoyed by the steady improvement in global investors' appetite for riskier assets. The euro also touched on a one-month peak against the Japanese yen, a five-month high against the British pound and a two-month high against the Canadian dollar. The broad unwinding of defensive positions that were accumulated during the height of the financial market chaos in the fall and winter, saw investors seek higher yielding and riskier investments that had previously been shunned. Indeed, the marked improvement in global economic data has been encouraging. Industrialized nations have all seen broad improvement in economic reports pertaining to manufacturing, services, household and business confidence, trade and even housing. Credit market conditions, while far from normal, have improved greatly as well. Major economies like Australia and China managed to avoid recession, while Japan, German and France surprisingly emerged from their recessions.

However, much of the improvement in macro economic conditions can be directly attributed to soaring government spending, not any meaningful improvement in final demand. Because global stimulus efforts are not likely to be sustained, risk assets like the euro, remain vulnerable to a pullback, especially as the actual pace of recovery in the global economy falls short of the market's elevated expectations. The trillions of dollars of government spending being pumped into the system, combined with the artificially low lending rates globally and the numerous credit easing facilities of various central banks has resulted in a "sugar high" that will eventually fade. If final demand from consumers is not able to sustain the current elevated levels of production, the global economy faces the threat of a "double dip". Such an outcome would see the euro underperform most of its major rivals.

Another key risk for the euro zone is the widening gap between Germany and France, whose economies emerged from recession in the second quarter, and the rest of the bloc, which remains mired in recession. The euro zone's two largest economies surprised the market by expanding by 0.3%(q/q) in Q2. The nascent rebound in global demand since March has most benefited exporters in the bloc's two largest economies. Germany and France also entered

the global recession on much more solid footing than economies like Italy, Spain, Portugal, Greece and Ireland. The Spanish economy contracted by 4.2%(q/q) in the second quarter, Italian output fell by 1.9%(q/q) and Ireland's GDP contracted by 5.7%(q/q). The widening gap in growth between powerhouses like Germany and France and the rest of the euro zone economy poses a host of challenges for monetary policymakers and governments and could potentially put heightened strain on the very fabric that holds the bloc together. Because the 16-members of the European Monetary Union have no independent control over lending rates or their currencies, the natural mechanisms to help cope with an economic downturn (including lower lending rates and a weaker currency) are unavailable. Additionally, the need for increase fiscal spending in poorer euro zone nations will likely be shouldered by richer nations like Germany, a situation that is likely to becoming increasingly unpalatable to citizens in more affluent nations. The potential for increased tensions within the EU could become a key source of weakness for the single currency as the uneven nature of the economic recovery strains the unity of the bloc.

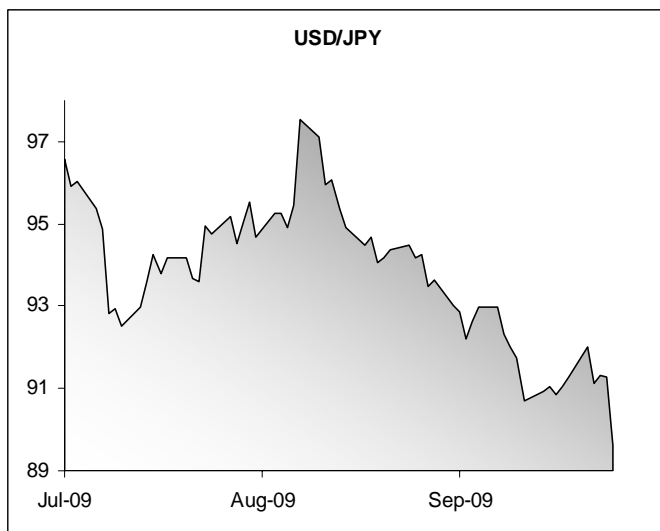
In addition to the outlook for increased market demand for safe-haven assets that should sap the single currency of much of its recent appeal, the euro could also suffer from nagging worries about the health of its banking sector. Banks in the 16-member bloc have a disproportionately high exposure to economies in hard-hit Central and Eastern Europe. A double dip recession for emerging European economies will likely see loan defaults to euro zone banks increase and remind investors of the still fragile state of the 16-member bloc's financial services sector and will further dent the appeal of the single currency.

While the euro's upside will be limited in the months ahead, a rapid selloff in the single currency is in no way guaranteed. The potential for the global economy to surprise to the upside and maintain its current elevated pace of recovery remains a key factor that could keep demand for higher risk assets high. The euro would stand to benefit from further improvement in macro global data and from signs that a global recovery will be more robust than expected. Talk of central bank reserve diversification out of USD assets will continue to be EUR-supportive, as will mounting concerns about America's longer-term fiscal outlook. However, given its steep gains over recent months and the likelihood that the markets have become overly optimistic for a recovery, the euro will likely come under pressure as investors favor safer assets in the months ahead.



## JPY Q3 Summary

Month: -3.65%    Quarter: -7.34%    YTD: -1.40%



**The Japanese yen rose to a new seven-month peak against the greenback and to a new two-month high against the Canadian dollar, despite the fact that global investors have become increasingly optimistic about a near-term economic rebound, a backdrop that usually dampens demand for the low yielding yen. Fiscal half year-end capital repatriation flows, options related buying and the new Democratic Party's apparent acquiescence to a stronger yen were broadly supportive in the third quarter of 2009.**

The yen's status as a safe harbor during times of economic and financial market uncertainty, which would normally have undermined its value amid the third quarter's broad improvement in sentiment, took a backseat to capital flows and technical buying. Surprising comments by Japanese officials in support of a stronger yen signaled a possible departure from the government's traditional position in favor of a weaker currency to help support its exporters.

## JPY Outlook

The Japanese yen is likely to benefit from as recent rally in risk assets fizzles over the coming months, with the resulting decline in demand for higher yielding investments rekindling interest in lower yielding, safer assets. Japan's new Democratic Party has signaled that it intends to take a much more laissez-faire approach to JPY appreciation, a development that gives investors the green light to bid the yen higher. However, the potential protests from Japan's powerful exporters as the yen appreciates further could force officials to take a more assertive position against currency appreciation. Concerns about the untested Democrats' proposed

spending projects and their impact on the nation's widening fiscal deficits could also cap some of the JPY's gains.

### Positive Factors

- While some of the yen's relationship with the overall level of risk aversion has broken down recently, it will still draw support from the still elevated state of global economic and financial market uncertainty. Disappointment in the actual pace of economic recovery would buoy safer assets like the JPY
- Japan's economy surprisingly emerged from recession by posting a modest 0.6%(q/q) rise in GDP
- Japan's newly elected Democratic Party has maintained a more hands-off approach to yen appreciation, a development that gives investors a green light to continue pushing the currency
- Signs of improving economic performance in China, Japan's largest trading partner, suggest that the worst of the recession may have passed and that global trade may have bottomed
- Sentiment, especially among Japan's large manufacturers, has improved markedly over recent months, suggesting a brighter outlook for capital spending and business investment
- The conclusion of Japan's general election and the resounding victory for the Democratic Party reduces political uncertainty

### Negative Factors

- Signs that the worst of the financial crisis has passed lifted optimism about a near-term economic recovery and saw investors unwind much of the long USD and JPY positions accumulated during the height of the market chaos in the fall and winter
- The Bank of Japan's 0.10% lending rate, the lowest in the industrialized world, leaves the yen vulnerable to carry trade selling in favor of higher yielding and riskier assets as market sentiment improves
- The Bank of Japan has revamped its quantitative easing program of buying JGB's (Japanese Government Bonds) with newly printed money. Such measures have historically had little positive impact on growth in Japan
- Much of the improvement in Japan's economy appears to be the result of short-term stimulus spending domestically and in key trade partners like China
- While signs of stabilization in global demand have helped Japan's balance of trade improve in recent months, total exports, a key driver of the Japanese economy, are still down over 35% since last year
- The newly elected Democratic Party is inexperienced and untested. Investors worry that their populist government spending projects, if passed, will exacerbate the nation's already dire fiscal situation
- Further yen appreciation could result in increased protest from Japan's powerful exporters and could result in the government taking a more assertive position against a stronger yen

## Conclusion

The Japanese yen stands to benefit from a number of potential market developments in the coming months. On one hand, many view the recent rally in risk assets as being overstretched at current levels. A broad pullback in risk that would likely be triggered by the market's disappointment in the pace of global recovery would trigger renewed demand for safe-haven investments- an outlook that favors the yen. Additionally, the yen's downside should remain protected, even in the event of continued market optimism about a near-term recovery, by the newly elected administration's seeming acquiescence towards JPY appreciation. However, in the event that yen appreciation becomes excessive, exporters are likely to pressure lawmakers to take a more active approach in limiting the currency's gains. The yen could also become vulnerable to losses if markets lose confidence in the Democrats' ability to reign in spending and improve the nation's fiscal standing.

The Japanese yen has long benefited from its status as one of the world's safe-haven assets. Japan's traditionally low lending rates and the government's desire for a weak currency to help support its exports, has made the yen one of the most popular funding currencies for investments in higher returning asset. During times of stability or improving market optimism, the yen has traditionally been sold in favor of assets in higher yielding regions like New Zealand and Australia. Conversely, investors have historically unwound so-called carry trades during periods of market uncertainty and volatility. Never was this more evident than in the yen's rise to decade and in many cases, record highs during the peak of the market chaos in the fall and winter. The unwinding of carry trades and the need for capital preservation were broadly supportive of the yen amid the backdrop of the Lehman Brothers collapse and the subsequent stress throughout global financial markets.

That close, inverse correlation between risk appetite and the yen's direction appears to have broken down somewhat in recent months. They yen jumped to a new eight-month peak against the broadly weaker U.S. dollar and to a 10-week high against the Canadian dollar late in the quarter, despite the fact global equities, commodities, higher yielding currencies and emerging market assets, all traditional barometers of investors' risk appetite, were near their highest levels all year. The Japanese yen instead began to take its cue from capital flows, options and technical buying and political factors around the second half of Q3. September 30 represents the fiscal half year-end for Japanese companies. The month of September is traditionally marked by a wave of capital repatriation by firms that are eager to get overseas earnings and interest payments on their books before the end of the month. The massive inflow of capital tends to be broadly supportive for the yen in September and during the end of Japan's fiscal year in March.

The yen also drew support from comments from the nation's newly appointed finance minister, Hirohisa Fujii, who said that a stronger yen is in the longer-term interest of the nation. His words marked a seeming departure from the previous government's historic stance in favor of a weaker currency. Japanese officials have long supported a weaker yen as a means to boost global demand for the country's key exports. However, Mr. Fujii, and the Democratic Party have argued that the longer-term policy of a stronger yen helps bring down the cost of imports, namely energy. Because Japan imports 100% of its energy needs and nearly all of the natural

resource inputs for its key manufacturing sector, a stronger JPY would bring down the cost of imports and would help the Democratic party live up to one of its campaign promises of increasing citizens' purchasing power. His comments have given traders a green light to push the Japanese currency higher. While further yen appreciation is likely over the near-term, government and monetary officials will face increased pressure from the nation's powerful exporters if the yen continues to breach key technical and psychological levels against the greenback. Such a scenario would likely result in a change of tone for the untested Democratic Party with regard to a strong yen. Stepped up rhetoric against JPY appreciation would likely limit the Japanese currency's upside.

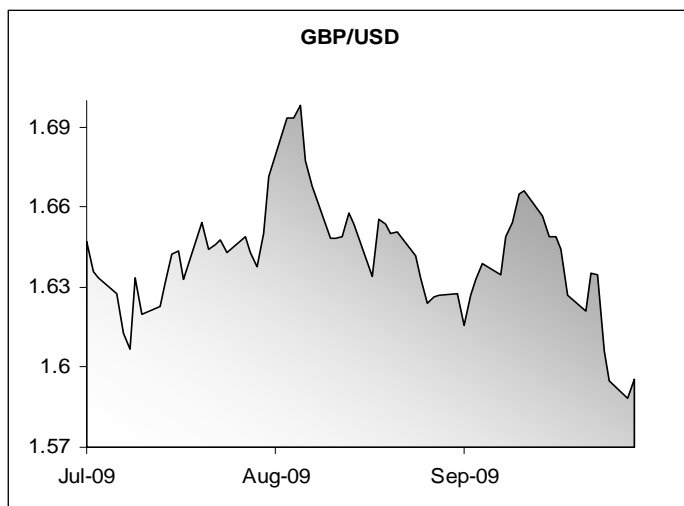
Another potential headwind to additional Japanese yen strength is the newly elected Democratic Party's untested track record. The resounding victory of the Democrats over the incumbent Liberal Democratic Party, which held on to power in Japan for nearly 50 years, was a testament to the level of frustration among voters in the world's second largest economy. The Democrats swept to power by promising change from antiquated policies that have kept economic growth stagnant for a decade. The Democrats also promised a number of populist reforms to help boost consumers' spending. Investors however, worry that increased government spending programs in support of consumers would exacerbate Japan's already dire fiscal situation, which is expected to see central and local government debt rise to a staggering 190% of GDP, second only to Zimbabwe. Failure to address Japan's dire fiscal state by reigning in spending or increasing government receipts would damage the nation's longer-term economic outlook and would undermine investor confidence in Japanese assets.

The Japanese yen stands to benefit from the likely reduction in risk appetite associated with the uneven nature of the global recovery, from continued technical and momentum-related buying and from the new administration's seeming acceptance of a stronger currency to help provide long-term stability to the economy. Market disappointment in the actual pace of global recovery versus investors' elevated expectations would dampen risk appetite and see the yen firm on a broad safe-haven bid. Given the recent hands-off language by Japan's finance minister, traders are likely to feel emboldened to test the officials' resolve. Ultimately, pressure from the nation's powerful exporters will cap the currency's upside, but its near-term trend higher is likely to remain in tact over the coming months.



## GBP Q3 Summary

Month: -0.98%    Quarter: -2.71%    YTD: -0.48%



**Sterling underperformed most of its major rivals late in the quarter, falling to a new four-week trough against the greenback, five-month lows against the euro and yen and a 10-week low versus the loonie. The British pound's broad weakness towards the end of the quarter was the result of the Bank of England's increased asset purchases and the potential for additional credit easing through unconventional measures in the months ahead. Acknowledgement of the weaker GBP's positive impact on the economy by the head of the BOE late in the quarter added to sterling's heavier tone.**

Trade-weighted sterling plummeted from an eight-month peak in August to a five-month low in September, broadly weighed by investors' worries about the potential for additional credit easing from the BOE. The central bank upped its asset purchases in early August and signaled that further increases to the plan were possible. While many sectors of Britain's economy have stabilized, credit conditions remain tight and threaten to derail the U.K.'s budding economic recovery. Stepped up quantitative easing or other credit easing measures are inherently GBP-negative and have pushed the pound broadly lower in recent weeks.

## GBP Outlook

The pound's upside against most of its major rivals will remain severely limited by the potential for additional credit easing from the BOE. The outlook for steady, rock-bottom lending rates continues to dampen demand for the pound as well. Any disappointment in the pace of recovery by market participants would be particularly damning for the pound, as its direction has been heavily correlated with fluctuations in risk appetite and equities. Improving risk appetite would benefit the pound, but the potential for increased quantitative easing should see GBP remain a laggard.

### Positive Factors

- The broad improvement in the outlook for a global economy recovery helps buoy the appeal of currencies like the pound, which are generally regarded as riskier investments
- Sterling's close correlation with risk appetite and its dominant financial services sector means it stands to benefit from further improvement in equities. The over 50% rise London's FTSE stock index improves the pound's tone
- A recent string of upbeat U.K. economic figures, including signs of a bottom in its troubled housing market, suggest that Britain's economy may finally have bottomed
- The BOE's aggressiveness in addressing its recession could eventually see the U.K.'s recovery outpace major rivals with more reactionary central banks like the European Central Bank
- Britain's dominant services sector has expanded for four months straight, further signaling that the recession is abating

### Negative Factors

- The BOE slashed its key lending rate by a total of 450 basis points to 0.50%, the lowest in the bank's 315 year history. Borrowing costs in the U.K. are not seen rising anytime soon
- The Bank of England's purchasing of government bonds, which it recently expanded by another £50 billion of newly created money, is inherently GBP-negative
- The BOE recently downgraded its outlook for inflation into the next two years, prompting investors to scale back expectations for timely removal of policy accommodation
- August's PMI manufacturing sector index surprisingly fell for the first time since November. The data raises concerns about the sustainability of Britain's recovery
- Job losses, while down from February's peak, remain at levels that threaten to keep any economic recovery very subdued
- Credit conditions in the U.K., remain extremely tight, despite the BOE's best efforts to encourage lending to firms and households. Inadequate credit availability will dampen the prospects of a robust recovery and keep the prospect of additional credit easing on the table
- The deteriorating public finances of the British government have undermined the pound's appeal

### Conclusion

The British pound's steep rally, which saw it appreciate by nearly 15% on a trade-weighted basis from March to early August, was largely fueled by the broad improvement in investor sentiment and the resulting increase in demand for riskier assets. The pound was also buoyed by the view that it was at broadly oversold levels at a 26-year trade-weighted low in the winter. While the general rally in risk assets continued through the end of Q3, the pound failed to take part in that rally late in the quarter as a result of the Bank of England's surprising increase in its quantitative easing budget that was announced in early August. The rise in the BOE's asset purchase budget and the fact that it has kept the door open to additional forms of credit easing have undermined the pound and seen it underperform most of its major rivals late in Q3. Still restrictive credit conditions and the potential for a sustained

pullback in risk appetite all suggest that the pound will continue to underperform into the year-end.

The pound benefited from the general rise in risk appetite through much of the second and third quarters of 2009. Given that much of the U.K.'s economy is made up of its dominant financial services sector, the pound has historically benefited from improving market sentiment and increased demand from global investors for assets with elevated yields or a higher risk profile. Risk assets like global equities, commodities and emerging market currencies all outperformed since early March at the expense of traditional safe-havens like the U.S. dollar. Sterling too took part in the general rally in risk assets, rising to a 10-month high against the U.S. dollar in early August, and six and seven-month peaks against the euro and Canadian dollars respectively in June. The close correlation with risk appetite and the pound's performance held strong for much of 2009.

However, that correlation quickly broke down in early August. On August 6<sup>th</sup>, the Bank of England announced that it would increase its quantitative easing, or asset purchase budget by an additional £50 billion to a total of £175 billion. The BOE began buying gilts, or government bonds in early March, as a way to keep longer-term interest rates low and at the same time, keep the monetary base growing. Because banks' balance sheets had been decimated by the credit crisis, they remained hesitant to lend and have instead been hoarding cash in the form of excess reserves. Buy pushing rates lower and opening the spigots of liquidity to banks, the BOE hoped to encourage lending to households and firms. However, a major consequence of quantitative easing, which amounts to the monetizing of government debt, is a weaker currency. Simple supply and demand laws suggest that the flood of newly printed sterling entering the market through QE, is inherently negative for the pound's outlook. Additionally, the purchasing of government debt threatens a massive wave of inflation if the excess liquidity is not removed from the system in a timely manner once a recovery begins to meaningfully gain traction.

Despite the BOE's best efforts, credit conditions in the U.K. remain tight. Consumer credit fell to record lows in June, July and August this year. Bank of England data from July showed that net lending to firms fell by its largest amount (£15.5 billion) since record keeping began in 1998. July's news followed a £3.3 billion drop in net lending in June. Monetary officials have repeatedly warned that the lack of access to reasonably priced credit could at best, keep a recovery very subdued, and at worst, derail the U.K.'s budding rebound. As a result, policymakers have left the door open to further credit easing schemes in the near future. Minutes from a recent BOE meeting showed that policymakers discussed increasing their asset purchase budget by more than the £50 billion agreed upon in August. Officials have toyed with the idea of lowering the remuneration rate, or the rate of interest paid out to banks on their excess reserves held at the BOE. Lower payout on their reserves would create a disincentive to hoard cash and make lending to firms and individuals more attractive. The potential for additional credit easing from the BOE is a clear signal that monetary conditions in the U.K. will remain ultra-accommodative for the foreseeable future, an inherently GBP-negative outlook.

Another potentially damaging development for the pound is the steady deterioration in the state of Britain's public finances. Britain posted a record deficit for the month of August following similarly

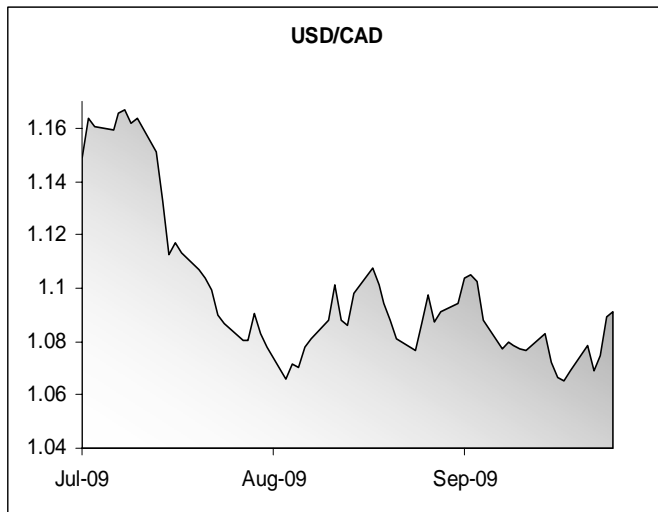
damaging figures in June and July. The current budget deficit and public sector net borrowing both rose to record highs in August as the recession continued to undermine government tax receipts at a time when spending programs are on the rise. Public sector debt remained at 57.5% of GDP in August, also a record high. The worsening shortfall in the budget could necessitate the maintenance of very low lending rates for an extended period of time- an outlook that undermines the pound's appeal.

While the potential for additional credit easing from the Bank of England and the likely pullback in risk appetite associated with the market's disappointment in an uneven global recovery will continue to dampen the pound's near-term outlook, it could still find support under a number of scenarios. Upside surprises to global economic data would further the notion of a near-term, robust recovery, which would buoy risk appetite and keep the pound's downside somewhat limited. Stronger global equities would also remain a supportive factor for sterling. The pound could pare recent losses if credit conditions begin to normalize and BOE officials signal a lower degree of concern with regard to bank lending to firms and households. However, the most likely scenario still remains one where the pound continues to underperform its major counterparts, especially the U.S. dollar, the Japanese yen and to a lesser extent, the euro.



## CAD Q3 Summary

Month: -2.81%    Quarter: -1.67%    YTD: -12.12%



The Canadian dollar enjoyed another sizable rally in the third quarter of 2009, soaring to a new one-year high against the greenback and an eight-month peak against the British pound. The CAD also touched on an eight-month peak against the euro earlier in the quarter before succumbing to losses against the single currency. The broad rise in risk appetite, which pushed stocks and commodities to highs for the year late in Q3, was a driving factor in the Canadian dollar's impressive rise.

The Canadian dollar's steep rise in the final quarter of this year was largely fueled by signs of stability throughout the global economy and the resulting rise in risk appetite. Firmer commodities, a consequence of the brighter outlook for global growth, buoyed the loonie along with its dollar-bloc counterparts from Australia and New Zealand. Relative resilience on the domestic economic front added to the CAD's upward momentum, despite the fact that the BOC pledged to keep lending rates low and expressed concern over the rise of the Canadian dollar.

## CAD Outlook

The CAD's fortunes will remain directly tied to the global economic outlook and the price of commodities. Continued optimism over a robust global recovery will keep resource prices elevated and likely see the loonie retest its recent one-year peak against the greenback. However, a pullback in risk appetite that could easily be triggered by market disappointment in the pace of global recovery

would see the Canadian dollar, along with other growth-dependant assets give up much of their recent gains.

### Positive Factors

- The Canadian dollar has benefited from the broad-based improvement in market sentiment and the subsequent rise in investors' appetite for risk. Further evidence that the global economy is recovering would add to the CAD's recent gains
- Canada's resource-rich economy benefits during times of elevated commodity prices. Additional signs of stabilization in the global economy would support the notion that the recession is abating and would put additional upward pressure on commodity prices
- Canadian banks have fared better than banks in the U.S. and U.K. in terms of their exposure to illiquid, toxic mortgage-backed assets
- The improved global economic outlook and upside surprises to recent Chinese growth metrics have put significant upward pressure on commodity prices and boosted CAD demand
- While the Bank of Canada has slashed its key bank rate to a record low 0.25%, it has avoided following the Fed, the ECB and the BOE down the path of unconventional policy easing or, quantitative easing
- While monetary officials have expressed concerns over the recent rise in the CAD, they are unlikely to actually intervene to weaken the currency

### Negative Factors

- The Bank of Canada slashed its benchmark lending rate to a new record low of just 0.25% and has repeatedly pledged to keep rates untouched until well into 2010
- While recent signs of stabilization boosted demand for risk assets and growth-dependant currencies like the CAD, the rally appears to be somewhat overbought at current levels
- Further CAD appreciation could spark increased concerns about choking off demand for Canada's exports and would likely result in firmer protests on the part of Canadian monetary officials
- The final destination for nearly 80% of Canada's exports is the U.S, which continues to see final demand remain extremely soft amid a backdrop of rising unemployment
- Consumer level inflation in Canada fell to its lowest level in over 55 years in July. Given the strength of the Canadian dollar and the level of slack in the economy, price pressures are not likely to force the BOC to normalize monetary policy anytime soon
- Much of the recent improvement in global growth metrics and the resulting rise in commodity prices appears to be the result of short-term government stimulus spending, not from any organic improvement in underlying fundamentals

## Conclusion

The Canadian dollar enjoyed its second-straight quarter of hefty gains against the greenback, benefiting from the broad improvement in the global economic outlook and the subsequent rise in commodity prices. In the early days of the crisis, the loonie and other growth-dependant investments plummeted as investors shunned any asset with even the slightest risk profile. The Canadian dollar slid to a four and a half-year low against its U.S. counterpart in March as the fallout from the Lehman Brothers collapse fanned fears of a “Great Depression” type of worst case scenario for the global economy. Since March however, the loonie, and risk assets in general have rallied as a result of the marked signs of stabilization throughout the global economy. The subsequent rise in commodity prices pushed the CAD to a one-year high in late September. While encouraging, the improvement in the global economy has largely been fueled by short-term government stimulus and not by sustainable improvements in underlying conditions. As global spending schemes fade, the subsequent pullback in output will be met with investor disappointment and a decline risk assets in general. The Canadian dollar would become vulnerable under such a scenario.

The rally in risk assets since March has been largely fueled by relief that a complete collapse of the global economy was largely averted. As investors abandoned defensive positions in assets like the greenback and Japanese yen, they sought to take advantage of the “reflation trade”, or the imminent rise in assets that would benefit most from the trillions of dollars of global government spending and historically low levels of global interest rates. The Canadian dollar, along with its dollar-bloc counterparts from Australia and New Zealand proved to be an effective tool in capitalizing on a brighter global economic prognosis. Increased manufacturing activity, as evidenced by the rise in global PMI manufacturing surveys, was a key sign that demand for natural resources was on the rise. In particular, the rise of China’s manufacturing sector activity to its highest level in a year in August underscored the view that the global economy had bottomed, that trade was improving and the demand for natural resource inputs would benefit in the coming months. The Canadian dollar was a major beneficiary of the reflation trade.

While encouraging, the stabilization in the global economy witnessed over recent months may prove difficult to sustain. Global governments, including the U.S., the U.K. the E.U., China, Japan and Canada have poured trillions of dollars of taxpayer money into various short-term stimulus projects. America’s “cash for clunkers” program, which was surprisingly successful in stimulating demand for automobiles, was particularly beneficial for Canada’s economy. Improved car sales over the summer boosted activity in the key industrial and automotive sectors and helped stimulate job creation in Canada in August. Combined with the historic slashing of lending rates by central banks around the world, the stimulus spending has helped to artificially prop up output to levels that far exceed global demand. Because global unemployment rates are forecast to continue rising even after other sectors recover, final demand should remain subdued for a considerable period of time. The key risk for the Canadian dollar, and risk assets in general, is if the pace of recovery, once government stimulus spending fades, falls short of the market’s elevated expectations. Such a scenario would result in a reduction in risk appetite and a pullback in some of the market’s best performers over recent months.

Another key liability for the Canadian dollar is if the BOC becomes more vocal in its opposition to further CAD appreciation. Recent commentary from the Bank of Canada has highlighted a growing unease with their currency’s appreciation, particularly against the greenback. A strong Canadian dollar makes the nation’s exports more expensive abroad and threatens to choke off already weak demand for goods and potentially derail a budding recovery. A stronger CAD also puts downward pressure on import prices, which keep overall inflation pressures low and threaten to keep the yearly CPI below the Bank of Canada’s target (2.0%) for a longer period of time than desirable. Increased rhetoric from the BOC against currency appreciation would likely limit the CAD’s upside.

Any pullback in risk appetite or a moderation in optimism about a near-term robust economic recovery would leave the Canadian dollar, and risk assets in general, vulnerable to selling pressure. Because the loonie has rallied so sharply over recent months, a correction lower is seen by many as overdue. However, continued optimism about a global recovery would keep risk assets like commodities and emerging market currencies at elevated levels and would likely see the Canadian dollar retest its recent highs against the greenback and currencies whose economies are seen as likely to underperform (the GBP, JPY). Against its dollar-bloc counterparts, the CAD would likely suffer under a scenario of elevated risk appetite over the coming months.

## Upcoming Central Bank Meetings

### October

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7-8 Bank of England Monetary Policy Committee Meeting

8 ECB Governing Council Meeting

13-14 Bank of Japan Policy Board Meeting

20 Bank of Canada Monetary Policy Meeting

### November

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3-4 U.S. Federal Open Market Committee Meeting

4-5 Bank of England Monetary Policy Meeting

5 ECB Governing Council Meeting

19-20 Bank of Japan Policy Board Meeting

### December

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3 ECB Governing Council Meeting

8 Bank of Canada Monetary Policy Meeting

9-10 Bank of England Monetary Policy Meeting

15-16 U.S. Federal Open Market Committee Meeting

17-18 Bank of Japan Policy Board Meeting

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