

# QUARTERLY REVIEW

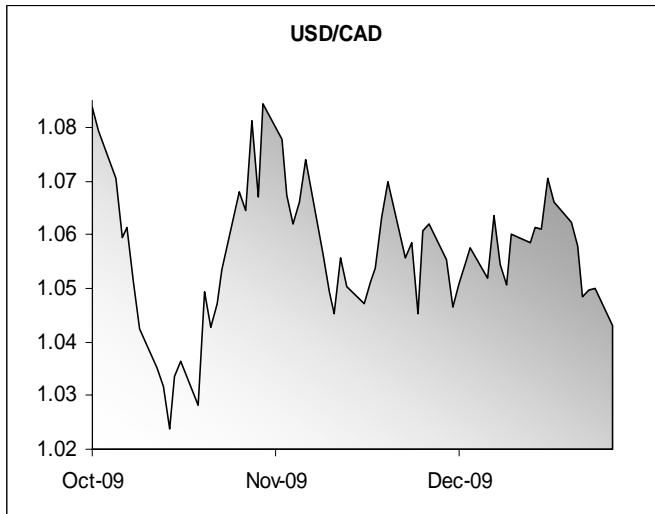
a quarterly market analysis from Travelex Global Business Payments

Posted: January 4, 2010



## CAD Q4 Summary

Month: +1.99%    Quarter: +4.60%    YTD: +14.75%



The Canadian dollar outperformed most of its major rivals in the fourth quarter of 2009, benefiting from elevated crude oil prices and an improving outlook for a global recovery. At its peak in October, the loonie rose to a 15-month high against the beleaguered greenback. Even as the U.S. dollar regained its footing late in the quarter, the CAD maintained its strength in its crosses, rising to a new 15-month peak against the euro, a two-month high against the British pound and a three and a half-month high against its Australian counterpart.

The Canadian dollar's impressive performance for most of Q4 stemmed from a number of factors. Firstly, improved market sentiment that was fueled by firmer equities and upside surprises to many global economic reports encouraged hope of recovery, pushed commodity prices higher and underpinned a key source of revenue for Canada's economy. Improving U.S. growth added to the upbeat outlook for Canadian exporters and the economy as a whole. Finally, the relative health of Ottawa's fiscal standing was a draw, especially given the market's increasing focus on sovereign credit issues.

## CAD Outlook

The Canadian dollar looks poised to outperform most of its major rivals in the opening months of 2010 as many of the factors that

lead to its recent strength should persist into the New Year. An improvement in the global economy in the first half of 2010 combined with the potential for geopolitical uncertainty in the Middle East, should keep oil prices elevated. Gradually improving U.S. growth will likely foster the "buy North America" sentiment that has added to the loonie's recent strength. The relative health of Ottawa's fiscal balance sheet should also continue to contrast most of the G7 nations. However, a key risk to the CAD remains the potential for global growth to disappoint in 2010. Such a scenario would keep crude oil prices under pressure and undermine those assets, like the CAD, that are heavily dependant on global growth.

### Positive Factors

- The Canadian dollar has benefited from the broad-based improvement in market sentiment and the subsequent rise in investors' appetite for exposure to global growth. 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 recovery hopes 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 improved optimism about a recovery in global trade and commodity 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
- An improving U.S. economy greatly benefits Canada's export sector, 70% of whose goods end up south of the boarder
- The relative health of Ottawa's fiscal balance sheet contrasts the rest of the G7, who suffer from increasing credit concerns

### 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
- While consumer inflation has rebounded from over a 50-year low in September, it still remains well below the BOC's 2.0%

target and given the excessive slack still in the economy, is not likely to push the BOC to lift lending rates 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 meaningful improvement in final demand

### Conclusion

The Canadian dollar enjoyed its third-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 early 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 15-month high in March. Even as the greenback recovered its footing late in the quarter, the Canadian dollar's downside was largely limited by improving optimism about a broader North American recovery. Going forward, some of the relative strength of the loonie could become sapped by a global recovery that loses steam in the second half of 2010. However, its upside should remain in tact in the coming months as investors look favorably on the prospect of a global recovery.

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. Unlike many of its European and commodity counterparts, the Canadian dollar's strength proved less of a function of U.S. dollar weakness and more an improvement in domestic economic fundamentals. This fact was clearly demonstrated in the month of December, when the U.S. dollar rocketed to a three and a half-month trade-weighted peak. Many investors were shaken out of speculative long positions in previously high-flying currencies like the Aussie and kiwi. USD/CAD however, failed to make any meaningful gains. Moreover, CAD crosses pushed broadly higher with EUR/CAD falling to a new 15-month trough and GBP/CAD a new two month low late in the quarter.

Much of the Canadian dollar's recent strength, like its dollar-bloc counterparts from Australia and New Zealand, was indeed tied to the indiscriminate appreciation in risk assets like commodities and emerging market assets that was largely funded by selling the greenback for the better part of 2009. Consequently, December's rebound in the U.S. dollar did see some of the loonie's upside erode along with most other currencies. However, because Canada stands to benefit directly from the perceived improvement in America's economy, its downside was, and is likely to remain more limited than most of its commodity counterparts. With over 70% of

the nation's exports destined for the U.S., any gradual improvement in final demand in the U.S. will have positive knock-on effects for Canada. The fact the crude oil has held above key support and approached \$80/barrel late in Q4, remains broadly supportive of the nation's energy and natural gas sector. The potential for geopolitical flair-ups in the Middle East, particularly involving Iran, should keep crude oil, and the loonie well supported in the first half of 2010. Even if global growth prospects dim in H2 2010, supply issues could keep crude prices elevated amid a broader pullback in other commodity prices. Such a scenario would see the loonie outperform most of its major rivals, including the AUD and NZD.

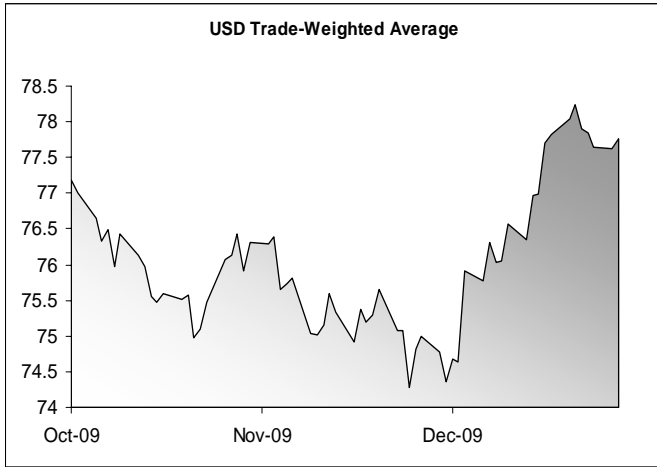
The loonie was also broadly supported by, and will likely continue to draw sizable support from the relative health of the government's balance sheet. Canada has the lowest net debt of any country in the G7. That fact should add to the appeal of CAD denominated deposits, especially as investors wrestle with mounting worries about deteriorating fiscal balance sheets in Greece, Spain, Ireland, Italy, Portugal, Japan and the U.K. The market's heightened focus on sovereign credit risk in 2010 will keep investors more selective of assets, even amid a backdrop of improving risk appetite, and should continue to reward the Canadian dollar for Ottawa's relative fiscal discipline.

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). Even amid a possible pullback in risk appetite in the second half of the year, the loonie should outperform most of its major rivals due to the gradual improvement in U.S. demand and the resulting benefit to Canadian exporters. Increased rhetoric from monetary officials about the detrimental impact of a strong currency could limit CAD gains, but should not result in an across-the-board moderation in CAD-positive market sentiment.



## USD Q4 Summary

Month: +3.76%    Quarter: +0.89%    YTD: -4.06%



The trade-weighted U.S. dollar index fell to its lowest level in 15 months late in the fourth quarter, broadly undermined by improving appetite for riskier assets and the view that U.S. borrowing costs will remain exceptionally low for an extended period of time. Mounting U.S. fiscal deficits added to the greenback's broadly heavier tone, as did persistent questions regarding the dollar's status as the world's reserve currency. The global flood of liquidity fueled by historically low lending rates and the printing of money by various central banks encouraged investors to sell low yielding dollars to buy commodities, equities and emerging market currencies.

Additional signs of stabilization in the global economy fueled appetite for riskier - trades that were often funded by borrowing and selling the low yielding USD. Ultra-accommodative monetary policy in most of the industrialized world along with central banks' printing of money flooded markets with liquidity that found its way into assets in emerging markets like Brazil and China. While concerns about the greenback's longer-term reserve status weighed, the outlook for near zero percent Fed lending rates remained the main drag on the dollar, especially against its higher yielding counterparts. Profit taking and improving optimism about a U.S. recovery helped the greenback regain its footing late in the quarter.

## USD Outlook

The greenback will continue to face an uphill battle in the months ahead as no expected change in the Fed's ultra-accommodative monetary stance will leave the U.S. currency vulnerable to additional selling in favor of higher returning assets. Still elevated optimism about a global recovery should keep risk appetite elevated and undermine lower yielders like the greenback. However, as the Fed begins to signal that it is closer to normalizing policy, likely sometime in H2 2010, the dollar should appreciate. Such a scenario would see positive U.S. economic data translate

more positively to the outlook for Fed monetary policy and benefit the USD. Elevated global recovery expectations could prove overly optimistic as the effect of governments' stimulus faces in H2, a scenario that favors a reduction in risk appetite and likely, a stronger dollar as well. Nagging deficit and reserve status worries should keep the dollar's upside somewhat limited.

### Positive Factors

- The U.S. dollar's status as the world's safe-haven currency continues to provide it with support, especially during periods of increased aversion to risk and economic or financial uncertainty
- Signals that the Fed is getting closer to eventually normalizing its ultra-accommodative monetary policy should help improve the yield appeal of USD-denominated assets and lead to more sustainable gains for the greenback
- The rally in risk assets since March, which was fueled by upside surprises to economic data and improving sentiment, appears to be pricing in an unrealistic pace of global economic recovery. A pullback in risk appetite would favor safer assets like the USD
- The Federal Reserve has signaled that it intends to unwind various credit easing facilities in the months ahead. The removal of policy accommodation is inherently USD positive
- While the unemployment rate continues to rise, the pace of monthly job losses has fallen sharply from its peak last winter
- Rising Treasury yields and LIBOR rates makes funding carry trades in higher yielding assets with the dollar slightly more expensive
- 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

- Signs of stabilization in the global economy suggest that recovery is gaining traction gradually. The resulting improvement in risk appetite favors higher yielding assets, usually at the expense of the USD
- 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
- Low U.S. lending rates and improving risk appetite incentivize traders to borrow and sell the greenback against higher yielding assets like stocks, commodities and emerging market assets
- 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
- The removal of policy accommodation globally will prove to be a very delicate procedure. Political pressure could delay the timely removal of policy accommodation and result in significant inflationary pressures
- The recent call of the G20 for a rebalancing of the global economy implies a need for a broadly weaker U.S. dollar
- 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. The Fed is unlikely to rise rates in an environment of rising unemployment

- Mounting talk of central bank reserve diversification out of dollar assets remains a key liability for the greenback

### Conclusion

The fourth quarter of 2009 marked a continuation in the U.S. dollar's longer-term downward trend. After starting 2009 off in broadly positive territory, the dollar succumbed to selling pressure and fell to a new 15-month trade-weighted low late in Q4. During the height of the global financial crisis, the dollar benefited from the market's extreme aversion to riskier assets like stocks, commodities and emerging market currencies. The wide-scale flight to safety pushed the U.S. currency to a three-year high against a basket of its major counterparts in March, the peak of financial market bearishness. However, since then, the dollar has suffered as investors became more and more optimistic that the worst of the crisis has passed. The resulting rise in risk appetite saw investors abandon defensive dollar assets in favor of riskier, higher returning investments abroad. That trend was encouraged by the greenback's near zero percent interest rates, improving optimism towards emerging market assets, and the flood of global liquidity, which kept hard assets like commodities in high demand. Persistent worries about America's gaping fiscal deficits and the dollar's status as a global reserve currency added to the broadly negative sentiment that undermined the U.S. dollar.

Global economic data, while mixed, pointed to continued improvement in underlying fundamentals in the fourth quarter. PMI manufacturing data turned positive in the U.S., the euro zone, the U.K., Japan and China. Services sector activity in the world's largest economies also improved markedly over recent months. Overall gauges of global trade have shown that activity likely bottomed last winter. Various metrics of business and consumer sentiment too have improved markedly over recent months, an encouraging indicator that economic activity will likely pick up further in the coming months. The U.S, the euro zone and Japan all emerged from recession in Q3 by posting mildly positive growth. Finally, while unemployment rates in most of the industrialized world are still rising, the pace of job losses has slowed significantly from last winter's peaks. The seeming improvement in much of the world's economies, albeit at still depressed levels, has encouraged investors to take on more portfolio risk in the form of stocks, commodities and increased exposure to emerging markets. The continued unwinding of defensive USD-denominated positions accumulated at the height of the crisis remains a key driver of the greenback's broadly downbeat tone.

Indeed the broad-based signs of stabilization in the global economy have been encouraging. However, many questions about the sustainability of the pickup in activity remain unanswered. Much of the improvement in the global economy has been fueled by trillions of dollars in various governments' stimulus plans, unsustainably low global lending rates, and the printing of money by the Fed, the Bank of England, the ECB and the BOJ. America's cash for clunkers and the first-time homebuyer's tax credit, for example, were hugely successful in sparking near-term activity in the troubled housing and automotive sectors. However, the schemes have done little more than bring forward demand for goods, or robbed from future demand for current consumption. In other words, the boost in activity as a result of the stimulus is likely unsustainable and could be followed by a significant drop in activity once the government spending winds down. Similar programs in

the U.K., the euro zone, Japan, China and Australia have all been credited with spurring activity in their respective economies. Again, while encouraging, the resulting rise in output is unlikely to be sustained once the stimulus has been removed. Moderation in global growth in the second half of 2010, once the crutch of government stimulus is gone, will weigh on risk appetite and could provide the dollar with renewed safe-haven demand. China in particular, which is often touted as the next engine of global economic growth, is vulnerable to a slowdown if its massive buildup in capacity is unable to find adequate demand, either domestic or global, in 2010.

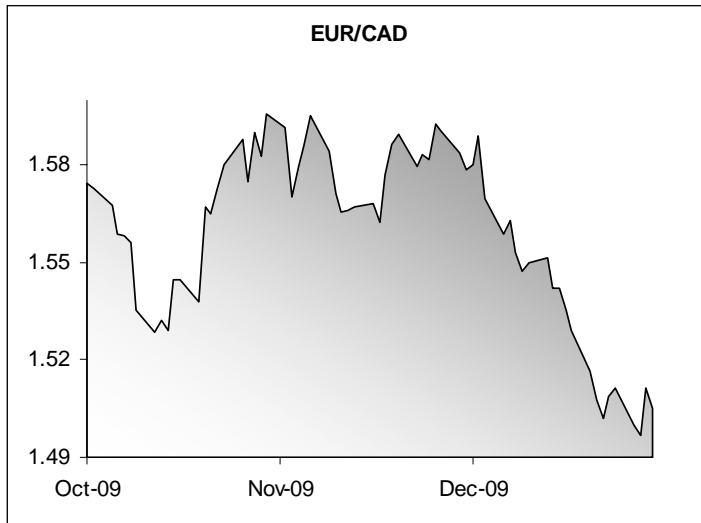
The greenback's recent slide could also lose steam once positive economic data begins to finally translate into a higher chance of Federal Reserve monetary policy normalization. The Fed as long maintained that lending rates in the U.S. will remain "extraordinarily low for an extended period of time", an outlook that leaves the greenback vulnerable to selling, especially against its higher yielding and riskier counterparts. Investors have actively borrowed USD and invested in emerging market assets and commodities- so-called carry trades. However, the Fed can not maintain its ultra-accommodative policy stance indefinitely. As economic recovery gains traction, inflation will increasingly become a key source of worry for both market participants and policymakers. While no change in the Fed funds rate is likely until late in 2010, the Fed will begin to more seriously lay the groundwork for policy tightening well before that time. The greenback should find increased support from the improving yield appeal of USD-denominated assets relative to their counterparts overseas.

The improved outlook for the dollar is not however, without considerable risk. Soaring government deficits and the required debt issuance to finance them remain a key threat to the dollar's longer-term stability. Global investors could easily shun U.S. government debt amid a backdrop of unchecked spending and borrowing from Washington or demand higher yields in return for financing. Soaring fiscal deficits also raise doubts about foreign central banks' willingness to continue investing their currency reserves in dollar assets. However, the "short US dollar/ long stocks, commodities, emerging markets" trade has become extremely overcrowded and appears to be pricing in an unrealistic pace of global recovery. While the dollar's long-term headwinds will likely keep its upside somewhat limited, its near-to-medium-term prognosis will likely prove more optimistic than its performance in most of 2009 would suggest.



## EUR Q4 Summary

Month: -5.55%    Quarter: -4.32%    YTD: -12.06%



The single currency put in a generally positive performance during the fourth quarter of 2009, rising to a new 16-month high against the beleaguered U.S. dollar, a one-month peak against the British pound and a two-month high against the Canadian dollar. The euro's broad strength was the result of continued improvement in global economic fundamentals and the resulting rise in risk appetite. The unwinding of defensive USD-denominated positions was a key driver of the single currency's upbeat tone. Profit taking and sovereign credit concerns saw the euro pare some of its recent gains late in the fourth quarter.

While euro zone economic data continued to show improvement in the last quarter of 2009, the figures highlighted an uneven and tepid recovery. While the euro zone's three largest economies managed to grow in Q3, smaller nations like Greece, Spain, Ireland and Portugal remained mired in economic and fiscal malaise. Even German data late in the quarter raised doubts about the sustainability of the broader 16-member bloc's recovery. Disinflation and excessive slack in the economy suggested little chance of any near-term policy tightening from the ECB.

## EUR Outlook

Because much of the euro's improved tone over the past seven months has been the result of the broad unwinding of defensive USD-denominated positions, it remains vulnerable to a pullback, especially if the actual pace of global economic recovery undershoots the market's optimistic expectations. Moreover, the

single currency could succumb to selling if its economic rebound lags its major rivals. Specifically, the widening growth divergence between Germany and France and the rest of the euro zone as well as mounting risk of sovereign default in one of the euro zone economies should keep the EUR's upside limited. Support would come from continued signs the global economy is on the mend or from increased hawkishness from ECB officials.

### 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. The bank has already begun to wind down some of its credit easing facilities like its fixed-rate loan auctions to the banking system
- 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. Italy joined them in growth in Q3
- The ECB's single mandate of ensuring price stability could prompt monetary officials to begin sounding a hawkish tone on inflation before the Federal Reserve, the Bank of England or the Bank of Canada. Such a scenario would be broadly EUR supportive
- 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
- Greece's sovereign credit downgrade by all three rating agencies, an S&P downgrade for Ireland and potential downgrades for Spain and Portugal weigh on the single currency and raise further sovereign risk throughout financial markets
- The euro zone's exposure to still struggling emerging European economies remains a key liability. Another flare-up in concern over the region or a debt crisis similar to Dubai's would have serious negative implications for euro zone banks
- Because markets have become so optimistic in pricing in a global economic recovery, the euro is vulnerable to losses if risk appetite falls back down to levels that are consistent with a more subdued pace of recovery
- While France, Italy 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 firmed against the greenback and the Canadian dollar for most of the fourth quarter, rising to 16 and two-month peaks respectively. The euro's generally improved tone against most of its major rivals was the result of a broad unwinding of defensive positions in favor of riskier and higher yielding investments, a move that continued to be fueled by improving global economic performance and expectations for a robust economic recovery. Investors continued to focus more on broad moves in sentiment and risk appetite and less on underlying economic fundamentals. Indeed, the euro zone did see marked improvement in many key sectors of its economy over recent months. However, its appreciation, particularly against the greenback, seems to be somewhat overdone, especially given the long list of headwinds facing the 16-member bloc's economy and the potential for global financial markets to be disappointed by the actual pace of recovery in the economy in 2010.

While the euro put in a mixed performance in many of its crosses, its gains against the greenback were the result of a broad unwinding of defensive positions that were accumulated during the height of the financial market chaos last fall and winter, which saw investors flock to 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 the U.S., Japan, Germany and France and Italy emerged from their recessions.

However, much of the improvement in macro economic conditions can be directly attributed to soaring government spending, not necessarily 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 if 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. Programs like America's "cash for clunkers" and similar measures taken across the euro zone have been effective in providing hard-hit industries with a short-term boost in demand. However, the rise in near-term activity could simply be robbing from future demand, which leaves those very markets vulnerable to a pullback once the stimulus spending winds down. 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 undermine risk appetite and see the euro underperform many of its major rivals.

Another key risk for the euro zone is the widening gap between Germany, France, whose economies emerged from recession in the second quarter, and the rest of the bloc, which remains mired in economic stagnation. The euro zone's two largest economies surprised the market with mild growth in Q2 and were joined in growth by Italy in the third quarter. 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, Spain, Portugal, Greece and Ireland. 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 monetary policy or their currencies, the natural mechanisms to help cope with an economic downturn (including lower lending rates and a weaker currency) are unavailable. While the bloc weathered the global economic crisis surprisingly well, it remains to be seen how it performs in an environment of a mixed economic rebound. The ECB will find it difficult to raise rates in an environment where Germany and France are growing, but the rest the 14-members continue to struggle. The potential for increased tensions within the EU could become a key source of weakness for the single currency in 2010.

As a result of the prolonged recession in many of the euro zone's economies, the decline in tax receipts combined with elevated government spending has resulted in swelling fiscal deficits that threaten the EU's Stability Pact, which governs debt limits of member states. Already Greece and Ireland have been downgraded by major rating agencies and Spain, France, Portugal and Slovakia may not be far behind. Rising sovereign concerns could raise borrowing costs for euro zone countries and further exacerbate the difficulty in financing new borrowing. The euro was dogged by sovereign risk late in the fourth quarter of 2009 when it fell to a 13-month low against the CAD and a three and a half-month trough against the USD, and could see added headwinds from mounting sovereign credit worries in 2010.

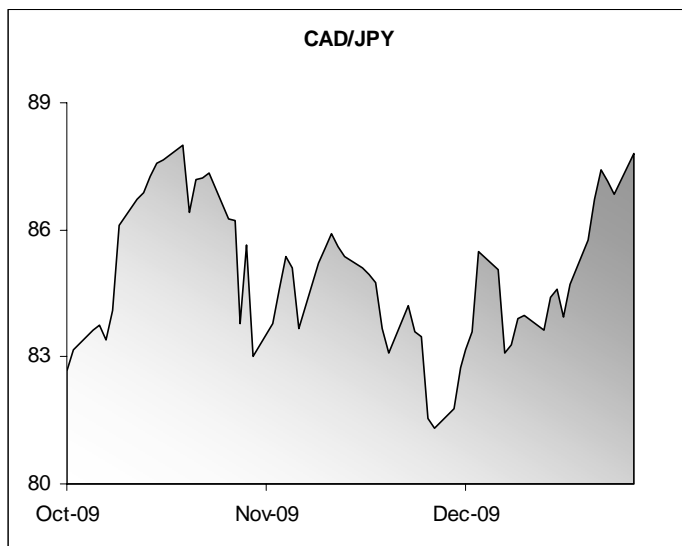
The euro could also suffer in the coming months from nagging worries about the health of its banking sector. Banks in the 16-member bloc have a disproportionately high exposure to economies in hard-hit Central and Eastern Europe and in emerging markets in general. While many of these emerging markets, like China, Indonesia, India and Brazil have been some of the world's best performers in the wake of the global financial crisis, much of their recent resilience has been the result huge stimulus programs in the U.S., China, Japan and Europe and from the rise in resource prices. The build-up in capacity in emerging markets has resulted in their outperformance over recent months. However, the lack of final demand in the industrialized world could eventually see overcapacity lead to another economic downturn. A double dip for emerging European economies will likely see additional loan defaults to euro zone banks and remind investors of the still fragile state of the 16-member bloc's financial sector, further denting 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 continue surprising to the upside remains a key factor that could keep demand for higher risk assets like the EUR high. Talk of central bank reserve diversification out of USD assets will continue to be EUR-supportive, as will mounting concern about America's longer-term fiscal outlook. Signs that the ECB is closer to normalizing policy than the Fed, the BOC or the BOE would also be broadly supportive of the single currency. However, the euro zone's uneven economic recovery, increased sovereign risk and exposure to still risky emerging markets should keep the ECB sidelined and the euro's upside very limited.



## JPY Q4 Summary

Month: -9.16%    Quarter: -7.90%    YTD: -20.58%



The Japanese yen rose to a new 14-year peak against the greenback, a four and a half-month high against the Canadian dollar and a seven-month peak against the euro in the wake of news about a possible debt crisis in Dubai. The development, and they yen's immediate reaction, highlighted the currency's close inverse correlation with risk appetite. The spike in investor nervousness about a possible debt default in Dubai fueled a massive unwind of yen-funded risky carry trades, which pushed the currency sharply higher across the board. Fluctuations in risk appetite remained the main driver of the yen's direction, not underlying economic fundamentals. Ramped up rhetoric in opposition to JPY appreciation capped the currency's gains.

Despite the broad improvement in global economic data and optimism about a recovery from the worst recession in decades, the yen remained underpinned by time-to-time flare-ups in risk aversion and the subsequent unwinding of JPY-funded carry trades. Mixed messages from Japan's new ruling party in the early days of its administration suggested less resolve on the part of policymakers in limiting the currency's gains. As the yen firmed to over a 14-year peak against the U.S. dollar, officials, under pressure from powerful exporters, ramped up rhetoric in opposition to JPY appreciation. The potential for additional monetary easing from the BOJ kept yen gains in check late in Q4.

## JPY Outlook

The Japanese yen is likely to continue to benefit from the potential for the recent rally in risk assets, which has largely been fueled by improving economic sentiment, to undershoot the market's elevated

expectations. The fact that optimism about a global recovery has become somewhat disconnected with the reality of a sluggish and mixed rebound, leaves risk appetite vulnerable to a pullback. Such a scenario favors a stronger yen. However, ramped up protests by policymakers against additional JPY appreciation could cap the currency's gains, especially if its 14-year peak against the USD is retested. The rise of U.S. Treasury yields above corresponding Japanese bonds makes the yen the de facto funding currency for carry trades and weighs on its outlook.

### Positive Factors

- While some of the yen's relationship with the overall level of risk aversion has broken down recently, it still draws support from periodic flare-ups in risk aversion sparked by crises like the potential for a Dubai debt default
- While global economic recovery has improved investor sentiment, risk assets appear to be pricing in a very robust rebound. Disappointment in the actual pace of recovery would see risk assets underperform against the low yielding JPY
- Japan's new finance minister's mixed messages regarding the Administration's yen policy has resulted in a slight loss of credibility and prompted investors to test officials' resolve by pushing the JPY higher
- 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 since hitting a record low in Q2 2009

### 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
- The BOJ recently sounded a more aggressive tone against deflation, which has kept open the door to further monetary easing through unconventional measures like bond purchases
- The rise in U.S. bond yields due to an improving outlook for recovery makes funding carry trades in USD more expensive. Consequently, the yen has become the funding currency of choice for higher yielding investments once again
- 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 low yielding yen. The yen could also benefit as investors continue testing the resolve of BOJ officials who gave mixed messages on their currency policy in the early days of the new administration in the fall. Recent comments from BOJ officials however, have signaled that policymakers will continue to provide the economy with unprecedented liquidity to avoid deflation and help a recovery take hold. Consequently, the potential for additional asset purchases from the BOJ will keep the yen's upside somewhat limited going forward.

The Japanese yen has long benefited from its status as one of the world's perceived safe-haven assets. Japan's traditionally low lending rates and the government's historic 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 a year ago. 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. The yen gradually firmed against most of its major counterparts throughout much of the quarter, despite the fact that global equities, commodities, higher yielding currencies and emerging market assets, all traditional barometers of investors' risk appetite, also steadily appreciated. The Japanese yen instead began to take its cue from capital flows, options and technical buying and political factors. However, news of a potential debt default in Dubai sent shockwaves throughout global markets and fanned fears of broader sovereign issues in many of the world's emerging markets. The subsequent pullback in risk appetite saw the yen soar to a new 14-year peak against the greenback, seven-month peaks against the euro and sterling and a four-month high against the Canadian dollar. The Dubai event and the market's immediate reaction highlighted the extent to which the yen still takes its cue from swings in risk appetite, and the potential for additional yen gains in 2010 if risk appetite dries up amid a backdrop of a disappointing global recovery or even a double dip recession.

Investors have recently tested the Bank of Japan's resolve by pushing the JPY higher across the board, a trend that could continue into 2010. In the early days of the Democratic Party's new administration in the fall, Japan's finance minister sent mixed messages to the market. He first said the DP's currency policy would encourage a stronger yen, which was consistent with campaign rhetoric that pushed for greater purchasing power for Japan's consumers. The comments paved the way for immediate, if

short-lived JPY gains on the view that Japanese policymakers had abandoned their long-standing desire for a weaker yen. However, once the Dubai story broke and the yen soared to multi-year highs, officials in the world's second largest economy quickly changed their tune. Pressure from the nation's large exporters and manufacturers likely prompted monetary officials to reaffirm their desire for a stable yen and called market moves "excessive", adding that currency market intervention was still an option. The mixed messages from rookie finance minister Fujii undermined some of the administration's credibility and have likely given traders a green light to continue testing officials' resolve to fight excessive yen appreciation by pushing the yen higher.

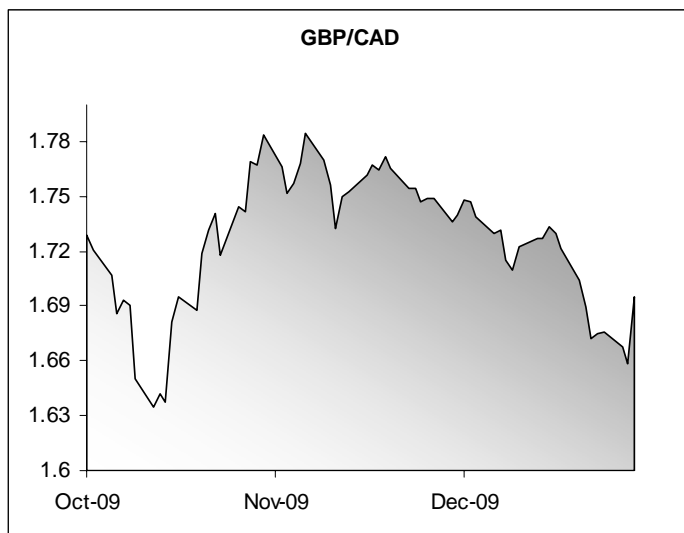
One key fact that could undermine the Japanese yen's upside over the coming months is the potential for additional monetary easing from the Bank of Japan. At the conclusion of the BOJ's most recent monetary policy meeting, officials sounded their most aggressive tone against deflation to-date. The world's second largest economy has wrestled with deflation for the better part of the last decade. With lending rates at only 0.1%, the BOJ has little (if any) ammunition left in its arsenal of traditional monetary tools. Consequently, the BOJ could increase its purchase of government and corporate bonds with newly printed yen, known as quantitative easing. Additional unconventional monetary easing by the BOJ would add to the supply of JPY in the market and put downward pressure on its value. Continued declines in prices pressures as measured by the year-over-year CPI would increase the risk of additional quantitative easing and weigh on the yen in the months ahead.

The Japanese yen stands to benefit from the potential reduction in risk appetite associated with the uneven nature of the global recovery, from continued technical and momentum-related buying and as investors test the BOJ's resolve in limiting additional yen gains. 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. The potential for additional crises in 2010 like the Dubai debt debacle would also result in a broadly stronger JPY. However, the potential for increased monetary easing from the BOJ and pressure on policymakers from the nation's powerful exporters will cap the currency's upside in the coming months.



## GBP Q4 Summary

Month: -4.03%    Quarter: -3.42%    YTD: -5.18%



**Sterling underperformed most of its major rivals for the better part of the fourth quarter, falling to new two-month lows against the greenback and Canadian dollar and a one-month trough against the euro. The British pound's broad weakness was the result of mounting worries about the dire state of U.K. public finances, the lackluster British economic recovery and the outlook that lending rates will remain at record lows for the foreseeable future. The pound remained undermined by the fact that the Bank of England has left the door to further monetary easing through increased asset purchase wide open.**

Trade-weighted sterling remained off of October's six-month low, but was still stuck near the lower end of recent ranges. The pound suffered, despite broadly firmer stocks in Q4, which have long been a key source of strength for sterling. Instead, investors focused on the deteriorating state of Britain's public sector debt, which rose to record levels as a result of the longest recession on record. The fact that Britain is lagging its major rivals in recovery has kept open the door to further GBP-negative monetary easing, while U.K. banks' exposure to debt stricken emerging markets like Dubai, kept investors wary of over-exposure to the pound, especially amid a backdrop of heightened sovereign and credit concerns.

## GBP Outlook

The pound's upside against most of its major rivals will remain severely limited by the lagging nature of Britain's economic recovery, which keeps alive 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. Further deterioration in the state of U.K. public finances would add to the long list of headwinds facing the British pound, as would renewed

worries about a debt crisis in Dubai, or other emerging markets where British banks have a high level of exposure. An expected general election in the first half of 2010 could spark political uncertainty and further undermine market sentiment towards the pound.

### 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 60% rise London's FTSE stock index to its highest level since October helps improve the pound's tone
- Britain's dominant services sector has expanded for seven months straight, further signaling that the recession is abating
- Even Britain's troubled housing market, as measured by Halifax's home price index, has improved in six of the last seven months to November

### 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
- Britain remains the only G7 nation still mired in recession. The lagging nature of the U.K.'s economic recovery highlights the view that policy normalization by the BOE will also lag and that the door to further monetary easing remains open
- The Bank of England's purchasing of government bonds, which it recently expanded by another £25 billion of newly created money, is inherently GBP-negative. Officials have not ruled out increasing their budget for asset purchases further
- The deteriorating state of public finances has greatly undermined the pound's appeal. November saw net borrowing rise to a new record high, a 25% increase in borrowing from the previous year
- August and September's PMI manufacturing sector index surprisingly fell. The mixed 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. The unemployment rate is near its highest since 1996
- 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
- A general election in H1 2010 could spark political uncertainty amid a broad backlash against PM Gordon Brown's administration's handling of the credit crisis and worst recession in generations

## Conclusion

The British pound, which rallied in the first half of 2009 as a result of broadly improved market sentiment and mounting optimism about a global recovery, failed to capitalize on continued gains in broader risk assets in the second half of the year. Sterling's upside became severely limited by the Bank of England's increased quantitative easing, which was employed as tool to combat the longest British recession on record. The fact that the U.K. remains the only G7 nation still mired in recession has kept the door to further monetary easing by the BOE wide open and has added to the headwinds weighing on the pound. Additionally, a deteriorating fiscal backdrop and exposure a potential debt default in Dubai weighed on the pound, pushing to two-month lows against the greenback and Canadian dollar late in the quarter. The lagging nature Britain's recovery should keep the threat of additional policy easing elevated, continue to undermine the U.K.'s fiscal outlook and keep sterling's upside significantly capped.

Data over the past months, while generally improved from the crisis levels of last year, painted a mixed picture of Britain's economic recovery. After rising above the key 50 level, which separates expansion from contraction for the first time in 15 months in July, Britain's factory sector PMI slipped back into contraction in August and September and barely held above 50 in November. In contrast, the equivalent measure of manufacturing sector performance in the euro zone rose to 54.2 in November, 53.6 in the U.S. and 61.2 in Canada. British retail sales, which have painted a surprisingly resilient picture of consumer spending in recent months, fell sharply in November, suggesting that the all-important holiday shopping season may disappoint in December. Consumer confidence fell in November and December after three-straight months of improvement. The hemorrhaging of jobs has slowed from its peak in February, but the unemployment rate, which hit its highest since 1996, continues to rise. And while home prices in much of the U.K. have shown signs of bottoming and in many cases, even rising, they remain at deeply depressed levels. Indeed, conditions have improved greatly from the crisis conditions of a year ago. However, the fact that the U.K. remains the only G7 economy still struggling with recession, now its longest on record, highlights the very lackluster pace of recovery and the potential for additional GBP-negative monetary easing in the months ahead.

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. By pushing rates lower and opening the spigots of liquidity to banks, the BOE hoped to encourage lending to households and firms. In March, the BOE launched its initial foray in to unconventional policy easing with a £75 billion budget for asset purchases, which was increased at three subsequent BOE meetings to its current total of £200 billion. 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 by a record £579 billion in October. Bank of England data from the fall showed that net lending to firms fell by its largest amount (£15.5 billion) since record keeping began in 1998. 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. 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. Most recently, BOE policymaker David Miles said that the future path of quantitative easing will be directly tied to the amount of slack in the economy. In other words, additional monetary easing from the BOE can not be ruled out as long as the British economy remains weak. 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 and an inherently GBP-negative outlook.

Another damaging development for the pound is the steady deterioration in the state of Britain's public finances. The U.K. government posted a record deficit for the month of November, which marked an increase in public sector borrowing of over 25% from 12 months earlier. The recession continues to undermine government tax receipts at a time when spending programs are at record highs. The worsening shortfall in the budget could necessitate the maintenance of very low lending rates for an extended period of time as the British government tries to inflate its way out of debt. A recent Labour Party plan put forth by Finance Minister Darling failed to encourage confidence in the government's ability to reign in spending and was not seen as a concrete solution to brining down the deficit in a meaningful way. Further deterioration in the state of public finances could result in a credit downgrade for British sovereign bonds and could remain a serious headwind for the pound over the medium and long term.

While the most probable scenarios call for the pound to remain vulnerable to additional selling pressure in the months ahead, a surprising improvement in underlying economic fundamentals in the U.K. could limit GBP losses. Specifically, an improvement in a labor market conditions would serve to improve consumer and business morale, shore-up domestic demand and improve the outlook for government tax receipts, which would have a beneficial impact on the outlook for public finances. The market has largely priced in a relatively tepid pace of recovery in the U.K., so any surprise to the upside, would likely see investors trim some of their bets against sterling. Improved economic news would also help limit the risk of additional BOE policy easing in early 2010. Still, the long list of structural headwinds facing the U.K. economy should see it lag its counterparts in recovery and keep the pound on the defensive.

## Upcoming Central Bank Meetings

### January

6-7	Bank of England Monetary Policy Committee Meeting
14	ECB Governing Council Meeting
19	Bank of Japan Policy Board Meeting
25-26	Bank of Canada Monetary Policy Meeting
	26-27

### February U.S. Federal Open Market Committee Meeting

3-4	Bank of England Monetary Policy Meeting
4	ECB Governing Council Meeting
17-18	Bank of Japan Policy Board Meeting

### March

2	ECB Governing Council Meeting
4	Bank of Canada Monetary Policy Meeting
3-4	Bank of England Monetary Policy Meeting
16	U.S. Federal Open Market Committee Meeting
16-17	Bank of Japan Policy Board Meeting

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