

QUARTERLY REVIEW

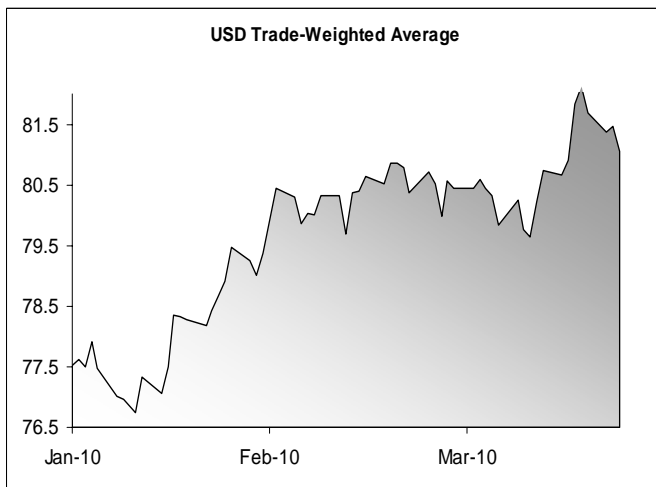
a quarterly market analysis from Travelex Global Business Payments

Posted: April 1, 2010



USD Q1 Summary

Month: +0.40% Quarter: +4.52 YTD: +4.52



The trade-weighted U.S. dollar index rose to a nine-month peak in the first quarter of 2010, boosted by the view that despite its long list of troubles, the U.S. economy is likely to outperform most of its major rivals and that the Fed will likely lead most major central banks in policy normalization. Generally positive U.S. economic data highlighted the improving pace of recovery, which contrasted the anemic rebound taking place in the euro zone, the U.K. and Japan. The greenback also continued to draw support from time-to-time flare ups in risk aversion and from mounting sovereign credit concerns in Europe.

The long-standing inverse relationship between risk appetite and the safe-haven U.S. dollar began to break down in the first quarter, as good economic news started to more directly translate to a higher likelihood of Federal Reserve policy normalization. The greenback found itself uniquely well positioned to benefit from both good domestic data, which highlighted the relative strength of America's economic recovery and from disappointing news which revived demand for more defensive assets. The greenback rose to a 10-month peak against the euro, a 10-month peak against the British pound and touched on a three-month peak against the Canadian dollar earlier in Q1.

USD Outlook

The U.S. dollar appears uniquely positioned to capitalize from both good economic news that brings in the timeline for an eventual Federal Reserve interest rate hike, and from disappointing reports that revive investors' aversion to riskier assets. While the world's largest economy is not likely to sustain the stellar growth experienced in the fourth quarter of 2009, it is still expected to outperform most of its major rivals in recovery. Consequently, the Fed should lead major central banks in monetary normalization, which should ultimately keep the greenback biased higher. Sovereign credit risk in the euro zone and U.K. should keep both the euro's and sterling's heavier tone in tact. A faltering economy as a result of the removal of government stimulus measures could dampen some of the market's enthusiasm about America's recovery, but is unlikely to meaningfully damage the notion that it should continue to outpace most other industrialized nations.

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 Federal Reserve has begun to unwind some of its emergency credit easing facilities put in place during the height of the financial crisis. Even its purchases of mortgage and asset-backed securities set to expire in late March
- While the unemployment rate continues to rise, the pace of job losses has fallen sharply from its peak last winter. The second quarter should finally see net monthly job creation in the U.S.
- Rising Treasury yields and LIBOR rates makes funding carry trades in higher yielding assets with the dollar slightly more expensive
- While America's deteriorating fiscal outlook remains a key liability for the greenback, the dollar's reserve currency status helps underpin demand for US assets (for now). The euro and British pound do not enjoy that same luxury

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
- While the Fed has begun to normalize monetary conditions by letting some of its emergency credit programs wind down, excess slack in the economy is likely to keep policymakers from raising interest rates until at least the end of 2010
- 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 raise 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 first quarter of 2010's U.S. dollar rebound surprised many market participants, who had become comfortable with the "short-USD, long-risk" trade. Investors had realized impressive profits by selling the low yielding greenback and going long any number of risk assets like stocks, commodities, emerging market assets or higher yielding currencies, a trade that paid off for the better part of 2009. However, the indiscriminate appreciation of risk assets was relatively quickly undermined by generally positive economic news from the U.S., which bolstered optimism about an accelerating recovery in the world's largest economy. Investors began to view the Federal Reserve as likely to lead its major counterparts, namely the Bank of England, the ECB and the Bank of Japan in monetary policy normalization. The improving U.S. economic data contrasted the generally anemic recovery taking place in the U.K., Japan and the euro zone. Heightened sovereign credit concerns in the euro zone, worries about monetary tightening in China weighing on global commodity demand and mounting political uncertainty in the U.K. all added to the greenback's broad appeal for much of the first quarter.

U.S. economic data in the first three months of 2010 was notably improved and highlighted what appears to be an accelerating pace of economic recovery. Historically low lending rates from the Federal Reserve, various unconventional credit easing programs and trillions in government stimulus helped bring the economy back from the brink following the worst credit crisis in generations. The long troubled housing market showed signs of stabilization, consumers' confidence and spending improved markedly while manufacturing and services sector activity continued to rebound off of their lows in the fall of 2008. The unemployment rate recently moderated from a 27-year peak of 10.2% and the pace of monthly job losses, which peaked around 700,000 in January 2009, fell considerably, even posting the first monthly jobs gain in two years this past November.

The U.S. economy put in a stellar performance in the fourth quarter of 2009, expanding by an impressive 5.9% on annualized basis. Much of that expansion was the result of short-term government stimulus like "cash for clunkers" and the first-time homebuyer tax credit. Artificially low lending rates and trillions in Federal Reserve credit easing have kept monetary conditions very accommodative, which contributed to the robust expansion in the final months of 2009. Most market participants agree that many of those stimulative

programs are not likely to be sustained into the end of this year and beyond. Another large component of GDP in the fourth quarter, 3.3% of the 5.9% to be exact, came from a slowdown in the pace of inventory liquidation. While the pace of production remained below the pace of sales (hence the still negative performance of inventories), businesses did in fact, raise their level of output such that the depilation of existing inventories slowed. That increase in production had a significant positive impact on GDP in Q4, and could further contribute to growth in Q1. However, it is unlikely that final demand from consumers, who are expected to be saddled with high levels of unemployment for the foreseeable future, will be at levels that would sustain elevated production for a meaningful period of time. Consequently, the U.S.'s robust pace of growth in Q4 is likely to falter towards the end of this year as the impact of government stimulus and the inventory cycle fade.

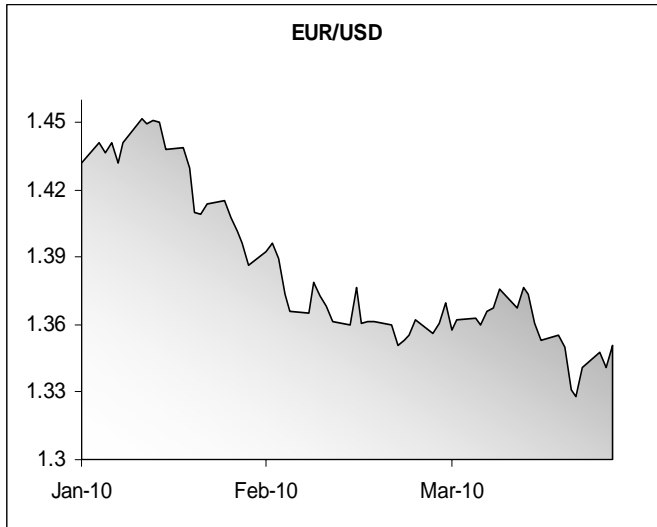
Such a scenario however, does not necessarily preclude continued U.S. dollar gains. A large part of the greenback's impressive performance in the first quarter was due to the view that America's economy is recovering faster than its major counterparts. A simple comparison of the U.S.'s 5.9% annualized GDP in the fourth quarter to euro zone's 0.1%(q/q), the U.K.'s 0.3%(q/q) and Japan's 1.3% highlights the extent to which America is currently outpacing its major industrialized rivals. The U.S. was the first and hardest hit of the major economies in the aftermath of the financial meltdown two-years ago. But thanks to the relatively decisive and aggressive steps taken by the Fed to counter the slowdown, the U.S. appears to be recovering at a much faster pace than other major economies. By comparison, the ECB and Bank of England were late in lowering interest rates and less aggressive in resorting to unconventional measures like asset purchases to stimulate the economy. Despite the potential for U.S. growth to moderate from its current levels in the quarters ahead, it is still likely to outperform the euro zone, the U.K. and Japan, which should ultimately lead the Fed to normalize monetary conditions before its major counterparts abroad.

The outlook for a stronger dollar, while somewhat more popular now than just a few months ago, is not without significant risk. Sovereign credit concerns have until now, been focused on peripheral economies like Dubai and Greece, but could quickly spread to major countries like the U.S., the U.K. and Japan. Because America's budget deficit has swelled to unsustainable levels in the wake of its recession and because the financing of its deficit is so heavily dependent upon foreign capital inflows, any decline in demand for U.S. assets could result in a sharp rise in borrowing costs and a precipitous drop in the dollar. A shift in demand for U.S. debt from China is practically threatening to the outlook for the funding of America's deficits and the greenback. The potential for a double dip recession could also undermine some of the greenback's allure, especially if the rest of the world avoids slipping back into contraction. Countless trillions in stimulus dollars will soon dry up, with final demand unlikely to have recovered to levels that would keep production at such high levels. The somewhat unlikely possibility of another decline in the U.S., while the rest of the world recovers would see the greenback slide on the decline in its relative appeal. Still, the most likely outcome is for the U.S. to outperform anemic economies in the euro zone, the U.K. and Japan and the Fed to normalize rates first, a scenario that should see the greenback continue to outperform.



EUR Q1 Summary

Month: -0.35 Quarter: -5.66% YTD: -5.66%



The single currency fell against most of its major rivals in the first three months of 2010 as investors focused on the deteriorating fiscal position of the bloc's peripheral members. Concerns about a Greek debt crisis undermined the market's taste for EUR-denominated assets. Similar concerns about Spain, Portugal, Ireland and Italy highlighted the view that difficult fiscal reforms would ultimately weigh on already anemic growth in the euro zone and postpone any policy normalization by the European Central Bank. Underlying growth in the euro zone improved but ultimately appeared to lag the more robust recovery in the U.S. and Canada.

The euro slipped to a 10-month low against the U.S. dollar and a 30-month low against the Canadian currency in Q1, broadly undermined by mounting sovereign credit risk and the bloc's lackluster pace of recovery. Worries about Greece's ability to service its huge deficits stung the single currency, while concerns about contagion of the crisis to other peripheral euro zone nations kept the overall level of investors' risk appetite under pressure. The outlook for the ECB to ultimately lag most of the other major central banks in policy tightening kept the euro's tone overwhelmingly negative for much of the quarter.

EUR Outlook

While the single currency has benefited from some near-term reduction in risk associated with a Greek debt default, its medium to longer-term outlook will remain severely dampened by continued

concerns about Athens' ability to implement its strict austerity plan to reign in its gaping deficits. Similarly dismal fiscal conditions in Portugal, Spain, Ireland and Italy will keep euro zone credit concerns at the top of investors' lists, while the hefty fiscal tightening needed to bring budget deficits back down to more reasonable levels will ultimately keep already anemic euro zone growth pressured and result in the ECB postponing policy normalization.

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
- Other EU nations' willingness to backstop Greek debt, or talk of a larger euro zone monetary fund would mitigate sovereign credit concerns and support the single currency
- The broad improvement in investors' appetite for risk associated with signs of a global economic recovery benefits the euro as investors unwind defensive positions in USD and JPY that were accumulated during the height of the financial crisis
- The ECB's single mandate of ensuring price stability could prompt monetary officials to begin sounding a hawkish tone before the Federal Reserve, the Bank of England or the BOJ, especially if inflation rises above its 2.0%/y target. 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
- Sovereign credit risk in the euro zone as a result of soaring deficits in Greece, Ireland, Spain, Portugal and Italy severely undermines the appeal of EUR-denominated assets. Even minimal risk of default should keep the euro broadly pressured
- Fiscal tightening needed to bring down unsustainably high deficits will undermine already weak growth and likely prompt the ECB to lag in policy normalization
- Lackluster growth in the 16-member bloc, which appears to be lagging both the U.S. and Canada, will ultimately keep any EUR gains limited, even if sovereign credit worries subside
- While France, Italy and Germany have shown signs of growth, much of the rest of the 16-member bloc has struggled to recover. The widening growth gap between euro zone nations could become source of further stress within the bloc

- Talk of an EU bailout for Greece or other struggling nations would sour sentiment in rich nations like Germany and put further stress on the very fabric that holds the EU together

Conclusion

The euro slipped against most of its major rivals in the first quarter of 2010, broadly undermined by mounting sovereign credit concerns, a lagging economic recovery and expectations that the European Central Bank will ultimately lag other major central banks in monetary policy normalization. Uncertainty surrounding the outlook for a Greek bailout as well as similar worries about other peripheral economies like Spain, Portugal, Ireland and Italy added to the general lack of appetite for EUR denominated assets and undermined the outlook for recovery in the 16-member bloc. While the euro stabilized late in the quarter as concerns about a Greek default subsided, its medium and longer-term outlook remains severely undermined by the bloc's debt issues and by signs that its rebound from the worst recession in generations will ultimately lag that of the U.S. The single currency also stands to suffer from another flare-up in risk aversion caused a shock to the global economy or by a global recovery that undershoots the market's elevated expectations.

The primary source of the single currency's broad-based weakness in the first quarter was the result of mounting worries about the rising risk of a Greek debt default. The combination of years of unfunded spending on entitlements promised by various governments, soaring simulative fiscal spending in the wake of nation's recession and the steep drop off in government tax receipts amid the sharp slowdown in economic activity resulted in the swelling of Greece's budget deficit to over 12% of GDP and public debt of over 113% of GDP. The EU mandates that member states maintain a deficit-to-GDP ratio under 3% and a national debt level under 60% of GDP. Soaring Greek deficits and the nation's inability to recover from recession made its worsening predicament unsustainable. Investors soon began charging Athens a premium to borrow from the market, which in early March, rose to double the cost of interest charged to the German government. A looming debt crisis presented two main choices to EU policymakers: force Greece to enact draconian austerity measures that would slash spending and raise taxes to bring its massive deficits back down, or come to the aid of Athens through some form of financial bailout.

In early March, Athens announced the latest round of austerity measures aimed at bringing down the nation's gapping deficits and finally getting its deteriorating fiscal condition under control. The latest steps, which amounted to roughly four billion euros in spending cuts and tax increases were met with cautious optimism by market participants. A successful bond auction in early March, which found surprisingly strong market demand for Greek debt, also helped assuage some of the market's concerns about Athens' ability to service its deficits. The resulting rebound in confidence, albeit marginal, sparked some profit taking on the single currency's declines in Q1 and helped lift it off of multi-month lows against most of its major rivals.

While encouraging, the improvement in sentiment regarding Europe's credit risk is not likely to be sustained. Greece may have sidestepped a broader debt crisis in the first quarter, but it still must repay € 30 billion in debt in April and May. The cost charged to Greece in rolling those debt obligations over may prove especially

taxing and could spark another round of concerns about the government's ability to services is debts. Moreover, similar debt issues in much larger economies like Spain, Portugal, Italy and Ireland are likely to prove much more difficult to contain. Even in the very unlikely event that all of Europe's credit issues are addressed without further fear of contagion or default, the austerity measures needed to bring soaring budget deficits back under control will ultimately undermine already anemic growth and postpone policy normalization by the ECB. Higher taxes and slashed spending will restrict fiscal conditions in the 16-member bloc and will likely result in the ECB trailing other major central banks, namely the Fed and the BOC in lending rate hikes.

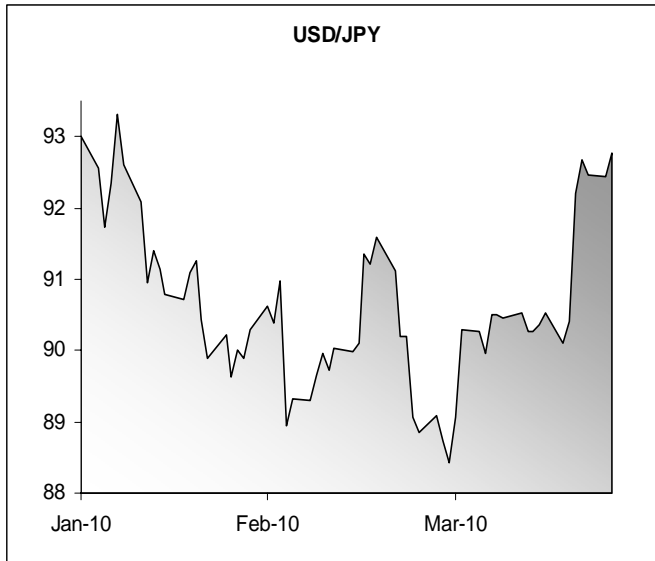
Underlying economic fundamentals in the euro zone have painted a mixed picture of the bloc's recovery. Manufacturing and services sectors within the 16-member bloc have stabilized, rising to 28 and 24-month highs respectively as measured by the PMI survey. Key gauges of business, investor and consumer sentiment have risen markedly since hitting record lows last year. Exports, a key driver of growth in Germany and the broader euro zone, have rebounded and helped contribute to the overall recovery in activity in the 16-member bloc's economy. Consumer prices, which had fallen to a record low in July 2009 and sparked concerns about deflation, have rebounded to around 1.0%(y/y), which is still below target but well above the -0.7%(y/y) of last summer. Still, the improvement in the euro zone's economy has been very anemic and activity still remains at historically low levels. Moreover, the latest months' data showed moderation in the pace of activity in the services sector, a much larger than expected trade deficit and a surprise drop in euro zone retail sales. Additionally, the euro zone's unemployment rate has remained at a decade high 9.9% since October and not expected to moderate meaningfully anytime soon.

The moderate recovery in the euro zone's economy has prompted the ECB to begin slowly normalizing monetary policy by allowing some of its extraordinary lending facilities to expire. The European Central Bank returned to a floating rate auction system for three-month operations, which was a subtle vote of confidence in the health of euro zone credit markets. However, the ECB kept in place one-week fixed rate loan auctions as a way to ensure financial firms have access to ample liquidity at artificially low rates. The euro zone's very lackluster rebound will result in a very slow normalization of monetary policy, with an eventual interest rate hike not likely until sometime in 2011. Additional fiscal tightening to bring budget deficits down will act to further restrict activity and postpone any ECB rate hike. Consequently, the euro should continue to have a very difficult time sustaining its gains.



JPY Q1 Summary

Month: -4.98% Quarter: -0.45% YTD: -0.45%



The Japanese yen held within a broad range against the greenback but slipped versus higher yielding or growth dependent currencies like the Canadian dollar. Generally improved investor risk appetite, the result of signs of acceleration in the pace of global recovery, undermined demand for the low yielding yen. Additional monetary easing by the BOJ in March added to the JPY's heavier tone. Uncertainty about sovereign credit risk, sparked by ongoing debt crises in Dubai and the euro zone helped underpin the yen. Seasonal capital flows ahead of Japan's fiscal year-end in March also helped support the Japanese currency.

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. Sovereign credit concerns about Greece and Dubai kept risk appetite in check throughout the quarter, even as underlying global economic fundamentals continued to improve. Seasonal capital flows back into Japan ahead of the fiscal year-end in March helped keep the JPY generally underpinned toward the end of the quarter. However, the yen suffered after the BOJ raised its budget for short-term loans to the banking sector in late March.

JPY Outlook

The Japanese yen could suffer in the coming months as the global economy continues to recovery and investors become more and more willing to take on risk for higher returns. As other major

economies recover, the rise in yield expectations will leave the JPY vulnerable to renewed carry trade selling, especially as USD borrowing costs rise above Japanese yields. Signs that Japan's economy remains mired in a state of lackluster growth and deflation will highlight the view that the BOJ will keep monetary conditions extremely easy in the months ahead. Ramped up protests by policymakers against JPY appreciation could add to the currency's heavier tone. However, flare-ups in risk aversion or elevated sovereign credit concerns will ultimately keep the yen's downside limited.

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 or a debt crisis in Greece
- 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
- Signs of improving economic performance in China, Japan's largest trading partner, suggest that regional economies remain robust and that demand may help offset declines in activity in the U.S. and euro zone
- 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 sell the low yielding USD and JPY in favor of higher yielding and riskier assets
- 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 eased monetary conditions further by doubling its budget for fix-rate loan auctions to its banking sector. The BOJ's move highlights Japan's very weak recovery at a time when other central banks are considering higher rates
- Soft domestic economic activity, characterized by lackluster consumer spending raises the risk that Japan could slip back into a deflationary spiral that wrecked havoc on its economy over the past decade
- The BOJ's more aggressive stance against deflation 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
- Japan's anemic recovery threatens to keep officials very vigilant in protecting the yen against excessive appreciation
- Japan's soaring fiscal deficit, the highest of any industrialized nation, threatens the nation's AAA sovereign credit rating

Conclusion

While the Japanese yen stands to benefit from the high level of uncertainty about the sustainability of the global recovery and time-to-time flare-ups in risk aversion, its upside will remain limited by the general improvement in market sentiment and Japan's lagging recovery. While the long-term sustainability of the global recovery remains questionable, continued inventory adjustment and government stimulus effects should keep growth accelerating in much of the world. The resulting improvement in market sentiment will keep the yen vulnerable to selling against higher yielding currencies. The potential for additional BOJ policy easing amid a very anemic recovery will also pressure the yen, as will officials' increasing protests against currency appreciation. The lagging recovery of Japan's economy threatens to keep the fiscal outlook very troubling and the Bank of Japan sidelined from policy normalization for the foreseeable future.

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 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 and Greece's credit crisis hit global markets and fanned fears of broader sovereign credit issues. The subsequent pullback in risk appetite saw the yen rise to a three-month high against the greenback and a one-year high against the euro. The market's immediate reaction to the Dubai and Greece events highlighted the extent to which the yen can still take its cue from swings in risk appetite and that it can draw significant support from shocks to the markets in the months ahead.

Excluding the potential for a shock to financial markets over coming months (a scenario that can never be ruled out), the yen should have a difficult time sustaining any meaningful gains against the greenback and the Canadian dollar. 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. In March, the BOJ, under increasing pressure from Japan's government, doubled to ¥20 trillion its budget for fixed-rate short-term loans to its banking sector in an attempt to increase liquidity and encourage institutions to lend more to households and businesses. 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 liquidity provisions to the banking sector or even add to its purchases of government and corporate bonds with newly printed yen, i.e. 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.

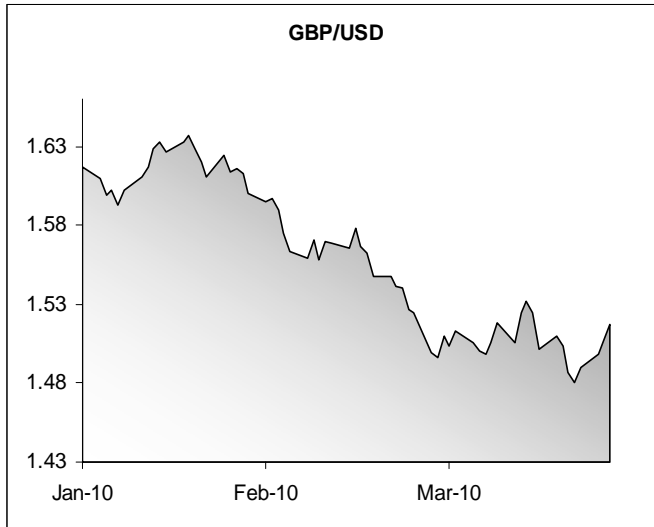
Another potential source of JPY weakness in the months ahead is the possibility for increased official rhetoric condemning yen appreciation or even actual currency market intervention to weaken the yen. In early March, the Bank of Japan raised the ceiling for borrowing in its foreign exchange "special account" for the 2010-2011 fiscal year. The move, which was downplayed as a technical adjustment to its account, increased the BOJ's budget for foreign exchange interventions for the first time in six years. With the economy mired in deflation that shows little signs of abating in the months ahead, Japanese officials are likely to employ every tool in their arsenal to foster a return to meaningful economic growth. With exports still the key driver of overall economic activity in Japan, any rise in the yen will be seen as adding to an already long list of economic headwinds. Consequently, the potential for yen-weakening market interventions remains high.

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 or a widening of Europe's sovereign credit issues would also result in a broadly stronger JPY. However, the potential for increased monetary easing from the BOJ and the fact that lagging monetary normalization will continue to leave the yen vulnerable to selling in favor of higher returns abroad should keep the JPY under sustained selling pressure, which is not likely to be met with any protest from Japanese officials.

GBP Q1 Summary



Month: +1.04% Quarter: -2.56% YTD: -2.56%



Sterling underperformed most of its major rivals for the better part of the fourth quarter, falling to new 11-month lows against a basket of its major counterparts in March. 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. While investors pared bets that the BOE would ease monetary conditions further through additional quantitative easing, the door to increased asset purchase was never officially shut by the BOE. Mounting political uncertainty ahead of a general election later this year added to the long list of headwinds weighing on the pound.

Sterling fell to a new 10-month trough against the greenback and a record low against the Canadian dollar late in the quarter. The pound suffered, despite broadly firmer stocks in Q1, which have generally 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 lackluster pace of recovery and record government spending. The fact that Britain is lagging its major rivals in recovery has made it impossible to rule out further monetary easing by the BOE at a time when other major central banks are eyeing an exit from ultra-accommodative monetary policy. Political deadlock in the U.K.'s upcoming election threatens to limit the ability of the government to tackle its soaring deficit though difficult fiscal tightening. Finally, sovereign credit risk in the euro zone kept investors wary of overexposure to sterling, generally considered a riskier asset.

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, albeit with a small probability, the potential for additional credit easing from the BOE. The outlook for steady, rock-bottom lending rates in the U.K., at a time when other major central banks are contemplating exit strategies from ultra-low rates, will keep the pound on the defensive. Further deterioration in the state of U.K. public finances would add to the long list of headwinds facing the British pound. An expected general election in the first half of 2010 will keep political uncertainty high, with signs of a hung Parliament likely to fan fears about the government's inability to enact strict fiscal reforms.

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 2008 helps improve the pound's tone
- Britain's dominant services sector has expanded for nine months straight, underscoring the U.K.'s recovery from recession
- The Bank of England signaled that it will allow its £200 billion pound quantitative easing program to expire
- Recent labor market reports have highlighted an improving backdrop. February saw the fastest pace of job growth since 1997

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 lagging nature of the U.K.'s economic recovery highlights the view that policy normalization by the BOE will lag other major central banks
- While the BOE allowed its quantitative easing program to expire, it technically left the door to additional asset purchases open if the economy falters in the months ahead
- The deteriorating state of the government's public finances has greatly undermined the pound's appeal, especially amid a backdrop of increasing global sovereign credit risk
- Job losses, while down from February's peak, remain at levels that threaten to keep any economic recovery very subdued. The unemployment rate is still near its highest since 1996
- A general election around the middle of the year has sparked political uncertainty. Investors fear that political gridlock in the U.K. could tie any government's hands in enacting difficult but needed fiscal reforms

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 since then. 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 economy's very anemic recovery has technically left the door open to further easing if conditions fail to improve further. While increased QE by the Bank of England remains unlikely, it does appear increasingly clear that British monetary normalization will lag. Additionally, a deteriorating fiscal backdrop and mounting political uncertainty ahead of this year's general election should continue to undermine the outlook for the pound, keeping its upside very limited in the months ahead.

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 last summer, Britain's factory sector PMI slipped back into contraction in the fall. In contrast, the equivalent measure of manufacturing sector performance in the euro zone rose in every month since last October, while America's ISM manufacturing index rose to its highest level since 2003 in January. British retail sales, which have painted a surprisingly resilient picture of consumer spending in recent months, fell sharply in January as a combination of wintery weather and an increase in the value added tax undermined demand. Investors worry that the run up in spending late last year was largely due to shoppers bringing in consumption ahead of the expected rise in taxes. The hemorrhaging of jobs has slowed from its peak last winter, with February posting its largest increase in employment since 1997. Still, the unemployment rate, remains within striking distance of a 13-year high. While economic conditions have improved greatly from the crisis conditions of over a year ago, the recovery in the U.K. at best looks very mixed. The very lackluster rebound in the U.K. highlights the outlook for the Bank of England to lag the U.S. and Canada in eventual monetary policy normalization.

The BOE began buying gilts, or government bonds in early March 2009 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. In March, the BOE launched its initial foray into 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. While the BOE allowed its quantitative easing program to expire as expected February of this year, it also left the door open to further credit easing if economic

conditions do not improve meaningfully. Indeed, the probability for additional asset purchase from the BOE is minimal. However, the fact that the door to additional QE remains open contrasts expectations for monetary normalization before the year-end in the U.S. and Canada.

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 February, a trend which dominated the fiscal performance for most month of the 2009-2010 fiscal year. Government borrowing is expected to reach a record of more than 12% of GDP due to the impact of the 18-month long recession and record government stimulus efforts. While the full year's figure for government borrowing may actually undershoot the Treasury's forecast for £170.4 billion, it remains at levels that are broadly seen as unsustainable. The anemic economy 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. Fiscal tightening needed to bring the U.K.'s soaring budget deficits back down to more manageable levels will ultimately dampen already weak growth. Already, a rise in the value added tax is seen as weighing on consumer spending. Further deterioration in the state of public finances could result in a credit downgrade for British sovereign bonds and is likely to remain a serious headwind for the pound over the medium and long term.

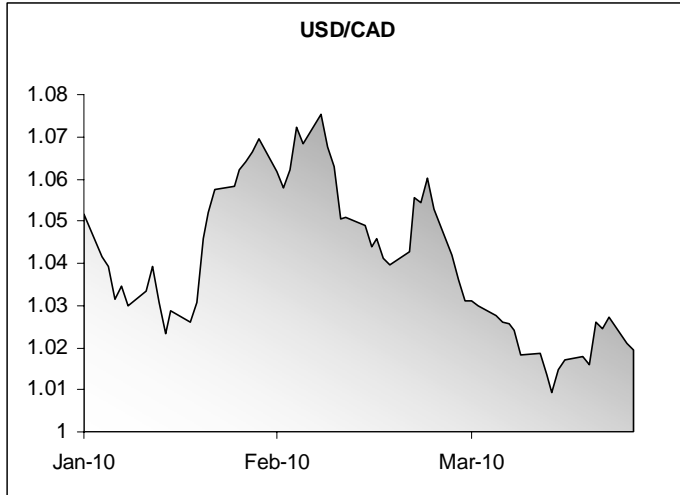
Polls ahead of an upcoming general election expected in May have shown razor thin margins separating the incumbent Labour Party and the opposition Conservatives. A hung parliament, with neither party able to achieve a majority, will greatly undermine any government's ability to enact strict fiscal reforms needed to bring down deficits. Political gridlock is seen as exacerbating the dire state of public finances in the U.K. and adding sovereign credit risk to the long list of headwinds weighing on sterling. Political uncertainty ahead of the election should become more acute, adding to the pound's heavier tone.

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. Still, the long list of structural headwinds facing the U.K. economy should see it lag in recovery and keep the pound on the defensive.



CAD Q1 Summary

Month: +2.59% Quarter: +3.52% YTD: +3.52%



The Canadian dollar outperformed most of its major rivals in the first quarter of 2010, benefiting from elevated crude oil prices, an improving outlook for global recovery, domestic economic strength and the relative health of Canada's fiscal balance sheet. While other commodity currencies from Australia and New Zealand were hit by credit tightening in their key trade partner, China, the Canadian dollar benefited from its relatively small exposure to Chinese demand. The improving domestic performance, partly driven by rebounding U.S. economic activity, sparked speculation that BOC lending rates could rise sooner than previously forecast.

The Canadian dollar's impressive performance for most of Q1 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. The resilient domestic economy combined with above target consumer inflation sparked speculation that the Bank of Canada could begin to normalize monetary policy sooner than its previous forecasts. Finally, the relative health of Ottawa's fiscal standing was a draw, especially given the market's increasing focus on sovereign credit issues in the euro zone and Dubai.

CAD Outlook

The Canadian dollar looks poised to continue to outperform most of its major rivals in months ahead as many of the factors that fueled

its across-the-board strength should persist into the second quarter of 2010. Continued improvement in the global economy in the first half of 2010 combined with the ever-present potential for unrest in the Middle East, should keep oil prices elevated. Gradually improving U.S. growth will likely foster the "buy North America" sentiment that added to the loonie's recent strength. BOC policy tightening before the Fed would add to the CAD's yield appeal and keep its upward trend in-tact. Finally, the relative health of Ottawa's fiscal balance sheet should continue to contrast other G7 nations. However, key risks to the CAD include the potential for global growth to undershoot expectations and further steps by China to reign its red-hot economy through additional credit tightening.

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 expansion in the global economy would support recovery hopes and would put additional upward pressure on commodity prices
- The rise in consumer inflation above the BOC's 2.0% target in February raised the risk of BOC policy normalization sooner than previously expected and importantly, before the Fed
- While the Bank of Canada has slashed its key bank rate to a record low 0.25%, it 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. The market's increasing focus on sovereign credit should continue to support the CAD

Negative Factors

- 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. It would also reduce pressure on the BOC to lift lending rates off of record lows
- With America's unemployment rate still within striking distance of a 27-year peak, demand from Canada's largest trade partner remains vulnerable. Another dip in activity south of Canada's boarder would undermine the outlook for growth and hurt the CAD
- Given the huge impact of government stimulus spending and artificially easy monetary and fiscal policies, it remains unclear how sustainable the global recovery is
- Monetary tightening in China or a rise in the value of the yuan currency would fan concerns about a slowdown in a key engine of global expansion, weigh on commodities and hurt demand for growth assets like the CAD

Conclusion

The Canadian dollar enjoyed its fourth-straight quarter of hefty gains against the greenback, benefiting from the broad improvement in the global economic outlook and the subsequent rise in demand and price for commodities. 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 2009 as the fallout from the Lehman Brothers collapse fanned fears of a "Great Depression" type of worst case scenario. Since Q2 2009 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 improvement in sentiment pushed the CAD to a 20-month high against the USD and a 30-month high against the euro late in Q1. Even as the greenback soared to a 10-month trade-weighted peak, the Canadian dollar's downside was largely limited by improving optimism about a broader North American recovery. Going forward, the CAD's upside should remain in-tact in as investors look favorably on the prospect of a global recovery and reward currencies whose governments have employed fiscal responsibility. As the BOC moves closer to normalizing monetary policy sooner than its major rivals, the CAD will likely test new highs.

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 counterparts, the Canadian dollar's strength proved less of a function of U.S. dollar weakness and more an improvement in domestic economic fundamentals. Late in the first quarter, the U.S. dollar rose to a 10-month trade-weighted peak, largely buoyed by improving U.S. economic growth and mounting sovereign credit concerns. During that same time period, the Canadian dollar held within striking distance of its peaks against the greenback, the euro, the British pound and even firmed toward its highs for this year against the Australian dollar and touched on an eight-month peak against the New Zealand dollar. The fact that the loonie managed to firm against its dollar bloc counterparts highlights the notion that its relative strength was the result of factors specific to Canada's recovery and not a general rise in growth assets.

The rise in consumer prices in February sparked speculation that the Bank of Canada will begin to normalize monetary policy sooner than previously expected, an outlook that added to the loonie's broadly resurgent tone. Core consumer inflation, which the BOC targets at 2.0%(y/y) rose above target for the first time since December 2008 in February. The news highlighted the resilience of Canada's economy and suggested that borrowing costs may not remain at record lows until early in the second half of 2010 as the BOC has long pledged. Strength in key industrial and manufacturing markets, improving retail sales, surprisingly strong residential and commercial real estate markets and net job creation

in five of the last seven months highlights the broad-based improvement in Canada's underlying fundamentals and supports the notion that record low lending rates of 0.5% could rise as early as June. Such a scenario would see the BOC increase rates before the Federal Reserve and support the CAD through a widening yield advantage over the greenback.

The fact the crude oil has held above \$80/barrel for most of March, remains broadly supportive of the nation's energy and natural gas sector. Continued recovery in the global economy, particularly in China, should keep demand for natural resources high and support the CAD. The potential for geopolitical flare-ups in the Middle East, particularly involving Iran, should keep crude oil, and the loonie well supported in the months ahead as well. 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, the U.K. and even the U.S. 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 EUR, GBP and JPY). While further monetary tightening in China could dampen the outlook for growth assets like the loonie, it should remain relatively underpinned by the fact that the vast majority of demand for its commodity exports comes from the U.S. As such, the loonie should outperform its dollar-bloc rivals from Australia and New Zealand under such a scenario. The CAD's strength could also diminish the need for BOC policy tightening and ultimately lead to more complaints from monetary officials about the detrimental impact of a strong currency. Still, the long list of tailwinds for the CAD should see it continue to outperform most of its major rivals in the months ahead.

Upcoming Central Bank Meetings

April

- 6-7 Bank of Japan Policy Board Meeting
- 8-7 Bank of England Monetary Policy Committee Meeting
- 8 ECB Governing Council Meeting
- 20 Bank of Canada Monetary Policy Meeting
- 27-28 U.S. Federal Open Market Committee Meeting

May

- 5-6 Bank of England Monetary Policy Meeting
- 6 ECB Governing Council Meeting
- 20-21 Bank of Japan Policy Board Meeting

June

- 1 Bank of Canada Monetary Policy Meeting
- 9-10 Bank of England Monetary Policy Meeting
- 10 ECB Governing Council Meeting
- 14-15 Bank of Japan Policy Board Meeting
- 22-23 U.S. Federal Open Market Committee Meeting

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