

# QUARTERLY REVIEW

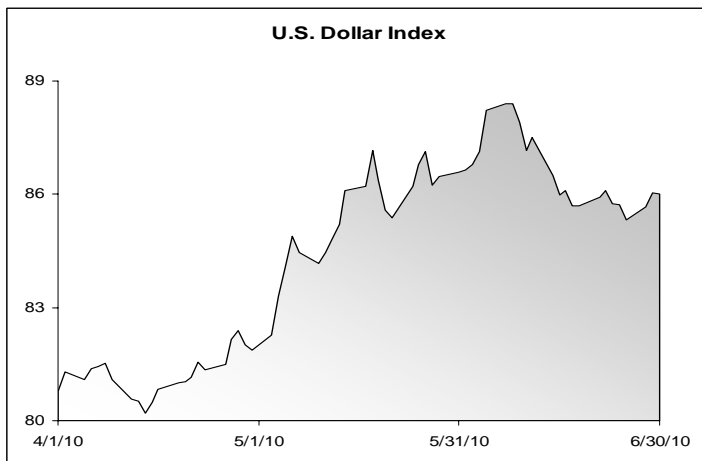
a quarterly market analysis from Travelex Global Business Payments

Posted: July 28, 2010



## USD Q2 Summary

Month: -0.66%    Quarter: +6.0%    YTD: +10.3%



The trade-weighted U.S. dollar index rose to a March 2009 peak during the second quarter of 2010, boosted by the view that despite its share of headwinds, the U.S. economy is likely to outperform its chief rivals and that the Fed may lead its European and Japanese counterparts in policy normalization. Generally positive U.S. economic data highlighted a continuing pace of recovery, which contrasted anemic rebounds under way in the euro zone, the U.K. and Japan. The greenback also continued to draw safe haven support from bouts of investor risk aversion and from mounting sovereign credit concerns in Europe.

For the majority of the second quarter, the U.S. dollar continued a trend in which it found steady support from both improving investor sentiment and from safe haven flows during times of economic uncertainty. The greenback started the second quarter still uniquely positioned to benefit from both good domestic data, which highlighted the relative strength of America's economic recovery, and from disappointing news that revived demand for more defensive assets. In prior quarters, the dollar had fallen out of favor as stocks and other riskier assets rallied which tempted market players out of lower-yielding assets and into higher-yielding ones such as the euro and the Australian dollar. The greenback, during the April to June period, rose to a four-year high against the euro, a 14-month peak against the British pound and neared a seven-month peak against the Canadian dollar.

## USD Outlook

The U.S. dollar appears generally positioned to capitalize from both good economic news that helps to bring in the timeframe for an eventual Federal Reserve interest rate hike, and from disappointing reports that revive investor risk aversion. While the world's largest economy is not likely to sustain the stellar growth experienced in recent quarters, it is still forecast to outpace its European and Japanese rivals in recovery. Consequently, the Fed should lead the euro zone and UK central banks in monetary normalization, which should ultimately keep the greenback biased higher. Sovereign debt troubles in the euro zone and the U.K. could help to restrain the upside potential of the euro and sterling. A slowing U.S. economy, as a result of the removal of government stimulus measures, could dampen some of the market's enthusiasm about America's recovery, but it is unlikely to meaningfully upend the notion that it should continue to outperform most other industrialized nations.

### Positive Factors

- The dollar's status as the world's chief safe haven currency continues to provide it with solid support, especially during periods of increased aversion to risk amid economic or financial market uncertainty
- Signs that the Fed is getting closer to normalizing its ultra-accommodative monetary policy should help improve the yield outlook of dollar-denominated assets and lead to more sustainable gains for the greenback
- The Federal Reserve has begun to scale back some of its emergency credit easing facilities that it put in place during the height of the financial crisis. Even some of the Fed's purchases of mortgage- and asset-backed securities expired earlier this year
- While the unemployment rate remains near double digits, the pace of job losses has fallen sharply from its 2009 peaks. Still, the recent improvement in the U.S. labor market could slow in the months ahead in the absence of government support.
- While America's deteriorating fiscal outlook remains a key liability for the greenback, the dollar's status as the world's main reserve currency helps underpin demand for U.S. assets. The euro and British pound do not enjoy that same luxury

### Negative Factors

- Increasing signs of stabilization in the global economy suggest the recovery is gaining momentum. The resulting improvement in risk appetite favors higher-yielding assets, usually at the expense of the U.S. currency
- While the U.S. central bank has slowly started to normalize monetary conditions by letting some of its emergency credit programs expire, excessive slack in the economy is likely to keep Fed policymakers from raising interest rates until next year
- Low U.S. lending rates amid improving risk appetite tends to encourage traders to fund carry trades in the low-yielding greenback

- 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 dollar-denominated assets
- The removal of policy accommodation globally should prove to be a delicate task for policymakers. Political pressure could delay the timely removal of policy accommodation and result in significant inflationary pressures
- The recent call by G20 world leaders for a rebalancing of the global economy implies a need for broadly weaker U.S. and Chinese currencies
- Persistently high unemployment, still near a quarter-century peak, threatens to keep aggregate demand in the economy under increasing pressure, even as other sectors recover. The Fed is unlikely to raise rates with the nation's jobless rate dangerously close to 10%
- Continued weakness in the U.S. housing sector should keep U.S. borrowing costs near a record low around zero
- Mounting talk of central bank reserve diversification out of dollar assets remains a key liability for the greenback

### Conclusion

The U.S. dollar entered the second quarter of 2010 on a solid uptrend against most major currencies. The greenback's upward drive had taken root toward the latter part of the fourth quarter of last year when positive November jobs data helped to fuel the notion that the U.S. recovery seemed on course to outpace its rivals in Europe and Japan. Based on that buoyant outlook, many market watchers took the view that the U.S. central bank would lift interest rates before the European Central Bank, the Bank of England, and the Bank of Japan. The prospect of a rate hike tends to strengthen a currency by bolstering its yield appeal.

The first month of the second quarter saw April employment figures grow at their fastest pace in four years, reinforcing investor optimism about the U.S. recovery. An improving labor market is considered a vital prerequisite to any Federal Reserve interest rate hike. Therefore, the April jobs data helped to further the notion that a U.S. rate hike could be in the cards later this year. With U.S. lending rates holding near a paltry record low around zero, the dollar got a boost from market talk of a Fed rate hike later in 2010.

Other data on the housing and manufacturing sectors showed signs of stabilizing early during the second quarter which also supported the view of a strengthening U.S. recovery. As a result, the dollar rose broadly, hitting fourteen-month highs against the euro and a one-year peak against the British pound. In addition to mounting optimism about the sustainability of the U.S. economic recovery, the dollar also found support from occasional bouts of market anxiety which often sent investors toward the safety of the U.S. currency.

With the greenback finding support on the dual fronts of a recovery seemingly gaining force as well as safe haven flows amid uncertainty over a worsening debt crisis in Europe, the U.S. currency built on its strength and powered to four-year highs against the single currency in early June. Still, it would take more than a labor market showing signs of healing. Another necessary ingredient of any eventual Fed rate hike would be for the U.S. housing market to start to show signs of renewed life. After all, the

key housing sector was at the heart of the worst U.S. economic downturn since the 1930s.

Initially during the second quarter, the housing industry seemed to have turned the corner. Sales of new U.S. homes soared by nearly 15% in April to its highest in almost two years. Though encouraging, most of the improvement the housing sector enjoyed was largely the result of government aid which was set to expire early in the quarter. Consequently, the U.S. government's April 30 expiration of a popular tax credit for first time home buyers had many market participants questioning whether the housing market could stand on its own legs in the absence of assistance from Uncle Sam.

Concerns about any rebound in the housing market were intensified by May data that reflected continued weakness in the key sector now that government aid had expired. U.S. new home sales in May plunged by more than 30% in May, a record tumble.

What had started off as another promising quarter for the U.S. currency eventually gave way to fears that the recovery was losing momentum. In June the Federal Open Market Committee gathered to take up monetary policy. As expected the rate-setting team left benchmark U.S. interest rates unchanged near zero, a record low level they vowed to maintain for "an extended period" to support the recovery. In its accompanying remarks, the U.S. central bank struck a dovish tone on the pace of recovery, characterizing it as only "proceeding," compared to its prior meeting in April when policymakers described the economy as having "continued to strengthen."

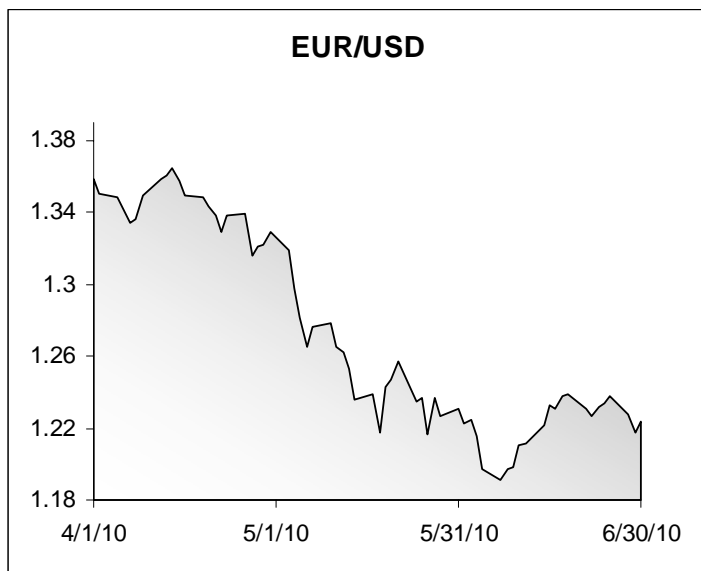
The June non-farm payrolls report showed the first net loss of U.S. jobs in six months. Although the majority of the job losses reflected the expiration of temporary government employment to help with the census count, the number of private sector positions came in below forecast. The creation of private sector jobs is the key to a sustainable recovery since they are considered the backbone of the economy.

The U.S. economic recovery ended the second quarter in far less favorable shape than it had started it. The dollar too pared some of the handsome gains that it had enjoyed throughout most of the April to June period as signs of a weaker pace of recovery cast strong doubt on the chance of a U.S. rate hike some time later in 2010. After all, the Fed's low rate pledge for an extended period was one largely understood by investors to be about six months. Consequently, the dollar lost some of its upward momentum as investors scaled back the timetable for an eventually Fed rate hike. In order for the dollar to resume its upward trek against its major rivals in the months ahead, U.S. data on the housing and employment markets will have to show marked improvement.

## EUR Q2 Summary



Month: -9.50%    Quarter: -11.55%    YTD: -17.58%



The single currency suffered hefty losses against most of its major rivals during the second quarter of 2010 as investors focused on the deteriorating fiscal position of the bloc's peripheral members. Escalating concerns about Greece's debt crisis undermined market appetite for euro-denominated assets. Similar fears 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 recoveries in the U.S. and Canada.

The euro tumbled to a 4-year low against the U.S. dollar and to an 8-1/2-year low against the Japanese currency during the second quarter, broadly damaged by intensifying sovereign credit risk and the bloc's lackluster pace of recovery. Worries about Greece's worsening fiscal position badly bruised 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. Expectations the ECB will lag most 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 bouts of short-covering following its collapse in early June to a four-year low against the greenback, its medium- to longer-term outlook should remain severely dampened by continued concerns about Athens' ability to successfully 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 1.0% 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 cut its key lending rate to a record low 1.0% and implemented unconventional policy easing measures through the purchase of longer-term covered bonds. While tentative 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 euro-denominated assets. Even minimal risk of default should keep the euro broadly pressured
- Fiscal belt-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 euro 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 a source of increased tension within the bloc
- Recent EU bailouts for Greece as well as talk of rescues for other struggling nations has soured public sentiment in rich nations like Germany and put further stress on the very fabric that holds the EU together

### Conclusion

Europe's common currency tumbled swiftly against the U.S. dollar during the second quarter as soaring levels of debt in some of the bloc's 16 nations drove risk sensitive investors away from the euro. The single currency's downtrend started in December 2009 when positive U.S. jobs data fueled expectations the U.S. central bank could boost interest rates before its euro zone and Japanese counterparts. Higher lending rates tend to boost a currency by enhancing its yield appeal to investors.

With the growth outlook favoring the dollar, the euro was dealt another setback late last year when Greece revealed that its finances were in far worse shape than originally thought. At nearly 14 percent of gross domestic product (GDP), the broadest gauge of an economy's strength, Greece's budget deficit was more than 4 times the limit that states belonging to the European Union are allowed. The far worse than expected news on Greece's finances unsettled investors, sending them toward the safety of the American dollar.

To improve the poor condition of its finances, Greece next had to come up with a credible plan to get its financial house in order. Greek policymakers agreed to implement painful steps to shrink its massive pile of debt which largely consisted of salary reductions and tax hikes. Such severe austerity plans to tackle its debt problems spurred strong public backlash which, on at least one occasion, resulted in the deaths of protestors.

Given the strong opposition by Greek citizens to the government's harsh measures, investors lost confidence in Athens' ability to effectively manage its finances. Consequently, the Greek government was eventually unable to raise funds the convention way by selling government debt. Bond investors wanted too high a premium attached to the sale of any Greek debt so much so that Athens had to turn to others for financial assistance.

The euro zone's fellow members – along with the International Monetary Fund – came to the rescue of Greece with a 110 billion euro (\$143 billion) bailout. But even that enormous amount failed to allay concerns about Greek's fiscal mess. That is because investors increasingly started to worry that other euro zone countries with massive amounts on debt could follow Greece down the road to financial ruin. After Greece, euro zone governments in Spain, Portugal, Italy and Ireland all have alarming levels of expenses that nearly eclipse their streams of revenue.

The euro's descent, in the meantime, started to gather pace. Despite the collective initial efforts of Greece's fellow European neighbors and the IMF, fears began to grow of a broadening sovereign debt crisis in the euro zone. The concern among investors was that the severe belt-tightening measures under way

in Athens and other southern euro zone states would have a dampening effect on economic growth in the region. The prospect of slower euro zone growth suggested to markets that the central bank in charge of the region, the European Central Bank or ECB, would have to keep interests rates at record lows for a longer period of time to help stimulate economic activity.

During the second quarter, in June, the single currency shed nearly 10 percent of its value, hitting its lowest level in four years against the U.S. dollar. The euro's rapid pace of deterioration led to a second bailout, a nearly \$1 trillion one, that was designed to shore up the embattled common currency and offer financial backing to any euro zone nations at risk of going bankrupt.

As of early June, the euro had shed nearly 17 percent on the year against the greenback. The single is now poised to fall below its average rate since its launch in 1999. The euro's rapid decline was not limited to the U.S. currency. Against the Swiss franc, the euro has plunged to a series of all-time lows and is down about 7 percent in 2010. The common currency recently touched an 8-1/2-year low against the Japanese yen, an 18-month low against the UK pound and to its lowest since 2001 versus the Canadian dollar.

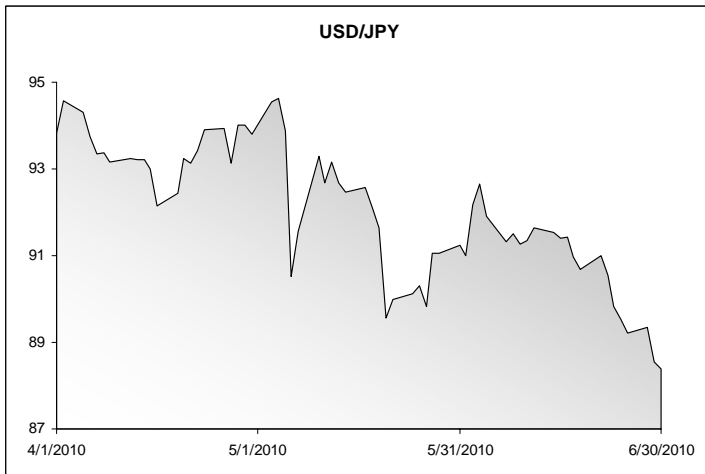
The euro's fall has made for an opportune time for U.S. travelers to head to the euro zone as the dollar's strength makes trips or vacations to Europe more affordable for Americans.

By contrast, the shared currency's collapse this year should come as a boon to euro zone exporters, whose goods are comparatively less expensive on world markets. In fact, an uptick in exports from the euro zone for such goods as German machinery and wines from France, to name a few, could help to bolster the bloc's economy. Such a scenario, over the longer term, might help to set the stage for a meaningful rebound in the single currency. Until then, the euro is vulnerable to further losses against the dollar and many of its rivals, given the bloc's dire financial outlook and its darkening growth potential.



## JPY Q2 Summary

Month: -3.22%    Quarter: -6.15%    YTD: -5.21%



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 risk appetite, the result of continued signs of recovery in the global economy, undermined demand for the low yielding yen. The prospect of additional monetary easing by the Bank of Japan has kept pressure on the yen. Uncertainty related to sovereign credit risk, fuelled by the ongoing debt troubles in Europe, helped to underpin the Japanese currency. End of month and end of quarter capital flows also lent support to the yen.

Despite the improvement in global economic data and optimism about a recovery from the worst recession in decades, the yen remained underpinned by bouts of market uncertainty which help to spur demand for safety and trigger a reversal of yen-funded carry trades. Carry trades are a trading strategy in which investors borrow low-yielding currencies like the greenback and the yen to buy ones that offer greater yield potential such as in currencies like the euro and the Aussie and kiwi dollars. Sovereign credit concerns in the euro zone and elsewhere kept risk appetite in check throughout the quarter, even as underlying global economic fundamentals continued to heal. 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.

## 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 a strong currency could weigh on yen sentiment. However, flare-ups in risk aversion or intensifying 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 shown signs of breaking down, it still draws support from periodic spikes in risk aversion sparked by fiscal debt problems in Europe and other nations
- While global economic recovery has improved investor sentiment, risky assets tend to price in a more upbeat rebound. Disappointment in the actual pace of recovery should see risky assets underperform against the low yielding yen
- Signs of improving economic performance in China, Japan's largest trading partner, suggest that regional economies remain relatively healthy and that demand may help offset any declines in activity in the U.S. and euro zone
- Business sentiment, especially among Japan's large manufacturers, has improved markedly since hitting a record low last year

### Negative Factors

- Signs that the worst of the global downturn 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 0.1% 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 fragile recovery at a time when other central banks are considering raising interest 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
- As U.S. bond yields rise, that tends to make the yen the funding currency of choice for carry trade investors
- Japan's anemic recovery threatens to keep officials very vigilant in protecting the yen against excessive appreciation, an unwanted scenario that would make Japan's key exports more expensive overseas
- 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 continued 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 by 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 Greece hit global markets and fanned fears of broader sovereign credit issues. The subsequent pullback in risk appetite saw the yen rise to a five-month high against the greenback in May and to an 8-1/2-year low against the euro the following month. The market's immediate reaction to the euro zone fiscal worries highlighted the extent to which the yen can still take its cue from swings in risk appetite and how 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.

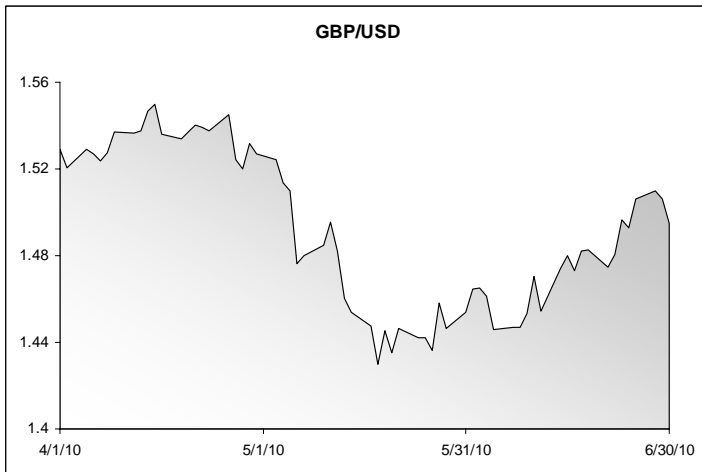
Another potential source of yen weakness in the months ahead is the possibility for increased official rhetoric condemning yen appreciation or even actual currency market intervention to weaken the yen. In early March, the Bank of Japan raised the ceiling for borrowing in its foreign exchange "special 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 more sovereign debt troubles around the globe in the months ahead would tend to support the safe haven yen. 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 Q2 Summary



Month: **+2.82%** Quarter: **-1.56%** YTD: **-8.11%**



**Sterling turned in a generally mixed performance during the second quarter of 2010, gaining against Europe's badly beaten down common currency, though the pound tumbled against a stronger U.S. dollar. Like it has in recent quarters, the British currency's weakness was linked to worries over the dire state of U.K. public finances, Britain's lackluster growth prospects and expectations the Bank of England will need to keep its key interest rate at record low levels for the foreseeable future. While market players reduced bets of further quantitative easing by the U.K. central bank, the door to increased asset purchases was never officially closed by the Bank of England. A tough austerity budget packed with tax hikes and pay cuts designed to slash the nation's massive debt burden helped to support to sterling ahead of the June 30 quarter-end.**

Sterling fell to a 14-month trough against the greenback and to a new record low against the Canadian dollar toward the middle of the second quarter. The pound suffered mostly in line with declining global stocks which tends to undermine demand for riskier currencies such as sterling. Moreover, 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. Finally, sovereign credit troubles 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 should remain broadly limited by the lagging nature of Britain's economic recovery, which keeps alive, albeit by 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 implementing exit strategies from ultra-low levels, should keep downward pressure on the pound. A further deterioration in the state of U.K. public finances would add to the long list of headwinds facing the British pound.

### Positive Factors

- An improving outlook for the global economic recovery helps buoy the appeal of riskier currencies such as the pound
- Sterling's close correlation with risk appetite and its dominant financial services sector means it stands to benefit when equity markets strengthen
- Britain's dominant services sector has remained in growth territory for more than a year, 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 trends have highlighted an improving backdrop. U.K. unemployment has fallen the last four straight months

### Negative Factors

- The BOE slashed its key lending rate by a total of 450 basis points to 0.5%, the lowest in the central 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 show fresh signs of weakening in the months ahead
- The poor state of the government's public finances has greatly undermined the pound's appeal, especially amid a backdrop of mounting global sovereign credit risk
- Job losses, while down sharply from their February 2009 peak, remain at levels that threaten to keep any economic recovery subdued. The unemployment rate is still near its highest since 1996

## Conclusion

The British pound, which rallied in the first half of last year as a result of broadly improved market sentiment and mounting optimism about a global recovery, has failed to capitalize on continued gains in broader risk assets since then. Sterling's upside became restrained 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 subdued pace of recovery has left the door open to more easing measures if economic conditions fail to show signs of healing. While additional QE steps by the BOE remains unlikely, it does appear increasingly clear that British monetary normalization will lag other developed economies. Furthermore, a deteriorating fiscal backdrop should continue to undermine the outlook for the pound, keeping its upside limited in the months ahead.

Recent U.K. data, while generally improved from the crisis levels of last year, painted a mixed picture of Britain's economic recovery. British retail sales, which have painted a surprisingly resilient picture of consumer spending in recent months, fell sharply in January and remained soft during the better part of the second quarter. Investors worry that the run up in household 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 around 8%. 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 2009, 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 a currency's outlook. Moreover, 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 in February 2010, 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 policy stances in Canada who on June 1 became the first Group of Seven nation to hike interest rates since the global economic downturn roiled financial markets.

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.

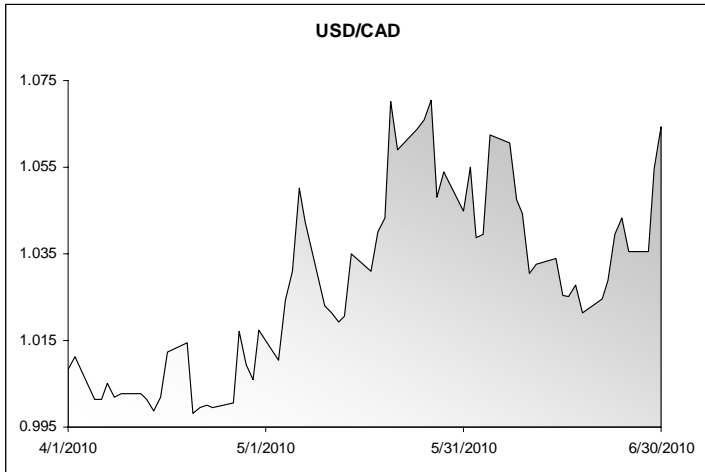
The first coalition government in the U.K. in sixty years helped to remove the political uncertainty that had accompanied sterling well into the second quarter. The new British government, headed by Prime Minister David Cameron, a Conservative, ran a campaign that put tackling the nation's record fiscal deficit at the top of its list of priorities if elected to office. In late June, the new UK government unveiled a tough belt-tightening plan to reduce the nation's fiscal deficit to virtually zero in a matter of years. The bulk of the government's plan to bolster its finances came largely in the form of pay cuts and tax hikes in the years ahead. Although the pound rallied off a one-year low against the dollar on the encourage budget news, its upside is likely to remain relatively limited for the foreseeable future as the tough austerity measures to cut the deficit are expected to come at the expense of more moderate U.K. growth in the years ahead.

While the pound remains vulnerable to renewed selling pressure in the months ahead, a surprising improvement in underlying economic fundamentals in Britain could limit sterling losses. Specifically, an improvement in 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 Q2 Summary



Month: +1.84%    Quarter: +4.84%    YTD: +1.0%



The Canadian dollar turned in a mixed performance during the April to June quarter of 2010, rising to all-time highs against Europe's common currency. However, the loonie plunged to a November 2009 low against the greenback toward the middle of the second quarter. An escalating sovereign debt crisis in the euro zone lent a powerful boost the Canadian dollar against the single currency. However, Europe's fiscal troubles helped to fuel a strong rally for the safe haven greenback which strengthened to its highest level in more than four years against the euro. Europe's economic problems battered investor sentiment hurting stocks and commodities. Underscoring the steep fall in commodities toward the height of the crisis, oil prices collapsed from \$86 a barrel in early May to below \$70 a barrel in a matter of weeks. As a resource-rich nation, the Canadian currency often takes its cue from oil market movements.

The Canadian dollar turned in an uneven performance during the second quarter of 2010. During the April to June quarter, the loonie strengthened to a record high against the embattled single currency amid heightened worries about finances in the bloc's southern states. Sovereign debt troubles in Greece, Spain and Portugal highlighted investor fears of the fiscal soundness of the euro zone's smaller economies. Despite the local dollar's strong advance against the euro, the Canadian currency slipped broadly against its U.S. rival. Worries about Europe's debt struggles lent solid support to the greenback as risk averse traders sought its safe haven appeal. Nevertheless, Canada's steadily improving economic recovery, highlighted by a stellar annual growth rate of more than 6% in the first quarter and a record rise of more than 100,000 jobs in April, bodes well for local dollar by reinforcing expectations for higher domestic interest rates.

## CAD Outlook

The Canadian dollar looks poised 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 third 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 supported. Gradually improving U.S. growth will likely foster the "buy North America" sentiment that added to the loonie's recent strength. BOC policy tightening ahead of the Fed added to the loonie's yield advantage, maintaining its upward trend. Finally, the relative health of Ottawa's fiscal balance sheet should continue to contrast other G7 nations that are saddled with high debt. However, key risks to the local dollar include the potential for global growth to undershoot expectations and further steps by China to rein in its red-hot economy through additional credit tightening.

### Positive Factors

- The Canadian dollar tends to benefit from improvements in market sentiment and the subsequent rise in investor appetite for risky assets linked to the global growth outlook. Further evidence that the global economy is recovering would add to the loonie's recent gains
- In June, Canada became the first Group of Seven nation to lift interest rates in the aftermath of the worst global downturn in decades, boosting the yield appeal of the loonie
- 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
- With consumer inflation holding toward the upper end of the Bank of Canada's 2% target, policymakers are likely to boost interest rates again during the second half of 2010
- An improving U.S. economy greatly benefits Canada's export-driven economy, which sends around 70% of its locally produced goods to its southern neighbor
- The relative health of Ottawa's fiscal balance sheet contrasts the rest of the G7, where most nations are saddle with high fiscal deficits. The market's increasing focus on sovereign credit should continue to support the Canadian dollar

### Negative Factors

- Further loonie 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 further boost interest rates
- With America's unemployment rate still near double digits and within striking distance of a 27-year peak, demand from Canada's largest trade partner remains vulnerable. Another dip in economic activity south of Canada's boarder would undermine the outlook for growth and hurt the loonie

- Given the huge impact of government stimulus spending and artificially easy monetary and fiscal policies, it remains unclear whether the recovery will be a sustainable one during the second half of 2010
- Monetary tightening in China or a rise in the value of the yuan would fan concerns about a slowdown to a key engine of global expansion, weigh on commodities and hurt demand for growth-dependent assets like the loonie

### Conclusion

The Canadian dollar snapped a string of four straight quarters of hefty gains against the greenback during the second quarter as the greenback remained a popular destination for risk averse investors seeking shelter from Europe's sovereign debt crisis. Similar to the early days of the global financial crisis, the loonie and other growth-dependent investments plummeted as investors shunned assets with even the slightest risk profile. During the global downturn, 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. Fears about Europe's debt crisis had a similar effect on risky and commodity-based currencies such as the loonie. The price of oil slid sharply at one point during the quarter, to below \$70 a barrel, toward the end of May. The cost of started the month of April around \$85 a barrel. As a major producer of key commodity resources such as oil and gold, the Canadian dollar often takes in cue from commodity market movements. Still, the Canadian dollar's downside was largely limited by improving optimism about a broader North American recovery. Going forward, the Canadian dollar's upside should remain intact as investors look favorably on the prospect of a global recovery and reward currencies whose governments have employed fiscal responsibility. The Canadian dollar should also see its downside cushioned by the prospect of higher interest rates in Canada this year.

Outside of the risks that Europe's debt crisis poses to the broader global economy, the loonie should find key support from increasing signs that its recovery is gaining traction. Among the positive pieces of data that came out during the second quarter, Canada in the first three months of 2010 showed annual growth of more than 6%, its fastest pace since 1999. March retail sales topped 2%, marking the best performance by consumers in five years. The labor market also continued its recovery trend, having added jobs in every month since January. Underscoring Canada's strengthening labor market, the jobless rate seemed on course to soon dip under 8%. Nearly a year earlier, Canada's unemployment rate soared to a January 1998 high of 8.7% which was during the height of the global economic downturn.

The highlight for the Canadian dollar during the second quarter came in June when the Bank of Canada boosted interest rates by a quarter-point to 0.5%. By doing so Canada became the first Group of Seven industrialized nation to hike interest rates from record low levels during the recession in the global economy. Canada by far beat its U.S. rival in lifting interest rates, a scenario that bolsters the loonie by making C\$-denominated assets more appealing than their American counterpart. By comparison, the U.S. central bank is decreasingly likely to boost its key benchmark lending rate in 2010 as Fed policymakers keep rates at record lows to assist with the recovery. Going forward, Canada's yield premium over the U.S., along with the prospect for further BOC rate increases over the

balance of 2010 should help the loonie hover near the stronger end of its recent ranges against not only the greenback but against its other major counterparts.

Another factor that should continue to prop up the loonie is Canada's relative healthy government balance sheet. Canada has the lowest net debt of any country among the G7 nations. That fact should add to the appeal of C\$-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.

Overall optimism about the global economic recovery should keep risky 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 euro, sterling and the yen). 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 a result, the loonie should outperform its dollar-bloc rivals from Australia and New Zealand under such a scenario. The Canadian currency'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 loonie should see it continue to outperform most of its major rivals in the months ahead.

## Upcoming Central Bank Meetings

### July

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- 8 ECB Governing Council Meeting
- 8-9 Bank of England Monetary Policy Committee Meeting
- 15 Bank of Japan Policy Board Meeting
- 20 Bank of Canada Monetary Policy Meeting

### August

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- 4-5 Bank of England Monetary Policy Committee Meeting
- 5 ECB Governing Council Meeting
- 8-9 Bank of Japan Policy Board Meeting

### September

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- 2 ECB Governing Council Meeting
- 6-7 Bank of Japan Policy Board Meeting
- 8 Bank of Canada Monetary Policy Meeting
- 8-9 Bank of England Monetary Policy Committee Meeting
- 21 U.S. Federal Open Market Committee Meeting

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