

## USD pares gains as oil prices rebound, EUR rallies

- **USD:** Mixed, equities fall sharply in China, risk aversion rises, upside limited by a rally in crude prices
- **JPY:** Higher, supported by safe haven demand as equity markets trade lower
- **EUR:** Higher, German PPI falls most on record, warning about second wave of credit risk
- **GBP:** Lower, MPC split on expansion of quantitative ease, warning about risk of UK debt default
- **CAD and AUD:** AUD & CAD lower, tracking global equities, Canada's CPI declines to 56 year low

### Overview

USD and JPY traded higher Wednesday supported by a spike in risk aversion as global equity markets decline. The Shanghai Index declined 4.7% pressured by concern about the global recovery. Equity markets in Europe and the US followed the decline in Asia. USD was also supported by a number of factors that include report of a split on the BOE's monetary policy board over the size of the expansion of quantitative ease. Three MPC members including BOE Governor King wanted a larger expansion of quantitative ease. GBP was pressured by the MPC minutes and warning from the Tory party of possible risk of UK government debt default. EUR opened lower pressured by report that German PPI fell at a record pace in July. EUR rallied in US session supported by a recovery in US equities gains in cross trade to GBP and a surge in crude prices. Crude prices rallied in reaction to DOE report of a sharp drop in crude stocks. Commodity currencies were hit hard by the spike in risk aversion and falling equity markets with CAD pressured by report that Canada's inflation rate fell to 56 year low. Commodity currencies reversed early losses supported by the rebound in crude and recovery in US equities. There was limited reaction to an IMF report which says that the global recession has ended. The IMF warned that the impact of the recession will last for many years. Warren Buffett says that the US is out of the emergency room and appears to be a slow path to recovery but he warned that the US federal debt poses risks to the economy. USD price direction is closely tracking risk sentiment and the direction of equities with the direction of the Shanghai Stock Index leading the way. As more analysts conclude that the global recession is ending investors will be looking to gauge the strength of the recovery. Most analysts see an uneven global economic recovery and this could lead to more back and forth price action in equity markets, commodities and FX trade. The decline in China's stock market generates speculation that the recent global equity market rally was not justified by underlying fundamentals.

### Today's US data:

No major US economic data was released in today's trade.

### Upcoming US data:

On August 20th initial claims for August 15th will be released expected at 540k compared to the 558k last week. Also on August 20th July leading indicators will be released along with the August Philly Fed. Leading economic indicators expected to rise 0.4% compared to 0.7% last month. The Philly Fed survey is expected to fall to -3 from -2 last month. On August 21st July existing home sales will be released expected at 4990k compared to 4890k last month.

### JPY

JPY traded higher supported by a sharp drop in the Shanghai Stock Index and concern about China's recovery. The Shanghai Index dropped 4.3% Wednesday contributing to a broad sell-off in Asian equity markets. This is the second time in the last three days that the Chinese equity markets have been hit hard. Credit tightening in China is the catalyst for the latest bout of selling pressure of the Shanghai Index. Last week China announced measures to cap construction lending and to limit expansion of steel production. Investors fear that the Chinese government may adopt additional tightening measures to try to slow the rapid speculative rise in equity markets, real estate and commodity prices in China. Concern about demand from China sparked aggressive selling of commodity markets in particular, copper prices have fallen 9% after rallying to a 10 month high last week Japan's June all industry activity rose 0.1% compared to 0.7% last month. The trade had expected a 0.4% rise. JPY price continues to maintain a close correlation to the direction of equity markets and risk sentiment.

Key technical levels to watch in USD/JPY include support at 94.05 the July 28th low and 93.50 the July 23rd low and 92.70 the July 14th low with resistance at 95.30 the August 18th high.



## EUR

EUR opened lower pressured by weaker equity market trade and report that German producer prices fell at a record pace in July. The decline in global equity markets sparked safe haven demand for the USD and JPY. German producer prices fell a record 1.5% in July and at an annual rate of 7.8%. The drop in producer prices reflects weaker oil prices. The German PPI report should dampen speculation of an earlier than expected ECB tightening as deflationary pressures continue. Tuesday, Germany reported a sharp rise in investor business confidence. The rise in German investor business confidence sparked debate about ECB policy outlook and whether the ECB would remain on hold as the German economy emerges from recession. EUR was also pressured by a report in the Daily Telegraph which discusses the risk that Germany may face a second wave of credit crunch. There was limited reaction to report that EU current account deficit narrowed by 0.3bln as exports

rise. The rise in exports suggests that the EU economy is improving. EUR surged mid-session supported by a rally in crude and gains in cross trade to GBP as equities erase early losses. The direction of equity markets and risk appetite will be key to the direction of the EUR.

On August 21st EU August manufacturing and services PMI's will be released. The manufacturing PMI is expected to improve to 46.6 from 45.7 last month and services PMI is expected to improve to 46 from 45.7 last month.

The technical outlook for the EUR is negative as the EUR breaks below 1.4100. Expect EUR support at 1.3965 the July 15th low with resistance at 1.4330 the August 17th high.



### GBP

GBP traded lower pressured by the release of the BOE's MPC minutes for the August monetary policy meeting. The MPC minutes unexpectedly showed that the MPC was split over the expansion of quantitative ease. At the August meeting the BOE elected to expand quantitative ease by £50 bln. According to the MPC minutes BOE Governor King and two other board members argued for an expansion of quantitative ease by £75 bln. The MPC voted 6 to 3 in favor of expanding quantitative ease by £50 bln. According to the MPC minutes the BOE sees positive impact from quantitative ease but remain concerned about weak UK money supply growth. This suggests that the BOE is unlikely to accelerate quantitative ease but will continue with quantitative ease until money supply starts to grow. UK M4 money supply for July will be released Thursday. GBP was also pressured by a report in the UK Guardian that the UK government could default on its debts. Tory leader Cameron warned that the UK

government debt level can get to a place where people will cease to lend to the government. There is growing concern that the expansion of quantitative ease is taking UK government debt to an unsustainable level. Tuesday the UK reported that CPI was unexpectedly flat last month. The UK inflation report diminishes the risk of UK deflation and may limit the chance that the BOE will elect to expand quantitative ease. The CPI report may encourage the BOE to move towards a more neutral policy bias and help reduce fears over UK debt expansion. There was limited reaction to report that UK CBI August manufacturing orders improve to -54 from -59. The trade had expected a reading of -50.

On August 20th July M4 will be released along with July net public-sector borrowing and July retail sales. M4 is expected to rise 0.1% compared to 0.2% last month. Public sector borrowing is expected to fall to -6.25 bln from 19.98 bln last month. Retail sales are expected to rise 0.2% compared to 1.2% last month.

The technical outlook for GBP is mixed as GBP fails to hold above at 1.6500. Expect near-term support at 1.6220 the July 14th low with resistance at 1.6610 the August 14th high.



## CAD

CAD traded lower pressured by report of weaker than expected Canadian headline and core CPI and declining commodity and equity markets. Canada's July CPI declined by 0.3% m/m and 0.9% y/y. The core inflation rate was flat. The trade had expected a 0.2% decline in CPI with a 0.1% rise in the core inflation rate. Canada's inflation rate sank to the 56 year low. The drop in Canada's CPI reflects lower energy prices. As noted in our special report Tuesday, the BOC says it will keep interest rates at record low 0.25% until June 2010 as long as inflation remains weak. BOC officials are not concerned about deflation but may have to address the fact that the core CPI is falling. Part of the drop in Canada's CPI can be attributed to the strength of the CAD. Today's Canadian CPI report may increase the risk of intervention rhetoric. The CPI report is unlikely to encourage the

BOC to adopt quantitative ease as they decline in gasoline prices is a major factor in the CPI decline. The BOC has refrained from adopting quantitative ease anticipating that Canada's economy will recover in the second half of the year and the recovery will limit deflation risk. The weak Canadian CPI will likely be discounted as the BOC has anticipated near-term price pressures in Canada over the next few quarters. CAD downside was limited by report of better than expected leading index for July. The July leading index rose 0.4%, the trade had expected a rise of 0.2%. This marks the first rise in the leading index since last August. The rise in the leading index reflected improving housing market in Canada. The leading indicator appears to support the BOC's outlook for Canadian economy. CAD traded sharply lower Monday pressured by concern about the global economic recovery as China's equity market traded sharply lower pressured by fear China's action to cap lending and limit expansion of steel production will hurt China's growth outlook. The Chinese economy is seen as key driver for the global recovery. CAD traded in a similar pattern Wednesday as the Shanghai Index came under renewed selling pressure. CAD direction will remain closely correlated to speculation about the global recovery and risk sentiment.

The technical outlook for CAD has turned negative as USD/CAD rises above 1.1100. Look for near-term support at 1.0985 the August 17th low with resistance at 1.1225 the July 16th high.



## AUD

AUD traded lower pressured by a sharp fall in the Shanghai Index and growing concern about the outlook for China's recovery. AUD price direction is the most sensitive to developments in the Chinese equity market as China is a major export destination for Australian goods and China's recovery is seen to demand for commodity prices. Report of overcapacity in China's industrial sector, China's plan to cap lending and China's ban on expansion of steel production all combined to generate fear that the Chinese recovery has run its course. AUD was also pressured by weaker commodity prices as metal prices trade lower pressured by concern about global demand. Copper prices have fallen sharply in the last few days. There is also a report in Fortune magazine that

sovereign wealth funds may be cutting exposure to commodity currencies because of concern the recovery may not be as strong as thought. AUD traded lower despite report that the IMF says the global recession is over and report that Australia's leading index fell by 3.3% compared to -5.3% in May. The improvement in the economic activity index supports the RBA's decision to hold monetary policy steady and shift to a neutral bias. At the August 4th RBA policy meeting the RBA elected to hold rate policy steady 3%. The policy minutes for the meeting state that further rate cuts are unlikely, current policy is appropriate and there is less need for accommodative action as the economy recovers. AUD erased most of the early decline supported by a rally in crude prices back above \$70 a barrel. AUD price direction remains closely correlated to risk sentiment and the direction of equity markets. The trade is closely monitoring the Shanghai Index.

The technical outlook for the AUD is mixed as AUD fails to hold above 8300. Expect AUD support at 8125 the July 29th low with resistance at 8330 the August 17th high.



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