

## 3Q 2012 Markets Outlook

# Is there a light at the end of the tunnel?

The second half of the year is full of unanswered questions that should make it a fascinating period for financial markets. Will European politicians work towards a banking union? Will elections in the Netherlands hurt market sentiment? The US fiscal cliff could potentially shift the focus from the Eurozone across the Atlantic with consequences for global financial markets. We will take a look at both the fundamental and technical pictures for financial markets this quarter, and give you our view on where assets may trade.

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### Was the EU summit a turning point for Europe?

The lead up to the EU summit at the end of June was a “week to save the Eurozone”, according to the Italian Prime Minister Mario Monti. Whether or not it succeeded, we will likely find out during this quarter. So what did the summit deliver and is it enough to draw a line under this crisis?

The summit pledged three things: 1, the creation of a euro-wide banking union, 2, more flexibility for the ESM/EFSSF rescue funds and 3, scrapping seniority for European authorities on bailout loans for Spanish banks. To evaluate what these steps mean we need to determine what a “successful” currency union should look like. The US is a good example of a successful union of individual states. It has fiscal unity along with a lender of last resort – the Federal Reserve. It also has a centralised political system and each individual state has sacrificed significant sovereignty to become part of the U.S.A. Within this framework, the EU summit fell short of sorting out the root problems that we believe lie at the heart of the sovereign debt crisis. It didn’t deliver fiscal union, or even a roadmap towards full fiscal union, and there is still no lender of last resort. However, the EU summit should not be written off completely.

While it does not draw a line under the currency crisis, the Eurozone is slightly less dysfunctional in the aftermath of the summit. For one thing, banking union could be a pre-cursor to fiscal union further down the line. Also, by clarifying the status of official holders of Spanish bailout bonds, which means they do not get to jump the queue ahead of private sector bond holders, it could make Spanish and Italian government debt more attractive to hold, thus helping to reduce the credit risk for both of these nations. As we enter the second half of the year, time is still a precious commodity for the future of the currency bloc. While the post-summit honeymoon period may be propping up risky assets at the start of Q3, for bond yields in Spain and Italy to continue to decline we may need to see EU officials agree on the details of a banking union - will it require a treaty change/ ratification by each government? - also the markets may desire a further re-capitalisation of the EFSSF/ ESM rescue funds especially if they will be used to stabilise government bond markets in future. Right now the fund has EU500bn, which is dwarfed by the amount of debt on Italy’s balance sheet – 120.6% of its GDP. While there is some market optimism at the start of this quarter, we would not rule out another bout of market panic that could send Eurozone bonds soaring and EU politicians back to the negotiating table. This could prove to be more dangerous than the June summit, as Germany gave up a lot of ground during the June negotiations and there may not be the will to take more drastic action to stem this crisis at a later date.

Market sentiment was cautious as we led up to the summit and it is cautious now that it is over. The markets are taking nothing for granted, and rather than experience a knee jerk reaction that soon unravels, we have seen some decline in

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risk aversion, but the markets are not getting over excited. The endgame for this crisis seems to be a long way off and the steps taken at the June summit are potentially one small step on a very long road.

We will be watching Italian and Spanish bond yields closely in the coming weeks and months. The chart below shows the spread between 10-year and 2-year Spanish bond yields. This is a useful indicator to show extreme stress in Europe's bond markets. When short-term yields rise at a faster pace than long-term bond yields it suggests that sovereign concerns are extreme. As you can see, 10-year yields have started to rise at a faster pace than short-term yields post the summit. We will be watching this chart to see if this continues, and if it doesn't then it is a good indicator that risk aversion could grip the wider market.

**Spain 10-year – 2-year spread**

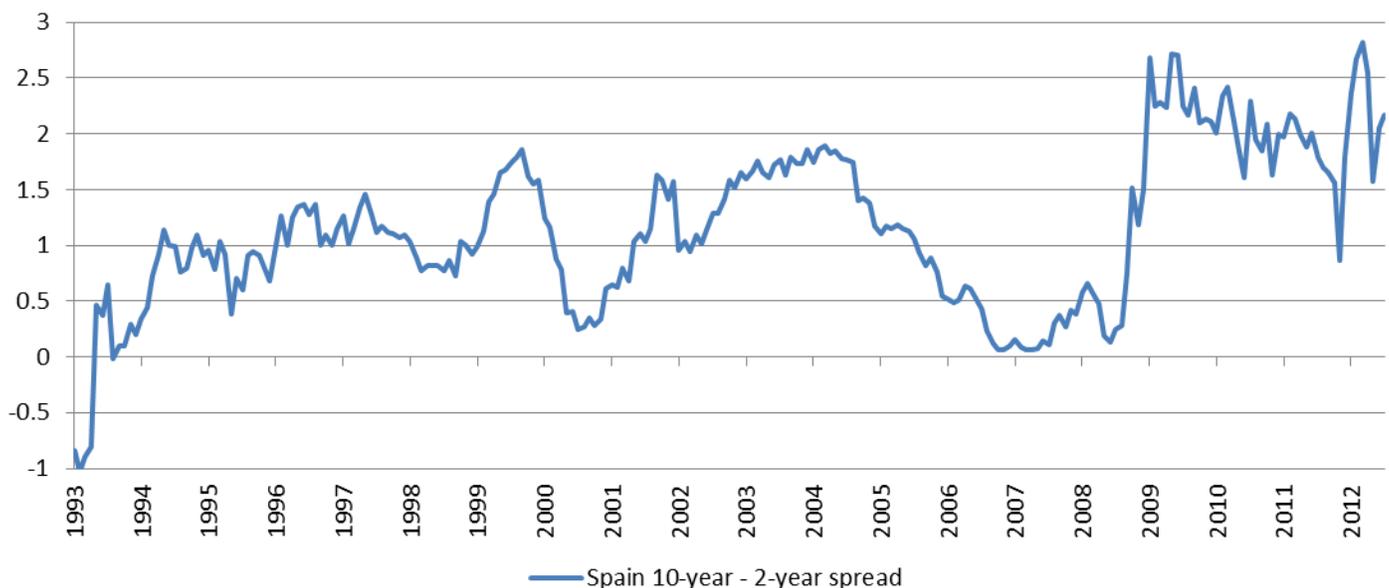


Figure 1: Source FOREX.com and Bloomberg

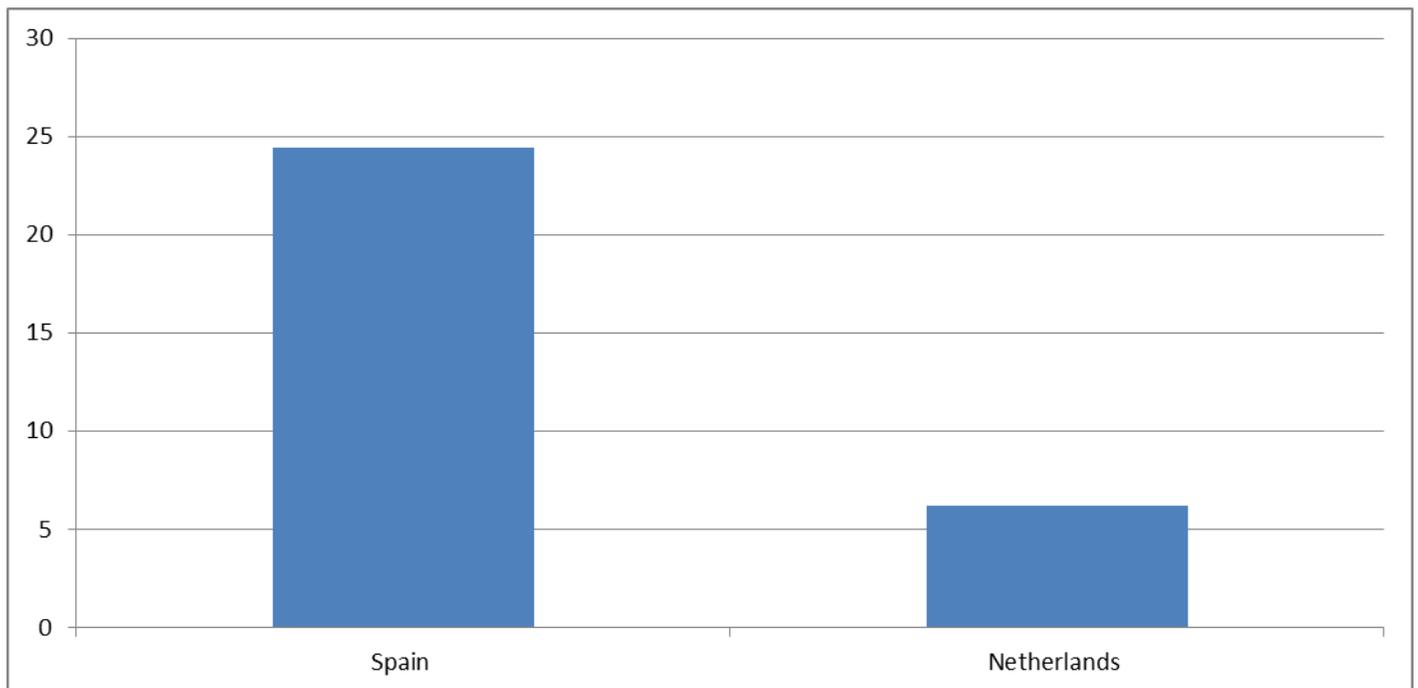
### Problems spread from the South to the North

What could trigger another bout of panic? While Greece's position in the currency bloc seems more secure post the outcome of the June 17th Presidential election, when the Greek people voted for the "pro bailout" party, it could be the Northern Bloc of Eurozone members that cause more trouble in the second half of the year. Elections in the Netherlands on 12th September are turning into a referendum on Eurozone membership. The election is gearing up to be a hard fought battle between pro-euro parties and small extreme parties including the Freedom Party that is not only anti-euro

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but also anti-Islam and anti-immigration. Right now the polls suggest there is no party currently in the lead. If no party has enough votes to form a government on their own then the only option may be a fractious coalition that could result in months of political instability in one of Europe's most fiscally prudent states, and, crucially, one of the AAA rated countries that are vital to the health of the Eurozone rescue fund.

**Relative unemployment rates (%) for Spain and the Netherlands**



**Figure 2: Source FOREX.com and Bloomberg**

The Netherlands is joined by Finland, who could prove to be a spanner in the works as the Eurozone tries to agree on an extended role for the EFSF/ESM rescue funds. Finland and the Netherlands are calling for European authorities to get special treatment in the event of a default from a Member State, which could place private sector bond holders at the back of the queue when it comes to getting their money back. This could hinder progress to forge a more functional union over the coming months and could also trigger bouts of risk aversion in the markets.

### The ECB to the rescue

We believe the European Central Bank (ECB) needs to bridge the gap between where we are today and where we want to be in future – in the land of fiscal union. After cutting the interest rate and deposit rate at its July meeting, we expect the

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Bank to remain on hold for the rest of the year, unless inflation falls dramatically. We would also expect the ECB to step in and re-start its sovereign bond –buying programme, the Securities Markets Programme, if we start to see Spanish and Italian bond yields rise. However, we tend to think that the ECB will only be willing to do this if there is evidence that Europe’s politicians are making progress towards a fiscal union and to extending the role of the EFSF/ ESM. Thus we wouldn’t expect the SMP programme to expand by much more than its current EU 210bn size.

### Can the euro weather the sovereign storm?

The euro may not stage a victory rally any time soon as the Eurozone still has a mountain to climb before it reaches a fiscal union. We do believe that its downside is limited however (bar a disorderly exit of a Eurozone member) due to 1, short euro positions are already at extended levels and 2, the threat of an economic slowdown in the US could keep the Fed on high alert to do more to stimulate the economy, which could be dollar negative. Thus, we may see EURUSD trade in a 1.20-1.27 range this quarter. We think there could be more excitement in the Euro-commodity currency crosses and we may see EURAUD break fresh record lows during the coming months. The first major hurdle for this cross is the 1.22 support zone from February this year. Below here opens the way to 1.20. We are looking for further declines in EURAUD even after sharp declines over the last 12 months because 1, the rate differential between Australia and Europe is likely to widen further after the ECB cut rates and 2, high-beta currencies like the Aussie tend to rally when global monetary conditions are loose as they are now. Combined with a reduction in sovereign risk for Europe’s periphery, Q3 could produce the right conditions for further gains in the Aussie.

### Global growth to remain fragile

Last quarter markets were more optimistic on the global economy, however the optimism quickly faded and growth outlooks, which were initially revised higher, had to be trimmed back down. It is easy to get caught up in the euphoria and despair and overshoot estimates both to the upside and to the downside. For example in the U.S., which is the largest economy in the world, the Fed revised upwards its GDP growth projections in April to 2.4-2.9% from the prior 2.2-2.7% and it is highly likely it will reduce these expectations further given the data deterioration of late, which includes some fairly lackluster payrolls data in May and June. What is clear is that volatility has increased and not only volatility in financial markets but also in economic activity.

Central banks have been noting the decrease in economic activity and have acted or reiterated their commitment to act if necessary. In China – the world’s second largest economy – the benchmark rate was cut for the first time since 2008 in June, this was followed by a second cut in July that was announced on the same day as the ECB and BOE announced fresh easing measures. This was not only an indication that Chinese officials acknowledged a slowdown, but also that they seem to be willing to act to support growth, now that inflation has started to fall at a fairly rapid pace. Consumer

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prices fell to 2.2% in June from 3% in May. . The People's Bank of China (PBoC) is likely to ease monetary policy further in the coming months which should impact the economy positively. While we do not think this will see a sharp turnaround in growth, it may ease the pace of deceleration and see a softer landing in the large Asian economy. With GDP last reported at 8.1% and the government target at 7.5% in 2012, there is scope for a further slowing of the economy. Further evidence of slowing is seen as the official manufacturing PMI has fallen to just above the pivotal 50 threshold with a reading of 50.2 to indicate expansion while unofficial figures continues to fall deeper into contractionary territory with the most recent print at 48.2.

Europe narrowly avoided a technical recession with Q1 GDP figures unchanged. (A technical recession is two consecutive quarters of negative GDP growth). Europe's largest economy, Germany, helped the region to escape a contraction and it is unlikely that the country will be able to do so in the coming quarter. Leading indicators suggest a downturn with manufacturing PMI's below 50, the ZEW survey plunging the most since 1998, and IFO readings steadily decreasing. Unemployment in the Eurozone is at a record high 11.1% and the region's fourth largest economy – Spain – has requested aid for its troubled banking sector. Politicians continue to debate about crisis resolution mechanisms in meetings that produce headlines which result in choppy price action. Austerity, which is being implemented throughout Europe, is weighing on growth prospects, decreasing confidence, and increasing political turmoil which is also negatively impacting borrowing costs. Official institutions, such as the World Bank and the IMF, are projecting negative GDP growth in Europe this year and we share their view. This suggests a contraction moving forward which can weigh on overall sentiment as well as on the common currency. EUR/USD remains in a long term bearish channel with the channel top currently around the 1.30 big figure. This is also where the 100-day SMA and 21-week SMA converges.

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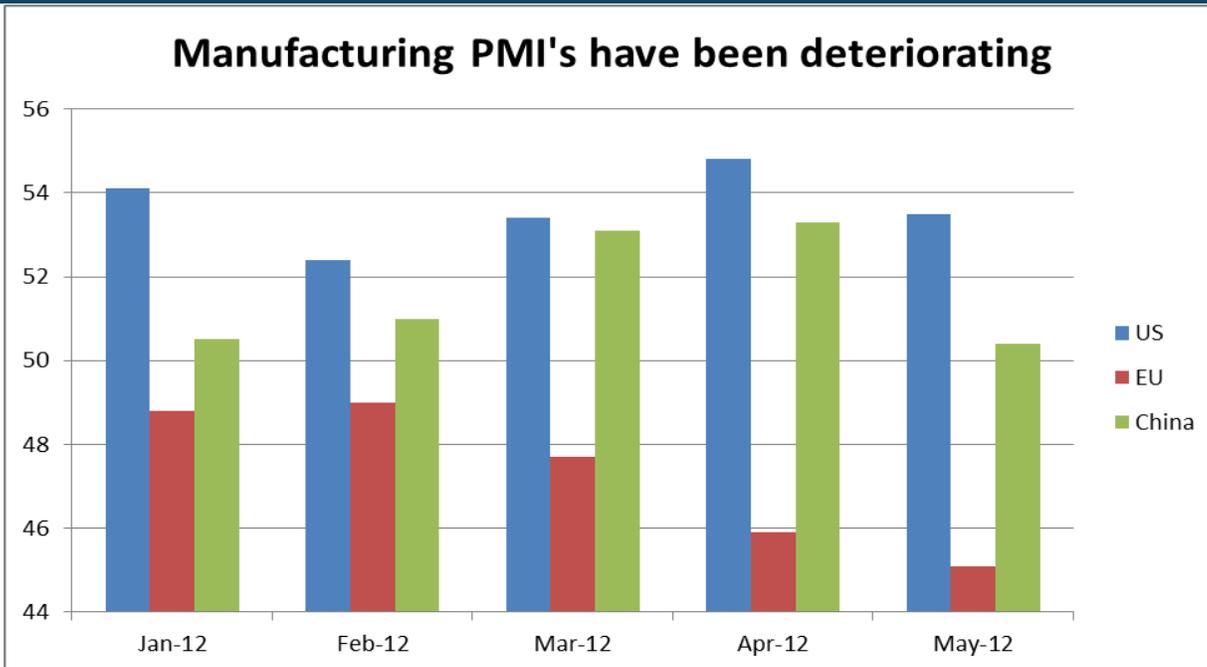


Figure 3: Source Bloomberg

In the U.S., the unemployment rate ticked higher, and retail sales dropped for two consecutive months with the most recent decline in retail sales less autos being the largest drop in two years. As consumption makes up the majority of the U.S. economy, the data does not bode well for Q2 growth figures which will be released in the coming months. Not too long ago, it seemed as though the economic recovery was picking up steam, however progress was halted and momentum was lost by a resurgence of tensions in Europe and government-driven austerity programmes impacting growth. With many countries attempting to reduce high debt ratios, the process of deleveraging has led to reductions in government spending which is also a key component of GDP growth.

Rather than seeing money put to work in the economy, the increased uncertainty is prompting a flight to safety as investors flock into havens. Bond yields in the U.S., U.K., and Germany have reached record lows in recent weeks as capital flows into government securities. We expect uncertainty to remain high which tends to see investors averse to risk and reluctant to deploy capital into businesses and spending.

We expect to see growth to remain subdued as the EU continues to deal with the ongoing debt crisis and as political uncertainty persists. Economic activity is likely to slow further in China, nearing the Government's GDP target for 2012 of 7.5%, the Eurozone may dip into recession, and restrictive fiscal policies may continue to impede growth. The risk is to the upside if central banks fire up their printing presses and provide more stimulus to support growth. However, it

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generally takes time for real economic activity to reflect expansionary monetary policy and central bankers have been more reluctant to act without their political counterparts doing more on the fiscal front.

### QE and done for the Bank of England?

After expanding quantitative easing by GBP 50bn at its July meeting, we believe the Bank of England is likely to remain on hold until at least November, when the next Inflation Report is due. The problem with more QE for the UK is that it has, so far, failed to be that effective or boost growth in a meaningful way. It didn't prevent a double-dip recession at the start of this year and it didn't help boost growth as signs point to a further slowdown in the second quarter after the PMI manufacturing index turned negative in May and the service sector continued to moderate in recent months. More QE in July was symbolic in our view, as the BOE tries to show it is doing something to boost growth, although BOE Governor King has said in the past that more QE will only have a limited impact on the economy. After all, long-term interest rates are close to record low levels, and it is unlikely that July's QE boost will cause them to fall low enough to stimulate growth or lending in the private sector. Instead, the Bank acted pre-emptively to protect the economy from a collapse of the Eurozone or sharp deterioration in global risk appetite. If the currency bloc manages to stabilise over the current quarter then we may see further QE remain on the back burner for the BOE.

We believe that growth is likely to remain flat to negative for the rest of the year in the UK. Job creation was strong in the three months to April, and the UK created 166k jobs, the fastest pace since mid-2010. We don't believe this will continue, especially after the sharp drop in the PMI surveys in May and June. We could see the unemployment rate actually start to rise towards 8.4% in the third quarter, currently it is 8.2%. Overall, growth is being weighed down, not by a slowdown in public spending, even though the UK is thought to be in the grip of austerity, but by a lack of consumer confidence and household spending. Added to this, exports are also a major drag on the UK economy. Looking at weak consumer confidence and the deterioration in the export sector independently, there is a chance that household spending could rise in the coming months. Although wage growth remains very muted, inflation is falling sharply, this may give householders the confidence to loosen their purse strings. Exports are unlikely to pick up any time soon in our view as the UK's largest trading partner, the Eurozone, is likely to remain mired in recession in the third quarter.

The unemployment rate tends to move in the opposite direction to the Service Sector PMI, so if we see the service sector PMI continue to deteriorate then we may see unemployment rise in the UK.

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## Services PMI vs. Unemployment Rate

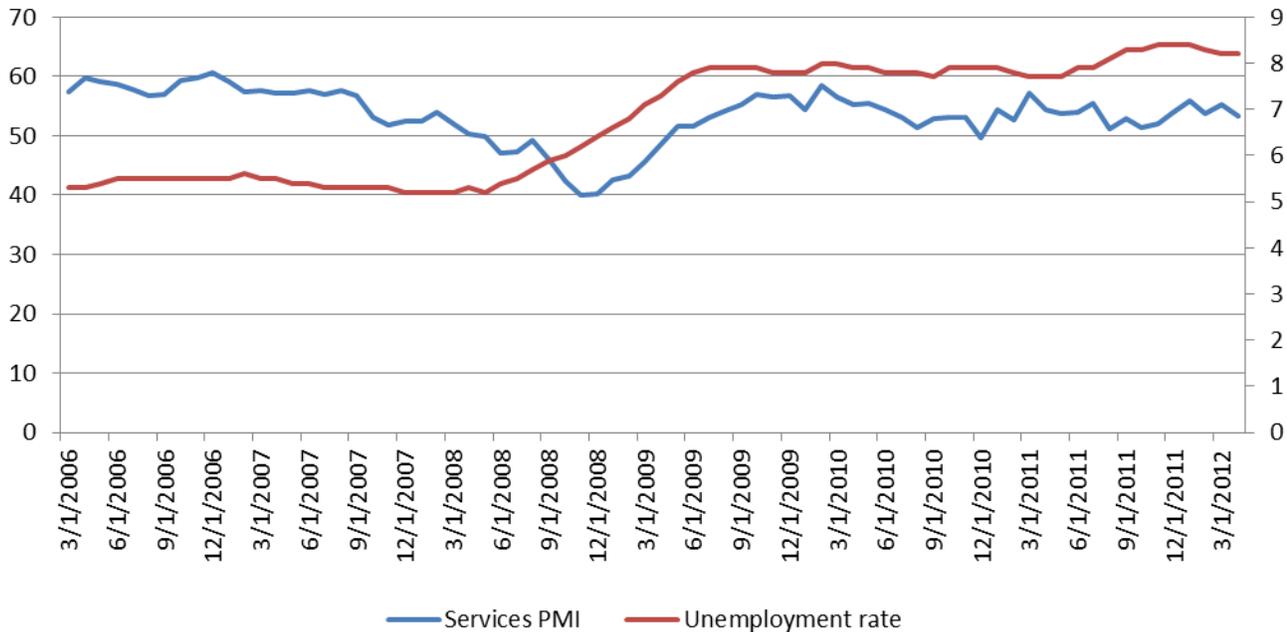


Figure 4: Source FOREX.com and Bloomberg

### The Olympic effect

Some people have wondered if the Olympics, arguably the largest sporting event hosted by the UK in its history, will have an impact on the economy. The games kick off on Friday 27th July, lasting for two weeks, and are then followed by the Paralympics. The latest research suggests that the Olympics will deliver a GBP 16.5bn boost to the UK economy, and help to create 62,200 jobs, according to a report compiled by Lloyds Banking Group. That seems like a decent return on the GBP 10 bn the Games cost to stage, however, the caveat is that the estimated benefits begin 5 years before the event and last for 5 years afterwards. You may think that tourism is the biggest beneficiary, but it is estimated to generate GBP 2 bn of gains compared with nearly GBP 14 bn for construction. Thus, it would take a marathon effort for the Olympics to have a meaningful impact on growth or the pound in the coming quarter.

We believe the pound could go back to being the wall flower of FX after a strong showing in the second quarter, particularly against the euro. We would look for GBPUSD to trade between 1.5350 – 1.5800 over the quarter. Downside is possible if there is a bout of risk aversion caused by another flare-up of events in the Eurozone, however, we believe

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pound weakness could be limited as the US economy also shows signs it is deteriorating, which could keep a lid on dollar gains. EURGBP may struggle to extend losses below 0.7850, a record low for this pair, due to economic weakness in the UK. Thus, we could see a moderate recovery in the single currency versus sterling, although we believe upside is limited to 0.8200.

### Time for more “powerful easing” from the Bank of Japan

This past quarter, the Japanese yen outperformed its G10 counterparts and gained nearly 5% against the USD while all other major currencies weakened against the buck. The Bank of Japan (BoJ) expanded its asset purchase program and continues to buy short term securities in operations which the bank refers to as “powerful easing”. The BoJ’s commitment to reach a 1% target rate of inflation still looks to be a far reach and Japanese government officials, as well as international official institutions, have been calling on the Bank to enact more stimulus.

The strength of the yen has been of concern to the Japanese as noted several times by BoJ board members and government officials. A strong currency lessens the appeal of foreign demand for Japanese exports (which is exacerbated by the already declining global demand from external factors). Furthermore, a strengthening currency is counterintuitive to combat domestic deflationary pressures. Finance Minister Azumi brought up the issue of a strong JPY at a G7 conference call and indicated that the group was supportive of intervention to address the currency moves. IMF officials recently noted that the yen is overvalued and that the BOJ should add more stimulus.

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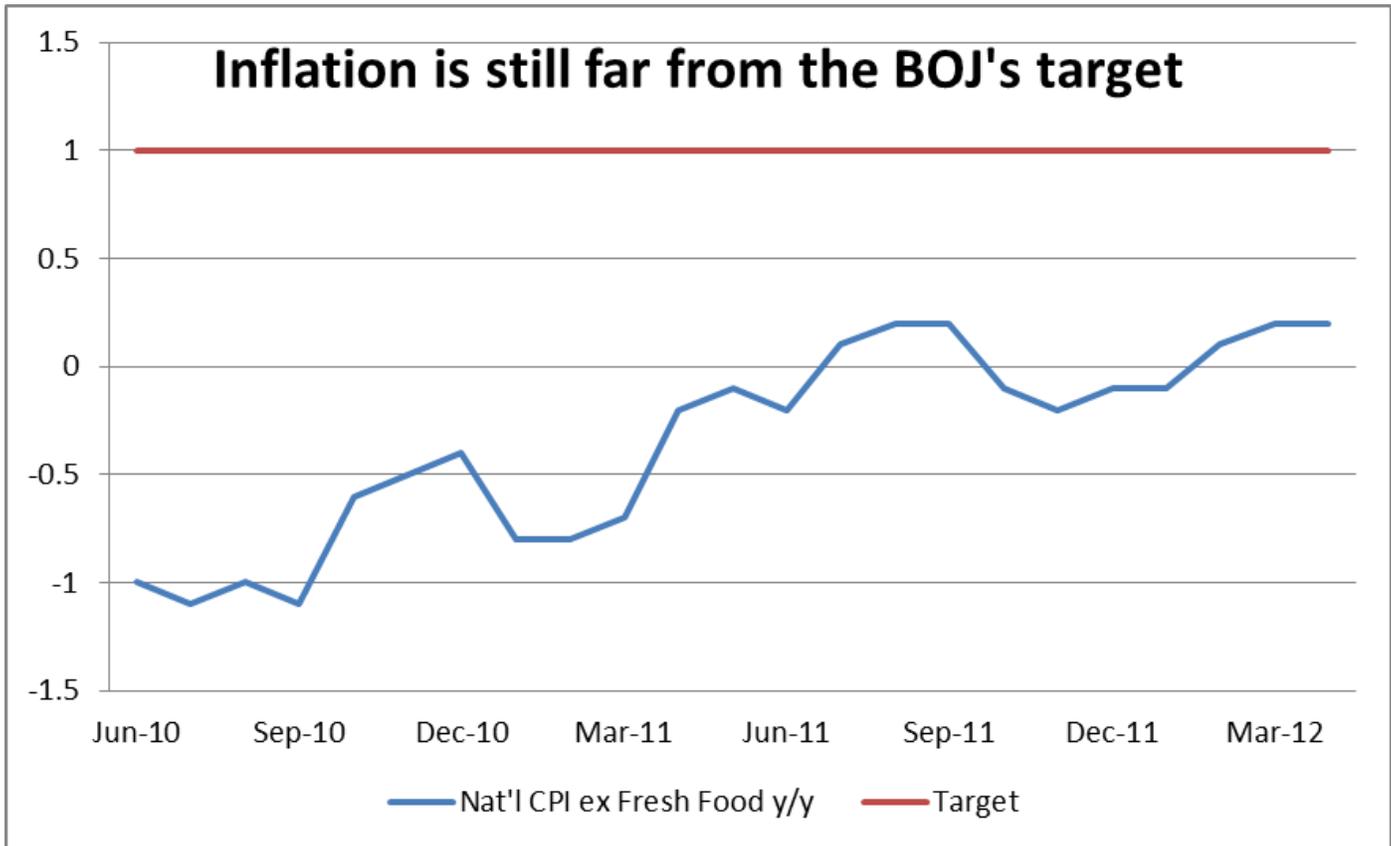


Figure 5: Source Bloomberg

The Bank of Japan's bond buying program began in October 2010 and in recent weeks the bank has seen its first shortfall in its bond purchases since the start of the program. With the bank facing difficulties in implementing its operations, we think that the bank may need to adjust its approach by increasing the maturity of its purchases (which is currently up to three years) or changing the composition of the bank's purchases to securities other than Japanese government bonds (JGBs). The bank has come under increasing pressure to expand stimulus and we believe that the Bank will likely act in Q3 as it attempts to move towards its inflation goal.

Intervention also remains a credible threat in the coming quarter as rhetoric has been elevated of late. Official action has – in the past – weakened the JPY sharply, but the effects in the exchange rates have been short lived. In our view, additional asset purchases or FX intervention would act to weaken the yen, however external uncertainties are likely to keep the yen supported as a safe haven. Therefore we expect USD/JPY to remain range-bound within its weekly Ichimoku cloud in the coming weeks. The cloud narrows towards the end of August through September which indicates a

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break of the cloud is likely which should provide more decisive price action from a technical standpoint. A convincing break of the weekly cloud is likely to see momentum pick up in the direction of the break and our outlook would be for a move to the upside.

### Are there any safe havens left?

As long as the situation in Europe continues to stabilise then we could see demand for safe havens start to moderate this quarter. Already, post the EU summit German and US bond yields are starting to rise and Spanish and Italian yields have backed away from their highs. We believe if an ECB rate cut, combined with action taken at the EU summit in June (see above), helps to reduce credit risk in Europe's periphery then we may see risk assets continue a moderate rise, which is good news for stocks and also high-beta currencies like the Aussie and the CAD.

Safe haven currencies have had a more muted reaction to the EU summit than other asset classes. Although USDJPY has risen from the lows reached at the end of May when this pair dipped to 78.00, it remains fairly lacklustre and has, so far, failed to break 80.00. While USDJPY tends to perform well during periods when risk appetite stabilises, upside may be limited as the markets worry about the upcoming fiscal cliff in the US and also the US Presidential elections that take place later this year. This could keep upward pressure on the yen, as the fiscal cliff threatens to de-rail US growth next year. Although the Japanese authorities have tried to "talk down" the strength of the yen and threatened to intervene, its bouts of intervention have been unable to stop the yen from further appreciation. In an environment of political risk and the potential for a fiscal-induced growth slowdown in the US, the markets may continue to buy the yen. Thus, we may see the trading range for this pair in the coming quarter widen to the downside to between 76.00 – 82.00.

The Swiss franc has been pegged to the euro during the latest bout of sovereign turmoil after the Swiss National Bank (SNB) implemented a floor in EURCHF at 1.20 back in August 2011. This pair has hovered around this level for most of this year, and volatility has shrunk to near zero, even though the SNB has seen its FX reserves and its holdings of euro both rise. Interestingly, the markets haven't been willing to buy EURCHF post the EU summit, potentially because investors are concerned politicians in the currency bloc may not follow through on the commitments they discussed at the June EU Summit in Brussels, which could cause another flare-up of sovereign debt concerns. If the Eurozone crisis flares up this quarter, which is a fairly low probability in our view, then we could see the floor collapse as investors pile into the Swissie, and the SNB does not have the firepower to protect the franc after holding the floor for a year. However, if the markets stabilise then we may see a move back towards 1.2050, however we don't foresee a prolonged recovery for this pair in the near-term until the market is convinced that sovereign danger is behind us, which may take some time yet (see the Europe section above).

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## EURCHF: will the SNB's resolve get tested in Q3?



Figure 6: Source: Forex Charts by eSignal

### More stimulus for the Chinese economy

When economists talk about China the discussion is typically based around two topics, stimulus and the property bubble. The Chinese government faces a difficult problem; how to stimulate growth without stoking inflation and/or the property bubble in its major cities. The simple answer is it can't. Beijing knows this, thus it has been carefully keeping one eye on inflation data whilst occasionally moving to ease growth restrictive policies, but it has stayed well away from the massive amounts of stimulus that it pumped into the economy following the financial crisis. If the stimulus of a few years ago was equivalent to adrenalin shot directly into the heart then the more recent growth stimulating measures would be akin to a series of strong coffees. Hence, with global economic conditions predicted to deteriorate further this year, Beijing may be forced to stimulate growth this quarter despite being in a zugwang situation. In other words, its China's turn to move a piece on the chess board, with the timer ticking but no real safe move to make.

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Nonetheless, the Chinese government has a lot more options available than other nations when it comes to stimulating growth. The recent favoured option of Beijing is to reduce the amount of capital major Chinese banks are required to hold, thereby freeing up capital which should, theoretically at least, makes its way into the domestic economy. However, this option is fairly limited and by the time the effects are felt in the real economy they are somewhat watered down. More recently, China decided to cut borrowing costs as well as giving banks more flexibility to set competitive lending and deposit rates. Both measures are aimed at encouraging borrowing and spending, thus should help to boost growth, but only if the domestic economy plays ball. So far, there is some evidence to show that the measures undertaken to simulate growth have worked, but only to a small extent. Manufacturing PMI is on a downward trend, and it seems only a matter of time before pessimists outweigh optimists in the public manufacturing sector – they already do in the private sector. Hence, there are calls for more aggressive easing from Beijing.

However, is looking towards domestic demand necessarily the right option? We can easily deduce from looking at the Chinese economy that one of the largest hindrances to growth is the European debt crisis, as a lack of demand from Europe hinders exports. Thus, it may be in Beijing's best interest to pump money into Europe, likely through the IMF, to help stimulate growth there. After all, it has a huge amount of FX reserves at its disposal. Unfortunately, it is not that simple. It is always easier to treat the symptoms as opposed to the disease, even more so when others are attempting to fight the disease and you have ample amounts of medicine to keep the symptoms at bay. Furthermore, it is not clear if a massive cash injection would solve the debt crisis, it may just prolong the inevitable without a proper long-term solution. Hence, Beijing remains happy to sit back and watch officials in Europe attempt to solve the crisis, whilst at the same time using the large amounts of domestic policy options at its disposal to help stimulate domestic demand.

Looking forward, we think Beijing will stay on its current path of stimulating domestic demand, unless the situation in Europe deteriorates significantly, in which case Beijing may have no choice but to interfere. Assuming Europe doesn't fall off a cliff, we expect the Chinese government to continue to cut the required reserve ratio (which dictates how much capital large banks must hold in reserve) by around 200 bps, possibly lower borrowing costs again and, importantly, increase infrastructure spending in certain key sectors of the economy. On the last point, we don't expect to see anything like the stimulus of 2008 but the government has hinted at the possibility of more spending if inflation allows it. The government will be careful to avoid the same mistakes it made in response to the financial crisis which severely limited its options. Nonetheless, we think the aforementioned growth stimulating measures will be enough to avoid a hard landing in China. In fact, we expect GDP growth to turn around in Q3, which should be reflected in data later in the quarter.

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### The Reserve Bank of Australia keeps its foot on the accelerator pedal, but only just

Since October last year the Reserve Bank of Australia (RBA) has cut the official cash rate (OCR) by 125 bps, citing global uncertainty and a benign inflation outlook. Yet, it wasn't until this year that the bank started to aggressively ease monetary policy as domestic data started to reflect what many already expected, that the Australian economy is suffering. This came as a surprise to some who expected the economy to coast through the Eurozone debt crisis much like it did during the financial crisis. But some subtle, and not so subtle, differences in the state of the global economy and financial markets are severely hindering the domestic economy. Namely; China hasn't opened the stimulus flood gates this time around, a high aussie dollar is hurting trade-exposed sectors of the economy and the country's terms of trade, confidence is shot and the government doesn't have a large current account surplus to play with. However, this doesn't mean we expect the RBA to continue to aggressively ease rates, especially if the post-EU summit optimism lasts.

In fact, we are leaning towards only one 25 bps rate cut during Q3, unless there is a significant deterioration in economic conditions offshore. Recent policy statements from the bank indicate that the domestic economy is trudging along pretty much as expected. Indeed, the most recent decision to cut rates was predominately driven by adverse conditions offshore.

It is clear the domestic economy is still facing a number of headwinds that are limiting growth, particularly from abroad. China appears to have both the will and ability to avoid a hard landing but growth and, in turn, demand for resources is not expected to pick up significantly during the quarter. Given that the resources sector is the main support leg and conduit of growth for the Australian economy, the somewhat slack levels of demand from China may hinder growth domestically. Elsewhere, Europe is still struggling under a mountain of debt and the US is expected to move forward at a snail's pace.

Domestically, we do not expect much from the Australian economy during Q3, with a predicted GDP growth rate of around 1.6%. Furthermore, we expect the upcoming Q2 inflation report to show that core inflation dropped to the bottom of the RBA's targeted range, which may make it a straight forward case for a 25 bps rate cut in August. It appears a lot of the positive impact from May's rate cut was eaten away by adverse conditions offshore. Thus, there is some scope for a small rate cut.

Overall, lacklustre levels of growth throughout the developed world and the associated impact on investor sentiment are second only to the inflation outlook as the main reasons why we expect the RBA to cut the OCR in August. However, we do not expect global growth to fall off a cliff, thus we are not expecting the RBA to ease aggressively in Q3.

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### The Aussie

AUDUSD has spent a lot of time recently trying to decide if it remains above or below parity. Accordingly, it has stuck in the same trading range since late 2010 – around 0.9500-1.1000. In actual fact, the pair spent most of its time above parity despite the uncertainty surrounding global growth. High interest rates, a solid economy when compared with Europe and North America and numerous other factors have helped keep the Aussie afloat.

However, in the midst of a monetary policy loosening cycle and severe amounts of global uncertainty, can AUDUSD remain around or above parity? At face value this seems unlikely, especially when we consider the current threats to global growth; Europe is struggling under a mountain of debt, the US economy is still struggling to regain its footing and Chinese GDP growth has slowed dramatically, not to mention the predicted rate cut from the RBA.

Furthermore, the other side of the AUDUSD equation doesn't paint a very rosy picture for the Aussie. Recent comments by the Fed have led the market to expect some form of QE later this year, which is weighing on the US dollar. But we think investors are going to be disappointed. Whilst there is some scope for more QE, the Fed has pretty much done all that it can and further QE may have more of a negative impact than a positive one. Whilst it is not even clear if the economy is in need of more stimulus (we don't think it is) each time the Fed pumps money into the economy the economic benefits are diminished, but the associated problems are not.

On the technical side, AUDUSD has punched through a major resistance level around 1.0225 – prior yearly high. Now the path is somewhat clear for a push towards 1.0500. However, momentum stalled a little after the pair ran into some resistance around a grouping of 200day and 100day SMAs. If the pair breaks through this level – currently around 1.0260-1.0270 – then we would look for a push towards 1.0500, but if it cannot then we can see the pair heading back towards parity. From there we are looking for a break of around 0.9970 to suggest some more possible downside, possibly towards 0.9580.

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## AUDUSD – Daily



Figure 7: Source: Forex Charts by eSignal

### Wait, wait and wait some more for the Reserve Bank of New Zealand

It was not too long ago that investors were predicting the Reserve Bank of New Zealand (RBNZ) would raise rates sometime later this year, but now markets are pricing in the possibility of a rate cut before the end of the year. The about-face is largely due to a softening of New Zealand's export commodity prices and the global economic outlook. However, calls for a rate cut have somewhat diminished due to recent weakness in the kiwi. Our base case is that the RBNZ will keep rates unchanged during Q3, but this may change if the global conditions continue to deteriorate and/or the kiwi strengthens significantly, which has the ability to cause the RBNZ to cut rates.

Looking at the domestic economic situation in NZ we can see that GDP growth is being limited by persistent weakness in NZ's major trading partners and, in previous quarters, a high domestic currency. Given that NZD is a commodity currency,

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and by extension a risk trade, these two aforementioned factors should somewhat offset each other. Thus, if global economic conditions deteriorate further, which may also cause commodity prices to drop, the kiwi should also weaken.

However, sustained lacklustre levels of growth in NZ's major trading partners may outweigh the positive impact on the domestic economy from a weakening local dollar.

Whilst NZ's direct trade link to Europe is somewhat limited, the continued growth slowdown in Europe is weakening commodity prices, which is the biggest threat to the New Zealand economy in our view, given the dominance of commodities as a portion of NZ exports. Thus, if commodity prices decline this quarter it may result in a softening of the country's terms of trade, and could weigh on the NZD.

Overall, we think the above factors will keep the RBNZ on hold. At the same time, inflation is expected to remain in the middle-lower end of the RBNZ's target range, which the reserve bank will be happy to maintain by doing nothing. Furthermore, we expect rebuilding in the Canterbury region will offset some of the negative factors limiting growth in NZ during Q3, including the predicted tight fiscal stance of the government as they aim to bring the budget back into surplus during the 2014/15 fiscal year. Hence, we expect the RBNZ to remain in a 'wait and see' mode throughout Q3.

### The Kiwi

Increasing speculation that the RBNZ will move to lower the official cash rate weighed on the kiwi in the latter part of Q2. A lot of these rumours were/are based around a deteriorating global growth situation, especially in Europe. Also, the resulting decline in investor sentiment weighed on commodity currencies. However, the better than expected results from the EU summit at the end of June helped to cull kiwi bears, pushing NZDUSD back above 0.8000.

Overall, we are looking for more downside for NZDUSD. There may simply be too much uncertainty, especially regarding Europe and China, to justify a rally in the kiwi. Europe is currently struggling under a mountain of debt and there is also the lingering question of whether the Chinese government will be able to steer its economy away from a hard landing. Whilst we think Beijing has both the will and ability to reverse China's current slowing GDP growth, we don't think it will be substantial enough in Q3 to lead a rally in commodity currencies.

We don't believe the Federal Reserve will embark on more QE, which could limit dollar losses during the quarter. The Fed has pretty much done all that it can and more QE may have more of a negative impact than a positive one.

The technical picture for the Kiwi is fairly constructive in the short-term, and we can see the potential for a push higher as the pair has broken through a few key resistance levels. If NZDUSD can hold above 0.8000 then the pair may be able to

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push toward a resistance level around 0.8300. But if it drops below 0.8000 then we are looking for a break of around 0.7850 to suggest more downside, with an end target of around 0.7500.

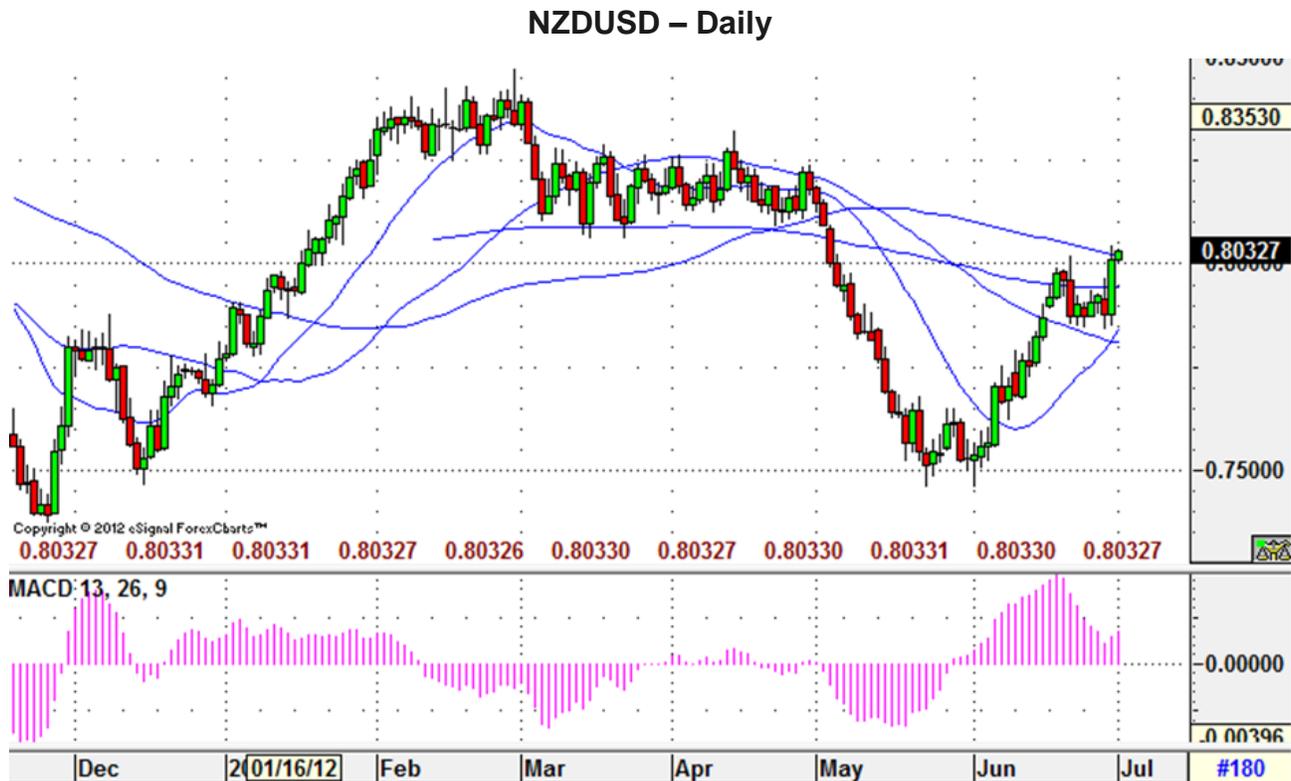


Figure 8: Source: Forex Charts by eSignal

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## Expected Q3 2012 Currency Ranges

Cross	Range	Bullish/Bearish	Comments
EUR/USD	1.20 - 1.27	Bearish	Risk to 1.15 if we break below 1.20
EUR/JPY	94 - 103	Bearish	Risk of 105.00 if BOJ intervenes
EUR/CHF	1.18 - 1.25	Neutral	SNB peg at 1.20 could limit downside
EUR/GBP	0.7500 - 0.8200	Bearish	Risk of .85 if we see broad based euro recovery
NZD/USD	0.7600 - 0.8400	Bullish	Risk of .7200 if risk sentiment falls
USD/JPY	78.00 - 84.00	Bearish	Risk of 76.00 if risk sentiment falls
USD/CHF	0.9300 - 1.0200	Bullish	Risk of move to 1.05 if we break 1.02
GBP/USD	1.51 - 1.58	Bearish	Risk of move to 1.60 if Fed does QE
AUD/USD	0.9700 - 1.07	Bullish	Risk of move to 0.95 if we break below 0.97
USD/CAD	0.9500 - 1.0400	Bearish	Risk to 1.0550 if we break above 1.0400

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