

# 4Q 2010 MARKETS OUTLOOK

## Headwinds Should Keep Major Currencies Weak, Metals Strong

### Highlights

**Brian Dolan** *Chief Currency Strategist*  
**Eric Vilorio**, CMT *Sr. Technical Strategist*

#### Sluggish global recovery to continue; downside risks prevail

Overall, we expect the global recovery will continue, but it will remain uneven and subject to continued high levels of uncertainty. While we expect the major economies (US, Eurozone, UK, and Japan) to slow further into the end of the year, we don't expect any of them to fall back into recession, but depending on the severity of the expected slowing, that risk may become more intense in 2011.

#### Risk sentiment should remain subdued over uncertainty

If our view plays out that the major economies will see new bouts of weakness, we would expect overall risk sentiment to remain cautious, and this should restrain stock and commodity prices broadly.

#### Increasing divergence between weak major currencies/strong minor

More broadly, we expect to see an increasing divergence between the currencies of the major economies (US, Eurozone, UK and Japan) and those of the smaller developed economies, namely Australia, Canada, and New Zealand, as well as the Nordic currencies, SEK and NOK.

#### Major central banks to stay on hold/minor central banks may pause

In light of our expectation that economic conditions are likely to deteriorate in the 4Q, we expect the major central banks (Fed, ECB, BOE and BOJ) to remain on hold for the rest of the year, effectively maintaining current policy settings and largely monitoring the degree

of any slowdown. The minor central banks (RBA, BOC and RBNZ in particular) are increasingly likely to move to the sidelines if conditions in the major economies soften as we expect.

#### Additional quantitative easing is a risk for major currencies

Speculation over whether additional unconventional easing is forthcoming will likely dominate market discussions of central bank outlooks in the months ahead. In particular, expectations that the Fed and the BOE may initiate additional asset purchases, aka quantitative easing or QE2, may see those currencies come under more extreme pressure.

#### Eurozone credit concerns may resurface if data softens

Eurozone sovereign debt concerns remain elevated as the 3Q draws to a close, and we think those fears will persist in the months ahead, keeping them as the Euro's Achilles heel. If economic growth in Euroland begins to show clearer signs of slowing, especially in the core countries (Germany, France, and Benelux), fiscal tensions are likely to reignite, as spending cuts are implemented alongside falling revenues on slower growth.

#### US Congress mid-term elections are a wild card

On the political front, the US congressional mid-term elections loom large. Current polls suggest the Republican party has a decent chance of taking control of both houses of Congress, but we think the Democrats may yet hold on to the Senate, potentially leading to split control.

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# Review of 3Q Outlook: Key Market Themes for 3Q 2010

## Bumpy Roads Ahead Most Everywhere

- Strength of the global rebound remains the key
- US recovery to stay anemic; unemployment to weigh
- Euro-zone fiscal retrenchment poses risks
- UK budget cuts may de-rail recovery
- Key central banks to stay on hold given uncertainty
- China additional stimulus may be a salvation

Looking back at the major themes we expected to drive markets in the 3Q, we think we hit on most of the key ones. Financial markets continued to move primarily based on incoming evidence of the strength of the global recovery, which remains uneven and highly uncertain.

The US recovery certainly remained anemic and actually showed signs of slowing, with final demand remaining depressed on continued high unemployment and weak housing.

Eurozone deficit reduction measures have yet to be implemented, and we were premature in highlighting fiscal retrenchment as a 3Q theme, but ongoing sovereign debt concerns and financial sector uncertainty resurfaced and have seen peripheral country bond yields and credit default swaps surge to levels last seen in May at the height of the debt panic.

**“We were early on the view that UK budget cuts could impact the UK recovery, but we clearly expect that to be a major theme for the 4Q”**

We were also early on the view that UK budget cuts could impact the UK recovery, but we clearly expect that to be a major theme for the 4Q and especially in the 1Q of 2011 when the spending cuts and tax hikes actually take effect. We'd highlight the UK government's Comprehensive Spending Review due after Oct. 20 as a near-term trigger to potentially wider budget-related fallout.

The major central banks (Fed, ECB, BOE, and BOJ) remained on hold as expected and minor central banks (RBA, BOC, and RBNZ) expressed higher uncertainty and moved closer to the sidelines.

China ultimately did provide additional domestic stimulus, though not in the traditional form of direct investment as in the past, but rather through increased credit supply to domestic lenders, achieving a soft landing as seen in rebounds in Aug. industrial production and PMI's.

## Specific Market Themes for 3Q 2010

- USD strength/risk correlation to continue
- EUR weakness to persist, but parity likely a story for 2011
- GBP may strengthen on budget, later weaken on growth
- AUD, CAD to strengthen as recoveries continue
- JPY may weaken on new government, extra BOJ QE
- Oil to weaken on excess supply, stalling demand

In terms of currency specific themes, we had some reasonable success with our outlooks. The inverse relationship between the US dollar and risk assets (e.g. stocks and commodities) remained intact, and overall USD weakness was mirrored by gains in shares and commodities.

The expected EUR weakness failed to materialize against the USD, but this was the result of weak US data leading to dollar weakness, as the EUR remained weak against most other currencies. The British pound did strengthen further following the June 20 release of the government's budget, but has recently shown signs of weakening as incoming economic data points to a slowdown ahead. The Australian and Canadian dollars both continued to outperform, with the Australian dollar making new yearly highs against both the Euro and the greenback. We missed the boat completely on expected JPY weakness, but the government has finally stepped in to restrain JPY strength through unilateral intervention, while the BOJ continues to contemplate additional easing measures.

### Our 3Q Expected Market ranges

EUR/USD	1.1200/1.2500	risk to 1.0500 if below 1.1200	USD/CAD	0.9800/1.1000	risk to 1.1600 if above 1.1000
GBP/USD	1.3500/1.5000	risk to 1.2500 if below 1.3500	EUR/GBP	0.7700/0.8700	risk to 0.7000 if below 0.7700
USD/JPY	88.00/95.00	risk to 100.00 if above 95.00	EUR/JPY	105.00/117.00	risk to 98.00 if below 105.00
USD/CHF	1.1000/1.2000	risk to 1.2500 if above 1.2000	Gold	1150/1300	risk to 980 if below 1150
AUD/USD	0.7800/0.8800	risk to 0.8400 if below 0.8800	Brent crude	68.00/80.00	risk to 58.00 if below 68.00
NZD/USD	0.6300/0.7300	risk to 0.5700 if below 0.6300			

Red = off target Green = on mark

Turning to our outlook for currency prices, our 3Q price range forecasts clearly missed the mark in the major US dollar pairs. Our basic view going into the 3Q was that the US recovery would slow and that this would undermine the overall global recovery, leading to heightened risk aversion and consequent safe haven demand for US debt and the US dollar. The US recovery certainly did slow in the quarter, but the fallout was not especially severe and resulted in USD weakness rather than a broader risk sell-off. We did better in gold, the commodity currencies and the crosses where our ranges held. In crude oil, price briefly exceeded our expected range high, but subsequently dropped and is currently back in the middle of our forecasted range.

### Results of our predictions

Buy USD/JPY	87.00/89.00	stop 84.00; target 98.00
Sell EUR/GBP	0.8500/0.8700	stop 0.8900; target 0.7700
Sell EUR/USD	1.2400/1.2600	stop 1.2800; target 1.1400
Sell WTI crude oil	78.00/80.00	stop 82.00; target 63.00
Sell AUD/JPY	79.00/81.00	stop 84.00; target 67.00
Sell NZD/CAD	0.7200/0.7400	stop 0.7600; target 0.6300

Red = off target Green = on mark

**“Our strategic expectations also suffered from our forecast for USD strength...”**

Our strategic expectations also suffered from our forecast for USD strength and our strategies in the USD pairs were all stopped out. Our view in EUR/GBP was triggered and remains open and currently in the money. The oil strategy forecast was stopped out when prices briefly exceeded our stop loss level, but that strategy has since gone back in the black. The AUD/JPY strategy forecast was also triggered and moved about 5 yen in the money back in August, but came up short of our target price and is currently back around recommended entry levels. NZD/CAD was also triggered and is currently above our entry recommendation, but is still below the stop level, which actually served as the range high for that pair.

# FOREX.com 4Q 2010 Markets Outlook

## Headwinds Should Keep Major Currencies Weak, Metals Strong

### Recovery to continue, but downside risks prevail

Overall, we expect the global recovery will continue, but it will remain uneven and subject to continued high levels of uncertainty. While we expect the major economies (US, Eurozone, UK, and Japan) to slow further into the end of the year, we don't expect any of them to fall back into recession, but depending on the severity of the expected slowing, that risk may become more intense in 2011.

If our view plays out that the major economies will see new bouts of weakness, we would expect overall risk sentiment to remain cautious, and this should restrain stock and commodity prices broadly. In currencies, signs of renewed weakness may see the JPY-crosses move lower again toward the lows seen in late summer. Again, depending how severely economic conditions deteriorate, the USD may also reprise as a safe haven currency, similar to its performance in the 2Q.

**“we expect to see an increasing divergence between the currencies of the major economies (US, Eurozone, UK and Japan) and those of Australia, Canada, and New Zealand, as well as SEK and NOK “**

More broadly, we expect to see an increasing divergence between the currencies of the major economies (US, Eurozone, UK and Japan) and those of the smaller developed economies, namely Australia, Canada, and New Zealand, as well as the Nordic currencies, SEK and NOK. This should lead to more cross-based trading opportunities in our view as opposed to straight USD- or EUR-based strategies, for example.

### Central Banks on the Sidelines, but QE2 is a risk

In light of our expectation that economic conditions are likely to deteriorate in the 4Q, we expect the major central banks (Fed, ECB, BOE and BOJ) to remain on hold for the rest of the year, effectively maintaining current policy settings and largely monitoring the degree of any slowdown. The minor central banks (RBA, BOC and RBNZ in particular) are increasingly likely to move to the sidelines if conditions in the major economies soften as we expect. Recent statements from the BOC and the RBNZ are pretty explicit in this regard. The RBA may prove to be the exception among central banks and continue to modestly tighten further in the 4Q, given strong domestic and regional data, especially out of China. We think a 25 bp. rate hike to 4.75% in November is the most likely outcome from the Australian central bank.

**“If the major central banks adjust policies at all in the 4Q, we think the only direction they'll move would be toward further easing“**

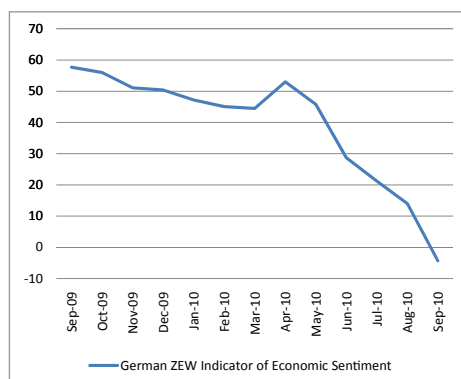
If the major central banks are to adjust policies at all in the 4Q, we think the only direction they'll move would be toward further easing. Speculation over whether additional unconventional easing is forthcoming will likely dominate market discussions of central bank outlooks in the months ahead. In particular, expectations that the Fed and the BOE may initiate additional asset purchases, aka quantitative easing or QE2, may see those currencies come under more extreme pressure. The BOJ may similarly increase asset purchases or even cut their policy rate to zero, now that they've joined in government efforts to weaken the JPY. The ECB is the exception here and seems unlikely to loosen policy in any way, though we think they will be compelled to maintain unlimited liquidity operations in support of the financial sector through the end of the year at least.

**“If economic growth in Euroland begins to show clearer signs of slowing fiscal tensions are likely to reignite”**

### Eurozone Debt Concerns Remain Elevated

Eurozone sovereign debt concerns remain elevated as the 3Q draws to a close, and we think those fears will persist in the months ahead, keeping them as the Euro's Achilles heel. If

**Exhibit 1**  
ZEW Economic Sentiment Index



Source: Bloomberg

economic growth in Euroland begins to show clearer signs of slowing, especially in the core countries (Germany, France, and Benelux), fiscal tensions are likely to reignite as spending cuts are implemented alongside falling revenues on slower growth. The sharp decline in the German ZEW economic outlook since April, intended to forecast conditions six months out, augurs poorly for core Eurozone growth into the end of the year and early 2011.

### US Elections May See Gridlock

On the political front, the US congressional mid-term elections loom large. Current polls suggest the Republican party has a decent chance of taking control of both houses of Congress, but we think the Democrats may yet hold on to the Senate, potentially leading to split control. Even if the Republicans do win both houses, they will not have sufficient votes to override a Presidential veto. In terms of policy then, we expect gridlock, with no major initiatives on further fiscal stimulus likely to ensue. In turn, this will leave the US outlook twisting in the wind, with only the Fed able to provide additional support.

**“In terms of policy we expect gridlock, (which) will leave the US outlook twisting in the wind”**

## 4Q 2010 Market Specific Themes

### Major currencies should stay weak

In terms of individual currencies, we think the USD is most likely to trade sideways against the other major currencies (EUR, GBP, and JPY), but may see additional weakness against the minor currencies (AUD, CAD and NZD), as well as the Swiss franc. In our view, the risks for the dollar are two-sided. On the one hand, moves toward additional quantitative easing by the Fed could see the dollar trade weaker, but we think the debate on QE2 within the Fed hasn't even begun and may not be resolved until early next year. On the other hand, if global growth begins to deteriorate more significantly, the USD could benefit as investors flee risk and seek safety in US Treasuries and the USD.

**“In our view, the risks for the dollar are two-sided”**

The Euro is likely to remain weak against most other currencies, especially the commodity currencies and the Swiss franc. Sharper downturns in the Eurozone outlook, or a further intensification of Eurozone sovereign debt concerns, are the most likely catalysts to a more severe decline in the single currency than we currently expect.

**“In the UK, we find it hard to see any upside to growth from impending fiscal austerity”**

The British pound is also subject to weakness in light of recent declines in forward looking indicators such as the CIPS/Markit outlook index, as well increasing speculation that the BOE may undertake a second round of asset purchases (QE2). The Conservative government is also intent on implementing budget cuts in the New Year, along with a VAT tax hike at the start of the year. The impact of the budget cuts on the UK economic outlook, especially on employment, will become more apparent following the Comprehensive Spending Review due out after Oct. 20, but we find it hard to see any upside to growth from impending fiscal austerity.

In Japan, the recent market intervention by the MOF/BOJ has altered the calculus on the JPY significantly. The sheer size of the intervention, as yet unconfirmed but possibly the largest single intervention on record, and that it remains unsterilized (the sold JPY will stay in the market) suggest a very serious commitment by the government and the central bank to prevent further JPY gains. However, market pressures leading to JPY-strength seem likely to persist, potentially leading to a narrow range-bound trading environment ahead. Japanese bond purchases by China may prove pivotal, and if the Chinese slow or stop buying JGB's, the JPY may see more pronounced weakness. As well, additional QE by the BOJ pose another downside risk to the JPY.

**“We would not be surprised by corrective weakness at some point in the 4Q”**

### Commodity FX may outperform again; JPY-crosses not so much

The commodity currencies--AUD, CAD and NZD--should prove resilient against the majors. These currencies have already seen significant appreciation in recent months, and we would not be surprised by corrective weakness at some point in the 4Q. However, we would view any such corrections as longer-term opportunities to buy those currencies, which stand to benefit from strong regional growth in Asia and overall solid commodity demand likely in the years ahead.

In terms of risk trades, JPY-crosses may lose some of their appeal as risk barometers following the intervention to weaken the JPY. But to the extent they still reflect risk sentiment, we favor further weakness overall in the JPY-crosses, as we mostly see downside risks to growth outlooks and consequently risk assets. If the Japanese intervention remains concentrated in USD/JPY, we would expect to see a disproportionate decline in the non-JPY components of JPY-crosses, for example a greater decline in GBP/USD relative to USD/JPY as GBP/JPY is sold.

### Precious Metals may shine

Gold is currently trading around record high levels against the USD just below the \$1,300/oz level, and generally speaking we think there is more upside potential for gold prices in the months ahead. However, we also think there is the potential for a short-term correction lower, especially in light of potential profit-taking interest around the \$1,300 psychological level and near-record long gold positioning, according to the latest CFTC Commitment of Traders Report.

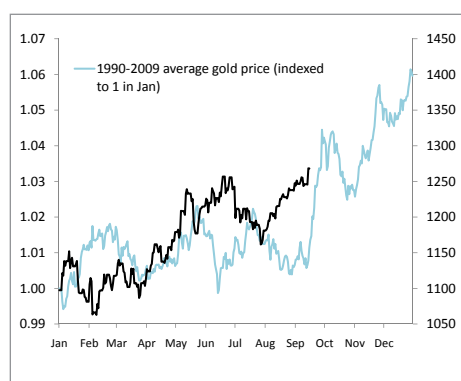
Additionally, our analysis of seasonality patterns suggests that gold could rally towards \$1,400 into the end of the year if past behavior is repeated. At the same time, seasonal patterns also support our view that gold prices may see a near term correction. Over the last 20 years, we would note that the months of October and December have typically experienced corrective price declines. If past behavior repeats, we would expect to be able to enter gold longs from lower levels.

Our fundamental view for higher gold prices is underscored by the overall weakness seen in many major currencies. High sovereign debt levels, low interest rates, and unconventional monetary policies are all working to undermine the value of key currencies and we think this has spurred demand for gold as a currency alternative. The prospect for additional monetary easing from some of the major central banks, especially the Fed, along with a prolonged period of low interest rates also support our outlook for higher gold prices down the road. As well, ongoing sovereign debt concerns continue to plague Europe and diminish the appeal of the Euro, which we think will provide additional support to gold as both a safe haven and a currency alternative.

Turning to silver, we would note that silver has gained 22.4% against the buck so far this year, outperforming gold on a relative basis. A look at the gold-to-silver ratio shows that one ounce of gold buys approximately 62 ounces of silver. The historical average is roughly 48 and we would anticipate a move back toward this level over time.

In our technical analysis of the gold/silver ratio, we think a break of the triangle consolidation pattern argues for a target objective around 51, not very far from the long run average of 48. For the gold/silver ratio to decline to those levels does not necessarily require a decline in gold prices. Instead silver merely has to appreciate at a faster rate or fall at a slower rate than gold to send the ratio lower.

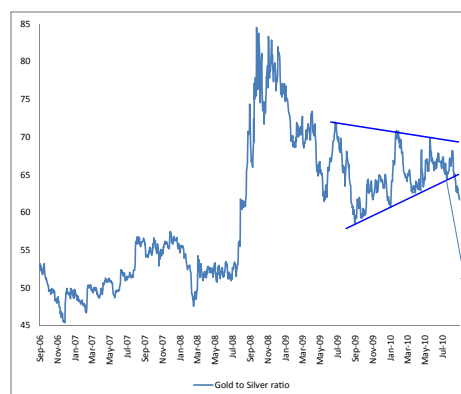
**Exhibit 2**  
Gold Seasonality Trends



Source: Bloomberg, FOREX.com

**“Our analysis of seasonality patterns suggests that gold could rally towards \$1,400 into the end of the year”**

**Exhibit 3**  
Gold-to-Silver Ratio



Source: Bloomberg

**Exhibit 4**  
Oil Prices to remain subdued



Source: Bloomberg, FOREX.com

**“We would note that inventories of US refined products are near all-time highs”**

**“Another upside risk for oil prices, in our view, would be a sharper than expected decline in the US dollar”**

**“Gold prices should remain elevated while the \$1190/1200 trend line level holds”**

**Oil may slide on slower growth**

Looking at crude oil, and here we focus on West Texas Intermediate as the proxy, we think the bias is to the downside based on overall weaker growth outlooks for the major economies in the 4Q. In particular, we think the combination of soft demand coupled with abundant supply may see oil fall below the recent \$70-80 range. In terms of supply, we would note that inventories of US refined products are near all-time highs, and that a major Canada/US oil pipeline has recently been re-opened, removing a potential source of supply disruption.

Overall we think oil prices are more likely to be driven by growth outlooks and here we like to look at the relationship between US stocks as a proxy for growth expectations and WTI crude oil futures. The S&P 500 is currently testing near recent highs, which should hold as resistance if our view for a weaker outlook is to be maintained. If shares do fail here, we would then expect oil prices to weaken toward recent lows as stocks retreat.

Of course, there are upside risks to our oil views. In particular we would note that China has recently surpassed the US as the leading consumer of oil, and stronger than expected Chinese demand may see oil prices gain ground. Recent Chinese data, such as the rebound in August industrial production, suggest the Chinese outlook may be stabilizing after the earlier slowdown over the summer. We will continue to watch Chinese data as an important driver of crude in the months ahead. Another upside risk for oil prices, in our view, would be a sharper than expected decline in the US dollar. We would have to reckon with more pronounced US dollar weakness if the Fed undertakes another large scale program of asset purchases. While we don't rule out a Fed QE2 at some point down the road, we don't think it will happen in the 4Q. We would also argue that if and when the Fed does initiate additional asset purchases, we think it will be in response to a greater deterioration in economic conditions, which would probably have already resulted in lower oil prices on weakening demand.

**Expected Ranges for 4Q**

In light of our overall view that the major currencies will move mostly sideways against each other, we expect 4Q price action in the major USD-pairs to remain centered around current levels. We think the risk to this scenario is biased toward unexpected USD strength and/or EUR, GBP, JPY weakness on a more pronounced deterioration to growth and financial market conditions and resulting safe haven flows into the USD.

For the commodity currencies, we foresee those maintaining most of their recent strength against the USD and think the risks are biased toward the potential for additional gains, especially in AUD/USD. EUR/GBP is expected to move sideways as both the Eurozone and UK outlooks diminish alongside each other, but we think the risk is for more EUR weakness on the potential for yet another round of sovereign debt/financial sector fear if growth outlooks disappoint more severely. EUR/JPY is likely to stay subdued, but the risk potential is to the upside on a larger effort to weaken the JPY.

Gold prices should remain elevated while the \$1190/1200 trend line level holds, but we think fresh gains will be impeded by profit-taking and may be harder to come by. We think WTI crude oil prices will remain roughly between \$70/80/bbl, with the downside supported by ongoing demand and USD weakness and gains limited by high levels of supply and the potential downside growth developments.

## 4Q Range Expectations

EUR/USD	1.2400/1.3600	risk to 1.1500 if below 1.2400
GBP/USD	1.4800/1.6100	risk to 1.3800 if below 1.4800
USD/JPY	81.00/89.00	risk to 94.00 if above 89.00
USD/CHF	0.9700/1.1000	risk to 1.1500 if above 1.1000
AUD/USD	0.8700/0.9900	risk to 1.0500 if above 0.9900
NZD/USD	0.6800/0.7800	risk to 0.8200 if above 0.7800

USD/CAD	0.9900/1.0900	risk to 0.9400 if below 0.9900
EUR/GBP	0.8000/0.8600	risk to 0.7500 if below 0.8000
EUR/JPY	105.00/115.00	risk to 124.00 if above 115.00
Gold	1190/1350	risk to 1030 if below 1190
WTI crude	70.00/81.00	64.00 if below 70.00

**“We have paired our views of weak major currencies with those of strong minor currencies”**

For our strategic expectations, we have paired our views of weak major currencies with those of strong minor currencies, resulting in potential opportunities to sell GBP/CAD and EUR/AUD from slightly higher price levels than current. For the USD pairs, we favor using remaining strength to sell the British pound against the dollar, and to use a pullback in AUD/USD as a potential buying opportunity for possible new highs. In gold, we think a correction below the \$1250 area also represents a potential buying opportunity on a longer-term basis. The last pairing in USD/JPY seeks to take advantage of Japanese intervention, but relies on markets providing a better potential entry-level just above the key 80.00 area.

## Potential Technical Levels

Sell GBP/CAD	1.6200/1.6400	stop 1.6600; target 1.5300
Sell EUR/AUD	1.4400/1.4600	stop 1.4850; target 1.3200
Sell GBP/USD	1.5800/1.6000	stop 1.6200; target 1.4700
Buy AUD/USD	0.8700/0.8900	stop 0.8500; target 0.9800
Buy XAU/USD	1210/1230	stop 1190; target 1330
Buy USD/JPY	81.00/83.00	stop 78.50; target 92.00

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