

4Q 2011 MARKETS OUTLOOK

The Global 'Ugly Contest' Continues

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FOREX.com 4Q 2011 Markets Outlook

Global Outlook: Brace for the worst; hope for the not-so-bad

We think market turmoil in the 3Q reflected stagnation and outright deterioration in the economic outlooks for the world's major economies, aggravated by the ongoing Eurozone sovereign debt crisis, which increasingly risks global financial sector upheaval. Looking into the 4Q, we expect further deterioration in major economies' growth prospects and increasing spillover into emerging market economies, potentially raising the risks of a global recession. We think such an environment will see risk aversion remain elevated and heightened volatility seems most likely to continue. As such, we are inclined to pursue a mostly defensive approach to major markets, with a bias in favor of safe haven assets and against risk assets like stocks and commodities.

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In its September 2011 World Economic Outlook (WEO) entitled “Slowing Growth, Rising Risks,” the IMF sharply cut growth forecasts for the most advanced economies from its earlier June estimates (see Figure 1). The IMF now expects the major economies to grow around 1.6% (down from 2.2%) in 2011 and only 1.9% (down from 2.6%) in 2012. Significantly, the IMF 2012 outlook is based on Eurozone leaders containing the debt crisis, the US finding a balance between stimulus and deficit reduction, and market volatility stabilizing. Any or all of those conditions might fail, which is one reason we expect further risk aversion.

Figure 1:

Latest IMF projections

Global growth will weaken despite emerging and developing countries' strong performance.
(percent change)

	2009	2010	Projections		Difference from June 2011 WEO projections	
			2011	2012	2011	2012
World Output	-0.7	5.1	4.0	4.0	-0.3	-0.5
Advanced Economies	-3.7	3.1	1.6	1.9	-0.6	-0.7
United States	-3.5	3.0	1.5	1.8	-1.0	-0.9
Euro Area	-4.3	1.8	1.6	1.1	-0.4	-0.6
Germany	-5.1	3.6	2.7	1.3	-0.5	-0.7
France	-2.6	1.4	1.7	1.4	-0.4	-0.5
Italy	-5.2	1.3	0.6	0.3	-0.4	-1.0
Spain	-3.7	-0.1	0.8	1.1	0.0	-0.5
Japan	-6.3	4.0	-0.5	2.3	0.2	-0.6
United Kingdom	-4.9	1.4	1.1	1.6	-0.4	-0.7
Canada	-2.8	3.2	2.1	1.9	-0.8	-0.7
Other Advanced Economies	-1.1	5.8	3.6	3.7	-0.4	-0.1
Newly Industrialized Asian Economies	-0.7	8.4	4.7	4.5	-0.4	0.0
Emerging and Developing Economies	2.8	7.3	6.4	6.1	-0.2	-0.3
Central and Eastern Europe	-3.6	4.5	4.3	2.7	-1.0	-0.5
Commonwealth of Independent States	-6.4	4.6	4.6	4.4	-0.5	-0.3
Russia	-7.8	4.0	4.3	4.1	-0.5	-0.4
Excluding Russia	-3.0	6.0	5.3	5.1	-0.3	0.0
Developing Asia	7.2	9.5	8.2	8.0	-0.2	-0.4
China	9.2	10.3	9.5	9.0	-0.1	-0.5
India	6.8	10.1	7.8	7.5	-0.4	-0.3
ASEAN-5 ¹	1.7	6.9	5.3	5.6	-0.1	-0.1
Latin America and the Caribbean	-1.7	6.1	4.5	4.0	-0.1	-0.1
Brazil	-0.6	7.5	3.8	3.6	-0.3	0.0
Mexico	-6.2	5.4	3.8	3.6	-0.9	-0.4
Middle East and North Africa	2.6	4.4	4.0	3.6	-0.2	-0.8
Sub-Saharan Africa	2.8	5.4	5.2	5.8	-0.3	-0.1

Source: IMF, *World Economic Outlook*, September 2011.
¹Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

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The IMF also cut its outlooks for emerging economies, though by a lesser degree. China saw its growth forecast cut -0.1% to 9.5% for 2011 and -0.5% to 9.0% for 2012. For the global economy, the WEO forecast global output growth at 4.0% for both 2011 and 2012 (down -0.3% and -0.5%), unnervingly close to the 3% threshold that signifies a global recession, according to IMF economists.

We think the primary risk into the end of the year is that weak demand in major economies leads to a more pronounced slowdown in emerging countries, creating a negative feedback loop and potentially resulting in a much feared global recession. That view is independent of whether or not a financial crisis in Europe occurs, which would obviously be an immediate trigger to a global economic meltdown.

In looking for bright spots on the economic front, our crystal ball is decidedly dim. Governments in most major economies continue to pursue austerity measures even as consumer sentiment gauges point to further retrenchment in private consumption.

Even in the US, where the Obama administration has proposed a nearly half-trillion dollar jobs/stimulus package, political dysfunction seems most likely to result in a severely watered down package consisting mainly of tax cuts. And since most of those tax cuts are merely extensions of earlier tax cuts, the positive impact will be mostly negligible. In the best case scenario, the full jobs/stimulus package will be passed, resulting in an estimated 0.5% increase to 2012 GDP, according to a recent Bloomberg survey of economists. While we don't think that scenario is plausible, if the political winds should shift in the months ahead and passage appears more likely, we think risk assets (stocks and commodities) could see a boost, similar to what occurred following the passage of tax cuts in Dec. 2010.

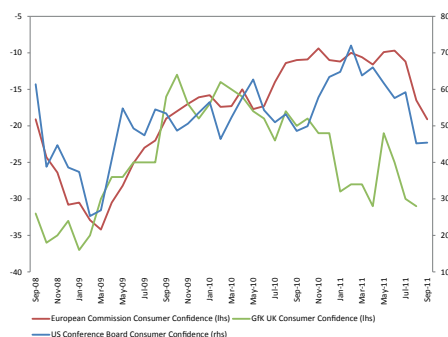
We expect the political drama over the jobs bill to play out in late October, with a likely conclusion by early November. We also think the expected display of partisanship in the jobs/stimulus fight may further unnerve investors who are increasingly worried about the basic functioning of government in the US, adding yet another potential cause for risk aversion.

Risk sentiment should remain fragile

While we are always cautious about expressing too extreme a degree of pessimism, and we certainly think current market sentiment is extremely pessimistic, we don't see very much on the fundamental horizon to encourage much optimism. The key fundamental drivers—entrenched high unemployment, consumer/business deleveraging, fiscal austerity, and weak housing markets—are all long-term sources of weakness and we don't expect to see any material improvements in those areas any time soon. In particular, if the US September employment report, due out Oct. 7, prints as weak as expected (+56K NFP Bloomberg consensus), it may serve as a reminder of the fundamental headwinds facing major economies and lead to another downdraft in risk assets to start the quarter.

In this environment, we think market sentiment will remain exceptionally fragile, with risk aversion playing a dominant role throughout the 4Q. Along those lines, we look for the USD to see further strength on a safe-haven basis against other major currencies. Other traditional safe haven currencies, such as CHF and JPY, seem likely to us to remain supported, but interventionist policies by their governments/central banks may also limit their upside, which we think will result in even greater USD demand during periods of market unrest. We also expect continued downside volatility in key commodity-linked currencies, like AUD, CAD and NZD, along with various EM currencies, during bouts of extreme risk aversion. We look at many of those currencies and provide concrete price levels to monitor in later sections of this outlook.

Figure 2
Declining US, UK and Eurozone
Consumer Sentiment



Source: Bloomberg, FOREX.com

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Returning to the notion that market sentiment is entering the 4Q in an already deeply pessimistic state, we think this argues for a more active trading style rather than a trend-following approach. By that we mean actively managing open exposures to protect gains from short-term reversals and periods of consolidation, rather than setting it and forgetting it as in a trending environment. We can certainly envision periods of not-so-bad news or even some better-than-expected moments that will see risk aversion subside, providing a catalyst for risk assets to recover in the short run. However, from a strategic perspective based on the weak economic outlook, we prefer to focus on using rebounds in risk assets as opportunities to establish short risk-positions at more advantageous levels.

Central bank expectations shift to easing

The 3Q saw a massive reversal in market expectations of major central bank policymaking as incoming economic data continued to disappoint and the Eurozone debt crisis dragged on. Just a few months ago, central banks in Europe, Australia, New Zealand, Canada, Sweden, Norway, and even the UK, to some extent, were expected to be raising rates into the end of the year. Futures market prices now indicate these central banks are expected to be cutting rates to varying degrees over the next 6-12 months. (NZ is the exception, but futures data suggests the RBNZ may raise rates by less than earlier expectations.)

The shift down in central bank policy expectations is partly behind some of the relative weakness these currencies have seen over the last couple of months. Looking ahead, we think rate cut expectations will provide another limiting factor to the upside for many of these currencies. At the same time, we think markets have likely been overzealous in the timing and degree of possible rate cuts. For instance, futures data indicate the RBA is expected to cut rates 100 bps by year end. Our own expectation is that most of those central banks will largely remain on hold in the 4Q, but we will continue to monitor policy statements and speeches for clues as to the timing of future rate cuts. The risk to our view is that global markets endure another tailspin, likely emanating from the Eurozone debt crisis, and central banks are forced to undertake emergency rate cuts.

In the US, the Fed initiated Operation Twist, its program of shifting its portfolio of Treasury holdings to longer maturities. The Fed statement indicated the program would run through June 2012, leaving the impression that the Fed was not considering additional measures in the meantime. We would agree with that, but we also think pressure may build on the Fed to undertake another round of asset purchases (QE3) if the US recovery deteriorates further. While we think the bar to QE3 is very high, we would expect markets to clamor for more Fed action should growth weaken further or if stock markets experience another sharp drop, both risks we think are quite real. For now, we expect the Fed to stay on hold into 2012, but we will be alert to any indications that Fed policymakers are considering fresh moves to shore up market sentiment. If QE3 talk re-surfaces, we would look for potentially sharp rebounds in global stocks and commodities and a related decline in the USD.

Europe: Greece stays in the Eurozone but stresses to remain

We enter the fourth quarter with the Eurozone crisis at a critical stage. Although we are used to regular flare ups in the sovereign debt crisis, this time it has engulfed the banking sector. Europe's main banking sector stock index has fallen nearly 30 per cent since the summer as funding dried up, fuelling fears of a liquidity crunch that could rival the 2008 collapse of Lehman Brothers.

This time round global central bankers have acted quickly to unblock liquidity channels thus keeping the banking sector afloat, but as we move in to the last three months of the year, some of Europe's largest banks are now reliant on the ECB for funds after the wholesale markets have

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essentially shut them out. Europe’s banks don’t only have a liquidity problem; they also have a solvency issue. They hold some EUR173 billion of Greek debt, but they don’t have large enough capital buffers in the event of a Greek default. The International Monetary Fund (IMF) has estimated this capital shortfall in the region of EUR200 billion, which is much higher than the Eurozone’s own estimate after the banking stress tests released in July. Thus, by the end of the year we expect Europe’s banks to engage in large-scale re-capitalisation along with asset sales to try to boost their cash buffers.

The question is where will this money come from? The obvious answer is China and other emerging markets rich with FX reserves. However, after getting burned in the 2008 financial crisis with their investments in US banks, this source of funding may not be widely available. Instead, state money may have to be used to boost capital buffers, and that means that the European Financial Stability Facility (EFSF) will need to see its size rise from its current EUR440billion to around the EUR2 trillion mark.

So far the EFSF has been used to provide bailout funds for Greece, Portugal and Ireland but we expect the duties of buying sovereign bonds and re-capitalising the banks will fall to the EFSF and this could be agreed upon sometime this quarter. However, when it comes to politics and the Eurozone anything can happen.

“...there is a risk that global markets will be disappointed in October if the EU doesn’t come up with a long-term plan”

The global community has nudged the Europeans to reach a sustainable, realistic solution by boosting the size of the EFSF. They even provided a deadline - mid-October - before the next finance ministers’ meeting. We believe that such a large increase to the fund will take a lot more wrangling and debate before it gets the go-ahead from EU leaders, so there is a risk that global markets will be disappointed in October if the EU doesn’t come up with a long-term plan. Right now the chance of an increase to the funds available to the EFSF is slim. Both German and Spanish leaders have dismissed the idea. Instead, Germany may push private sector bond holders to accept larger haircuts on their debt, which currently stands at 20 per cent agreed back in July. This could delay the extension of the EFSF to EUR440bn, let alone EUR 2-3 trillion. Throughout this crisis Europe’s leaders have worked slowly and it appears that yet again the global community is working on a faster timetable than the European policy makers.

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However, as we have said before we believe that Greece will remain a member of the Eurozone and eventually Germany and the other “core” economies of Europe will have no choice but to extend the EFSF rescue fund. Greece can’t default unless the banking sector is recapitalised and if Italy and Spain start to have problems this could cause financial Armageddon. So a disorderly Greek default is a non-starter due to the cost to the Eurozone in our view. Likewise Greece can’t leave the currency bloc legally. Firstly, there is no mechanism written into the Maastricht Treaty that created the Eurozone back in 1992 for a country to abandon its membership. Added to this there is no legal basis for expulsion from the euro area – so without a massive treaty change Greece is likely to stay a member of the Eurozone as we head into year-end.

But we expect more flare-ups in this crisis. Firstly in October if the EU hasn’t agreed on a sustainable plan to boost the EFSF; and secondly in December. This is when Greece is scheduled to receive its seventh tranche of bailout funds, which tend to cause default speculation and market volatility. So until a long-term solution is found to this crisis then Greece has the potential to cause even more turmoil.

Growth and the sovereign debt crisis

The sovereign debt crisis is closely intertwined with the slowdown in growth in the Eurozone. In the second quarter the growth rate slowed to a mere 0.2 per cent and signs don’t look good for the third quarter. The manufacturing sector’s purchasing managers survey fell into negative

“...we expect growth in the Eurozone to dip into negative territory in the fourth quarter.”

territory in August, while the services sector saw contraction in September. And weakness in growth is broad-based. Europe's core economies are also slowing sharply, which is worrying since they make up the bulk of growth. There are a couple of bright spots: Spain has seen some improvement in its labour market and Ireland had stellar growth in the first half of this year, its economy expanded by 1.6 per cent and 1.9 per cent in the first and second quarters. On balance though, we expect growth in the Eurozone to dip into negative territory in the fourth quarter.

The sovereign debt crisis has knocked both business and household confidence levels to multi-year lows, which is weighing on growth just as the public sector is starting to shrink. Thus, without a solution to the debt crisis growth in the fourth quarter is unlikely to recover. This leaves the European Central Bank (ECB) to step in and fill the gap.

The ECB has hiked rates twice since April, the last one in July. However, if the economy slips into recession then pressure will build on the ECB to start to reverse some of the tightening. So when could this happen? The outlook for the global economy remains cloudy and the ECB is likely to want to see more data before it acts. As well, the surge in September Eurozone CPI to 3.0% YoY (prior 2.5%) suggests those looking for an ECB rate cut in October will be disappointed. This makes November and December crucial months in our view for monetary policy. By then the ECB Staff projections for growth and inflation will be ready. If revisions to growth and prices are significantly lower than the original forecasts, we think this will boost the chances of at least one 25 basis point rate cut.

“...stabilization on the banking sector and a resolution to the debt crisis would be the best medicine for Eurozone growth.”

Actions by the ECB will be crucial for the euro as we move towards year-end. If the ECB manages to avoid cutting rates then we may see the euro perform well, especially since it seems increasingly likely that the Bank of England will join the Federal Reserve and announce new measures to boost its flagging economic recovery sometime this quarter. The ECB could avoid rate cuts in our view. Its main task over the next few months will be to ensure there is enough liquidity in the banking sector. With real interest rates already negative a rate cut at this stage would do little to boost the economy and consumer confidence in our opinion. Instead stabilization on the banking sector and a resolution to the debt crisis would be the best medicine for Eurozone growth.

This quarter is full of event risk and due to this our range for EURUSD is fairly wide and comes with a caveat. Our expected range for EURUSD is 1.2900 to 1.3900. Although we aren't looking for outright collapse, if we get below 1.2650 then we could see a sharper move lower towards 1.1800 – the low reached in April 2010.

UK: Can the Bank of England fix the UK economy?

The third quarter was notable for the massive shift in thinking at the Bank of England (BOE). No Committee members are voting for hikes anymore and the focus has changed from stubbornly high inflation levels to weak growth. According to the minutes from the September meeting, “most members thought that it was increasingly probable that further asset purchases to loosen monetary conditions would become warranted at some point.”

“The BOE could not have put it simpler: QE is on the cards.”

The BOE could not have put it simpler: QE is on the cards. In fact the same minutes reiterated that it was a finely balanced decision to keep asset purchases stable in September, so expectations have grown for more quantitative easing (QE) possibly as soon as October. We expect the Bank of England to keep interest rates on hold this quarter but we think it will announce more QE, most likely on the order of GBP 50 bio. Since the Bank was close to announcing asset purchases in September we think the next round of QE may come in October. The economic data hasn't picked up since then and all members of the Committee

remain convinced that inflation pressures will moderate in the long-term, thus why wait if you think the economy needs a boost now?

“The weakness in the UK economy has fuelled renewed concerns over the UK’s fiscal position.”

The economic downturn has been broad-based and industrial production is weak along with retail sales. The IMF has also cut its forecasts for UK growth in 2011 and 2012 to 1.1% for this year, down from 1.5% and to 1.6% in 2012 down from its original forecast of 2.3%. This puts the UK behind the US, Germany, France and Canada for growth this year. The weakness in the UK economy has fuelled renewed concerns over the UK’s fiscal position. The debt problems in Europe and the US have taken the heat off the UK; however, it may return as the UK’s budget forecasts look harder to achieve. The main problem is that the bulk of the UK’s debt problems are structural in nature and are less likely to be wiped out by strong growth. This means that the government may have to stick to their consolidation plan even if growth continues to stagnate.

The coalition government remains stuck between a rock and a hard place. The bond vigilantes may target the UK if the government reduces its fiscal targets, yet growth is likely to get worse before it gets better especially since the Eurozone, the UK’s largest trading partner, is also at risk of falling back into recession. So in our view it is up to the BOE to step in and fill the growth gaps.

This will have a major impact on the pound, and makes further weakness more likely. The problem is what to trade it against. We think GBPUSD may fall further but the dollar could also weaken, especially if it looks like the Federal Reserve will embark on QE3. Thus, our expected range for GBP/USD is 1.5000- 1.5800 There is a risk of a fall to 1.4500 especially if the UK’s fiscal position starts to worry the bond vigilantes, although we believe there is only a slim chance of this happening by year-end. More likely is a crisis in the banking sector, which is already experiencing funding difficulties.

“Overall, we think it will be a difficult quarter for the UK and the pound is likely to suffer. ”

The banking sector faces two issues: firstly, the Bank of England has noted tightening funding conditions for the banks, which could thwart their ability to lend and weaken the economy. The BOE has urged the banks to re-capitalise as soon as possible and preferably with long-term funding. Secondly, if the EU proposes a financial transactions tax this will be negative for the UK since the financial sector is an integral part of the economy. If the banking sector starts to look more vulnerable, this may cause a sharper sell-off in sterling. Overall, we think it will be a difficult quarter for the UK and the pound is likely to suffer.

SNB & BOJ: To intervene or not to intervene

The past few quarters have seen risk aversion surge due to a series of factors: uncertainty surrounding the European sovereign debt crisis, completion of QE2 and political bickering regarding the debt ceiling in the United States, geopolitical concerns in the Middle East and North Africa, natural disasters in Japan, Australia and New Zealand and the belief that the low global interest rate environment would be coming to an end. Subsequently, traders moved into traditional ‘safe-haven’ currencies (JPY and CHF).

After the devastating earthquake/tsunami/nuclear meltdown in Japan earlier this year, the BoJ was forced to act as the JPY strengthened sharply within just a few days. Through talks with global leaders, they initiated coordinated G7 intervention which led to abrupt JPY declines over the ensuing weeks: USD/JPY – 76 to 85, EUR/JPY – 107 to 123, GBP/JPY – 123 to 140, and CAD/JPY – 77 to 89. However, since bottoming in mid-April the JPY has done nothing but strengthen, consequently sending all the JPY-crosses lower in the process. Nevertheless, as we stated earlier the yen wasn’t the only currency to strengthen over this time period, as the Swiss Franc saw massive gains, too. The SNB however was in no position to take action after the utter

failures of their previous attempts to intervene in EUR/CHF between 2009 and 2010 – first at 1.50/51, then 1.46, next 1.43 and finally 1.40, before ultimately giving in to Franc appreciation. Yet in August of 2011 the pain became too much to tolerate as EUR/CHF plummeted. The SNB reacted by expanding bank sight deposits and narrowing the Libor target range, yet EUR/CHF still neared parity. It was not until talk circulated of a potential 1.15 peg before the franc's appreciation halted. At the beginning of September the SNB took further action by setting a floor in EUR/CHF at 1.20.

“ In USD/JPY we believe a break below 75 is warranted before intervention is justified.”

Following these actions, the BoJ and SNB are still faced with the increasingly difficult decision over pursuing further currency intervention as we head into Q4. With USD/JPY hovering just above its all-time low (75.90/95), GBP/JPY at all-time lows and EUR/JPY at levels not seen since in 2001, Japanese exporters are feeling tremendous pain and market sentiment about possible action by the BoJ/MoF to counter the strength of JPY has been growing. We believe such action will not be taken unless the JPY strengthens significantly from current levels. In USD/JPY we believe a break below 75 is warranted before intervention is justified. If MOF/BOJ intervention were to occur, we believe this would yet again be another good opportunity to establish a bearish view on JPY-crosses into the end of 2011.

“...the SNB's resolve to defend the 1.20 floor set in place just a few weeks ago has yet to be tested and they may even feel pressure to raise the floor further to 1.25...”

Separately, the SNB's resolve to defend the 1.20 floor set in place just a few weeks ago has yet to be tested and they may even feel pressure to raise the floor further to 1.25, which has been widely rumored throughout the market. Keep in mind, the SNB is carrying large losses from their previous attempts to intervene over the past few years and some remain skeptical of their success this time around as the SNB's current holdings at the end of August jumped to a record 253.4 billion francs (which is prior to setting the floor) – This is roughly half the Swiss GDP. When questioned on their solvency, the SNB suggested they “cannot become illiquid” and could simply create francs “out of thin air”. All eyes are now watching the SNB's publication of their September reserves on October 6th. Should this number come out vastly higher than expected, look for traders to aggressively test the SNB's resolve once again. Initially, we would envision a test of 1.20 as an opportunity to establish a bullish EUR/CHF position in light of the SNB's pledge to defend the franc ceiling with all determination. However, looking further out (Q2/Q3 2012), should the Eurozone situation deteriorate further the SNB may have no choice but to relent in defending the floor in EUR/CHF.

“...while much of the developed world is facing financial turmoil and deteriorating growth, the Australian economy seems to be chugging along.”

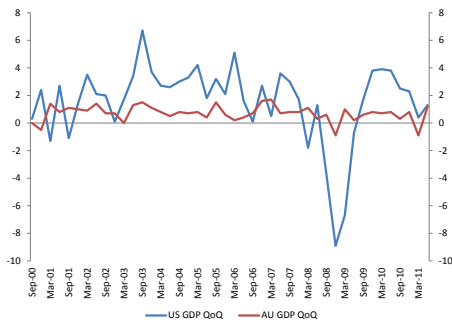
AUD may falter even though economic fundamentals remain strong

The most recent GDP data out of Australia showed that the economy grew at 1.4% y/y in Q2 from the 1.0% yearly growth in Q1. This was double the expectations of +0.7% expansion. Quarterly GDP growth in Q2 rose 1.2% from the prior -0.9% also beating expectations (cons. +1.0%). The data highlights the state of the Australian economy versus market expectations. It appears that while much of the developed world is facing financial turmoil and deteriorating growth, the Australian economy seems to be chugging along. The market has been largely expecting that weakness in the US and EU will flow through to Australia, however economic data suggests this is not the case.

“...Battellino states that ‘it is clear that China now has a large influence on the Australian economy’.”

RBA Deputy Governor Ric Battellino delivered a speech entitled ‘Will Australia catch a US cold?’ in which he stated that the Australian economy has been less vulnerable to severe US symptoms using the examples of the 2001 and 2008/9 US recessions and their relatively mild impact on the downturns in Australia (Figure 3). As we have noted in the past, Battellino states that ‘it is clear that China now has a large influence on the Australian economy’. The Chinese and Australian economies are complementary as Australia produces a good deal of resources for which China has a very strong demand. The RBA Deputy Governor suggests that the ‘question at present is whether the recent turmoil in global markets will eventually overwhelm the positive effects on the Australian economy from China’. Although China's economy has

Figure 3
Australia GDP less dependent on US growth



Source: Bloomberg, FOREX.com

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“Persistent high volatility in the financial markets and global uncertainties are likely to keep equities under pressure which may weigh on the AUD.”

moderated from its Q1 2010 peak of 11.9%, it continues to grow at an extraordinary pace – last at 9.5% GDP growth in Q2.

The domestic economy has softened somewhat in the near term as the most recent RBA minutes detail, but the bank says ‘the medium-term outlook still appeared positive’ as ‘prices for key Australian commodities had remained very high, with growth in China continuing to be solid.’ Inflation has picked up – last at 3.6% for 2Q from the prior 3.3% – and the RBA minutes show the bank’s concern over rising cost pressures. Though labor data has been soft with the unemployment rate unexpectedly rising to 5.3% in August from 5.1%, there has been solid growth in total hours worked and strong household consumption with retail sales rising by more than anticipated (+0.5% at last print).

The RBA has held the target cash rate at 4.75% since November 2 as the international outlook has become more clouded. The market has been pricing in rate cuts by the bank for the end of this year, but the RBA commented that the “market pricing might not be giving an accurate reading of expectations” causing traders to adjust expectations. We expect the RBA to remain on hold through the remainder of 2011 while it assesses the impact of global turmoil. Continued strength in the Chinese economy is likely to be supportive of the Australian economy moving forward.

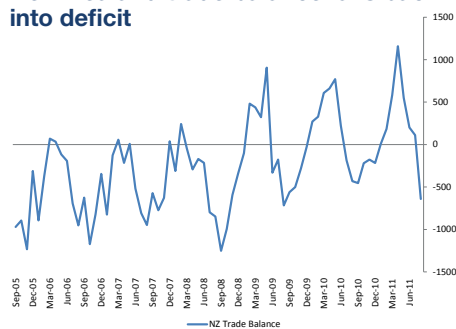
While the Australian economy may not suffer to the extent that most of the developed world is likely to, the Aussie is likely to come under selling pressure, specifically against the USD. The AUD has been highly sensitive to fluctuations in global equities markets and is viewed as a ‘risk’ currency as evidenced by the high beta of the AUD to the S&P 500. As such we believe that while the fundamental outlook for the Australian economy is likely to remain firm, one cannot ignore the high correlation (above 0.80 over the past month and a half on a % change 60-day rolling basis) between the currency and equities. Persistent high volatility in the financial markets and global uncertainties are likely to keep equities under pressure which may weigh on the AUD. The bias remains lower however sharp declines in AUD/USD are likely to see subsequent profit taking and maybe long positions being established as fundamental value is present. We would prefer to establish AUD longs against currencies such as the EUR and GBP, selling the EUR/AUD and GBP/AUD crosses on rallies.

RBNZ not ready to reverse policy rate yet

The RBNZ has held the official cash rate at a record low 2.50% after a 50 bps cut that came following the devastating earthquake that struck Christchurch in February. New Zealand Finance Minister Bill English said that a historically strong currency and global growth concerns will reduce demand for NZ exports which will weigh on the nation’s economic recovery (exports make up roughly 30% of GDP). English said, “when our growth is export driven and the exchange rate is elevated, it’s going to have an effect”. This effect has been evident as recent data has shown slowing growth in Q2 and a trade deficit in August.

New Zealand’s 2Q GDP figures showed disappointingly slow growth of only 0.1% q/q from the prior 0.9% (cons. 0.5%) and yearly figures unexpectedly dropped to 1.5% y/y from prior 1.7% (cons. 1.7%). The August trade balance added to the deteriorating outlook of the NZ economy as the August NZ trade balance showed a larger than expected deficit of -641M (cons. -321M) from the prior month’s surplus of +111M (Figure 4). Exports fell as anticipated to 3.44B from 3.72B while imports rose by more than forecast to 4.08B from the prior 3.61B. Inflation has picked up as the most recent CPI figures showed a rise to 5.3% y/y in Q2 from the prior 4.5% in Q1. The Bank has noted that this is above the RBNZ’s 1 to 3 percent target band and believes it the elevated levels to be temporary.

Figure 4
New Zealand trade balance falls back into deficit



Source: Bloomberg, FOREX.com

“For some time, the market has been anticipating the RBNZ to reverse the 50 bps ‘emergency cut’...”

For some time, the market has been anticipating the RBNZ to reverse the 50 bps ‘emergency cut’ in the overnight cash rate as the bank has had a hawkish tilt. At the most recent meeting RBNZ Governor Bollard said, “If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase. For now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent”. We believe that the bank will remain on hold throughout Q4 but market expectations of a rate hike and positive data surprises may prove supportive of the kiwi.

The NZD is also highly sensitive to equity market fluctuations as is the AUD. NZD/USD has seen a significant decline due to disappointing economic indicators and falling stock markets sending NZD/USD collapsing below key technical levels. It broke below the key horizontal support which is around the 0.7980 area (also the 50% Fibonacci retracement of the rally from the March lows to the August highs) and the 200-day SMA which comes in around the 0.7950/55 level. The 200-day SMA has since become resistance as the pair was rejected from a test of the SMA. We anticipate further NZD declines against the USD, however due to future rate hike expectations, the kiwi may outperform against the EUR and GBP as their respective central banks are becoming increasingly dovish, suggesting to us potential opportunities in those crosses.

Canadian economy vulnerable to US slowdown

Canada’s economy is largely tied to the health of the US economy as it ships about three-quarters of its exports to the US. Crude oil is the nation’s biggest export and fluctuations in the price of oil tend to have an impact on the economy as well as the exchange rate of the CAD. The Canadian economy shrank in Q2 with a contraction of -0.4% on a quarterly annualized basis following a 3.6% gain in Q1. The Bank of Canada attributed the contraction to temporary factors and said that it ‘continues to expect that growth will resume in the second half of this year’.

“Policy makers and traders fear that the weakness of the US economy will flow through into Canada.”

External uncertainties are the main determinants of Canada’s economy and the CAD exchange rate in the coming quarter. The bank noted that while ‘global equity and commodity prices have fallen significantly’ in response to uncertainties in Europe, the ‘direct impact of a renewed slowdown in the United States, our largest trading partner, is more material’. Though commodity prices have declined due to the diminishing global growth outlook, they remain relatively high. Policy makers and traders fear that the weakness of the US economy will flow through into Canada. Demand for Canada’s exports is anticipated to be soft due to a faltering global recovery and strength in the CAD. As uncertainty remains elevated and risks to the economy are tilted to the downside, we believe that the Bank of Canada will remain on hold removing monetary policy as a key factor driving the currency in Q4. The key exchange rate drivers are likely to be the price of oil, equity market fluctuations, and outlook to the global growth.

Technically, USD/CAD appears to have an upwards bias suggesting weakness in the Loonie. The daily Kijun line is currently just above parity which is also where the 38.2% Fibonacci retracement (of the rally from the July lows to September highs) and prior double top resistance come in. While the pair remains above parity, we think it is likely to see continued upside potential.

Expected 4Q 2011 Major Currency Ranges

EUR/USD	1.2900/1.3900	risk to 1.1800 if below 1.2900
GBP/USD	1.5000/1.5800	risk to 1.4500 if below 1.5000
USD/JPY	74.00/80.00	risk to 85.00 if above 80.00
USD/CHF	0.8800/0.9500	risk to 1.0000 if above 0.9500
AUD/USD	0.9200/1.0200	risk to 0.8500 if below 0.9200
NZD/USD	0.7300/0.8300	risk to 0.6500 if below 0.7300
USD/CAD	1.0000/1.0800	risk to 1.1300 if above 1.0800
EUR/GBP	0.8300/0.9100	risk to 0.7800 if below 0.8300
EUR/JPY	98.00/110.00	risk to 115.00 if above 110.00
EUR/CHF	1.2000/1.2500	risk to 1.3000 if above 1.2500

“Cross-asset currency correlations reached cyclical highs in the 3rd quarter...”

Exodus out of emerging market (EM) FX

In the final month of Q3 2011, risk assets sold off sharply as fiscal stalemates from both sides of the Atlantic enveloped collective risk sentiment in fear. In FX, the crisis of confidence resulted in an exodus out of beta currencies (EUR, AUD, NZD, GBP) for the majors; and in some cases an even larger exodus out of minor/emerging market currencies (TRY, ZAR, PLN, MXN, HUF, SEK, CZK, DKK, NOK, SGD). The resultant deleveraging of risk sent flows pouring into USD, once again evidencing the greenback's supremacy as ‘the’ safe haven in periods of extreme uncertainty. Even gold prices declined in the final month of the third quarter, a result of both position adjustments and the USD's liquidity advantage over any security independent of asset class.

Cross-asset currency correlations reached cyclical highs in the 3rd quarter evidencing the tight relationship between developed and emerging market economies, but more specifically reflecting the contagion effect of downside growth prospects in developed economies to emerging markets. Price action across asset groupings have been dominated by headlines regarding both US and EU fiscal difficulties; generally taking the form of positive event-related anticipation leading to marginal risk rallies which in many cases were more than offset by post-event disappointment.

“...we believe any further declines in risk are likely to be accompanied with pockets of ‘risk on’ instances.”

As financial markets cautiously step into the final quarter of 2011, we think risk assets are likely to remain under pressure. However, as was the case for much of the 3Q, we believe any further declines in risk are likely to be accompanied with pockets of ‘risk on’ instances. Overall, we think emerging market currencies will remain closely linked to movements in broader risk assets and believe any short term rallies in the EM currency space may provide longer-term short opportunities.

HUF – The ugly duckling of EM Europe...

In terms of recent EM currency movements versus USD, the Hungarian Forint (HUF) was the ugliest duckling of the EM space (for EM currencies offered by FOREX.com) with September declines totaling around -14%. As financial markets sunk deeper into red territory, HUF outflows accelerated at a feverish pace. Recent developments suggest the NBH (National Bank of Hungary) stands ready to intervene if necessary by hiking if HUF weakness reaches extreme levels. However, Hungary's economic situation reflects a dilemma faced by many emerging market economies at the moment – elevated inflation levels in the face of deteriorating growth prospects – which may handcuff the central bank from tightening. Accordingly, we think continued risk aversion may lead to concurrent Forint weakness towards the key 219.00 technical pivot in USD/HUF.

“...we think lower commodity prices and an accommodative SARB may weigh on ZAR towards recent highs around 8.5000.”

ZAR – The ugly duckling of EM MENA...

The South African Rand has also experienced elevated weakness versus USD into the end of the 3Q – ZAR losses totaled around -13.3% in just September alone. Such downside, however, should not come as much of a surprise considering ZAR performance has generally paralleled that of commodities. However, the extent of declines does come as a bit of a surprise – ZAR is down about -14% since last year while losses in the CRB Index amount to just about -8%. In its most recent September 22nd meeting, the SARB opted to hold its policy rate steady at 5.5%. However, the tone of the MPC statement was markedly dovish from prior ones with the MPC noting a willingness to act if necessary. If our overall opinion of further downside for risk assets in the 4Q '11 materializes, we think lower commodity prices and an accommodative SARB may weigh on ZAR towards recent highs around 8.5000.

SGD – The swan of EM ASIA?

“... rapid deterioration in developed economies has led to a fallback in Singapore’s growth prospects...”

While SGD lost approximately -7.31% versus USD in September, the Singapore Dollar is still up almost 2% against the US Dollar over the last year (as of 09.28.11). Firming domestic demand and export volumes alongside elevated inflation levels saw the MAS maintain a tightening bias towards SGD appreciation for most of 2011. However, rapid deterioration in developed economies has led to a fallback in Singapore’s growth prospects, resulting in SGD downside towards the bottom end of its band as Q3 drew to a close. Overall, we think still firm domestic demand and elevated inflation levels will see the MAS maintain a stance in favor of SGD appreciation, albeit at a slower pace in acknowledgement of the significant downside risks to the global economy.

Spill-over effect: Developed Market economic weakness to EM currencies

While Brazil and Turkey have taken the lead within central banks of the EM space in terms of easing (China to a certain extent with the recent expansion of personal income tax exemptions), elevated inflation readings pose a significant risk for many EM central banks to follow their leads. However, price action in the tail end of Q3 makes crystal clear that the health of developed markets heavily influences that of emerging markets and their respective currencies. That said, we think further weakness in advanced economies is likely to have a spill-over effect to the currencies of emerging market economies in the coming quarter.

Metals

“...silver will tend to under-perform gold when the economy slows...”

Will the ‘bears’ hibernate this winter? We think not...

The price action divergence between gold and silver was prominent in the third quarter. At the time of this writing, gold has risen over 7% while silver has fallen more than 13% in Q3. However, this is not to say that we were surprised by this, as it was our preferred scenario in our 3Q Outlook. In our view, silver’s ‘chart’ was clearly broken after what had transpired in the beginning of May – falling from nearly \$50 to trading on a \$32 handle a mere two weeks later, yet gold remained firm and this proved paramount in the third quarter. While both metals are typified as traditional safe havens and hedges against inflation, industrial usage accounts for a much larger share of silver demand than gold. Consequently, silver will tend to under-perform gold when the economy slows (see Figure 7 gold/silver ratio) as was the case over the past 3 months. Furthermore, the ratio reached our projected 50-52 level a week ago as risk aversion gripped global markets.

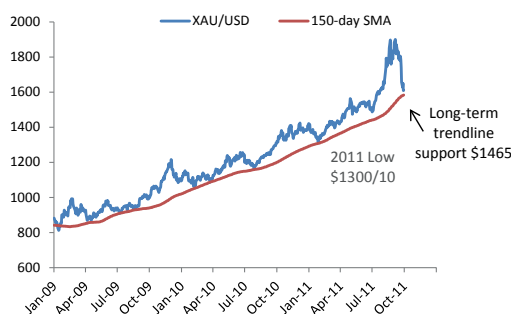
Figure 5
Gold/silver ratio may signal weakness in equities



Source: Bloomberg, FOREX.com

“...therefore we view \$1700-40/oz. as an attractive area to establish a bearish bias as we head into Q4.”

Figure 6
Spot gold at risk of dropping below long-term support



Source: Bloomberg, FOREX.com

“...as long as markets continue to trade on headlines, then we would expect volatility to remain high and the lack of conviction to persist.”

With that said, where do metals head in Q4? In a ‘textbook’ world, gold and silver would continue to surge higher on the back of Eurozone sovereign debt concerns; however that is currently not the case and we saw a similar reaction in late 2008...so what gives? We believe this is attributed to, yet again, liquidity. In times of a liquidity crisis, all assets sell-off and investors plow into cash. This was most evident recently when gold sold off to the tune of \$250 over a 3 day period, before eventually rebounding. While it appears many Eurozone leaders are finally coming to realize the urgency of the situation, they have yet to come to terms with a sufficiently large enough bailout package. Should an EU plan fail to materialize within the next few weeks, we’d envision a substantial amount of ‘risk aversion’ through the end of 2011. If this is the case, look for the gold/silver ratio to test the 65-67 level in Q4. Under such a scenario, for those wondering what this would mean for equities, picture the S&P500 trading closer to 1000 which would be around the 2010 lows.

While Gold is currently trading around the psychologically significant \$1600 level, our proprietary model suggests another sharp pullback may be in order before finding a more meaningful bottom. Gold’s 150-day sma has limited the downside on multiple attempts since reaffirming its trend higher at the beginning of 2009, however it broke below it (\$1580-85/oz.) on an intra-day basis September 26th. Hence, another test of this level may see it falter and could be the eventual trigger to another severe decline. Perhaps what’s even more disturbing is the yellow metal’s performance during the month of September (currently down over 11%), as this is month which our proprietary model typically advocates a strong bullish bias. Over the coming quarter we believe commodities are likely to remain weak and the USD will remain in vogue, therefore we view \$1700-40/oz. as an attractive area to establish a bearish bias as we head into Q4. We would view a test of long-term trendline support (drawn from the 2008 low) and the May 2011 lows which coincide around \$1465-75/oz as an objective. However, should a bounce fail to materialize and gold moves directly lower, breaking below the 200-day sma near \$1530/oz., it runs the risk of a sharper sell-off towards the lows of 2011 around \$1300-10/oz.

Silver has led the move lower over the past few weeks, from a high of \$44 in mid-August to its current level around \$30. Interestingly, it pulled back to our projected Q3 zone of \$26-28 before briefly rebounding. However, silver’s recent rejection between \$32-34 (May and June 2011 lows) suggests further downside may be in store for the poor man’s gold. Furthermore, should the events in Europe fail to come to a resolution then silver’s downside could be much more severe over the coming months. A break below the 2011 low near \$26 could give way to a test of the 2010 highs around \$20.

No matter how you slice it, as long as markets continue to trade on headlines, then we would expect volatility to remain high and the lack of conviction to persist. With global exchanges keen on raising margin requirements on gold and silver in this topsy-turvy environment, the battle between those who perceive it as another “asset class” and those who believe it’s a “flight-to-safety” play may have shifted and metals may trade more in-line with ‘risk’ over the coming quarter.

Oil

Deteriorating macro outlooks may weigh on Q4 crude oil prices

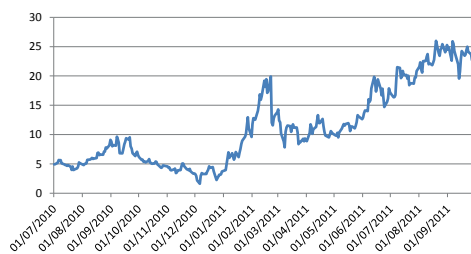
In the month of September, both US (WTI) and UK (BCO) crude oil shed about -6% and -8%, respectively. This is quite the departure from a few months back when firm underlying fundamentals lifted US Oil towards \$100/bbl. and UK Oil to around \$120/bbl.. Heading into the

Foreign exchange and other leveraged trading involves significant risk of loss and is not suitable for all investors.

“The primary sources of risk stem from both the US and EU struggling with tremendous fiscal difficulties.”

“...policymakers from both sides of the Atlantic have responded in similar fashion - by agreeing to disagree.”

**Figure 7
Spread between UK and US crude oil still elevated Spread between UK and US crude oil still elevated**



Source: Bloomberg, FOREX.com

“...markets are still looking vulnerable as we head into the fourth quarter.”

4Q, US Oil is currently testing below the \$80/bbl. level and UK Oil is drifting lower toward \$100/bbl., we think mainly as a result of deteriorating macro outlooks.

In terms of the global economic backdrop, much has changed since the beginning of the 3Q. Growth forecasts for developed and emerging economies have been shifted lower as risks to global growth have substantially increased. The primary sources of risk stem from both the US and EU struggling with tremendous fiscal difficulties. The result for financial markets – massive deleveraging of risk in favor of USD and thus against dollar denominated commodities.

Although euro-area concerns have dominated recent headlines, policymakers from both sides of the Atlantic have responded in similar fashion - by agreeing to disagree. The political tug-of-wars have resulted in a crisis of confidence for which there seems no end in sight. The longer each respective stalemate drags on, the greater the potential downside for risk assets in the coming quarter – including crude oil.

Tightening UK-US crude spreads?

While crude oil prices have moved markedly lower, the spread between UK and US crude oil remains elevated near record highs around \$25/bbl (see Figure 7). Supply outages and low inventory levels in Europe alongside relatively ample Cushing supply have resulted in widening UK-US crude oil spreads throughout much of Q3 '11.

Recent and upcoming developments, however, suggest some tightening may be in store. To start, any further negative news flows out of Europe will likely have a larger downside impact on UK Oil (global standard) over US Oil (N.A. standard) due to its implications for global growth moderation and resultant oil demand deterioration. Additionally, Libyan oil production may reach levels near +300k b/d in the 4th quarter, alleviating some upside UK Oil price pressures resulting from European supply disruptions. Lastly, end of year tax-related benefits may put the UK-US crude oil spread under further pressure with US refiners likely to depress inventory levels for financial benefits.

Overall, we believe crude oil may continue to head lower in Q4 '11; mainly due to the interconnected influences of a further slowdown in the global economy, deteriorating oil demand, and a stronger USD. Accordingly, we believe US Oil may trade within a \$65-\$90/bbl. range and UK Oil within an \$85-\$110/bbl. range in the coming quarter.

Stocks

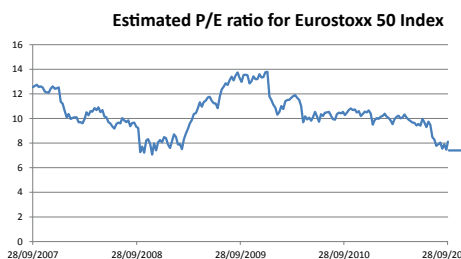
Are stocks cheap enough to buy?

The last few weeks of the third quarter were a bloodbath for global stock markets. Dragged lower by fears about Europe's sovereign debt crisis and weakness in banking stocks the markets are still looking vulnerable as we head into the fourth quarter.

Going forward there are a couple of outcomes for stocks in our view. Firstly, as long as anxiety remains about the sovereign debt crisis then markets may be driven by investor risk appetite rather than domestic fundamentals, with markets remaining extremely correlated and falling in unison. That is the most negative scenario. The second outcome is more positive. It envisages investors starting to see value in global stocks after the sharp falls of recent months. As an example, the Eurostoxx 50 index has fallen nearly 30 per cent since May 2011. This has pushed down the price/earnings ratio (P/E), which is often considered a useful gauge of value in stock

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Figure 8
Estimated price earnings ratio for
Eurostoxx 50 index



Source: Bloomberg, FOREX.com

“The risk is that weak growth feeds into corporate profits, which weighs on stocks prices for the next three months.”

markets (see Figure 8).

The estimated P/E ratio for the European index is back at levels last reached in 2008 – the peak of the financial crisis. US indices have also sold off heavily, although not to the same extent as European markets, hence the P/E ratios for US stocks remains slightly higher than their 2008 lows.

Back then, P/E ratios bounced around their lows for about 6 months between September and March 2008/2009, before embarking on a sharp rebound. Although history isn’t always a perfect fit for the future, it does suggest that we could see some more weakness in stocks for the rest of the year before they start to recover.

Ultimately the outlook for equities will depend on whether a solution to the sovereign debt crisis in Europe is forthcoming and whether we are experiencing a small dip in growth or an outright recession. The risk is that weak growth feeds into corporate profits, which weighs on stocks prices for the next three months.

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