

## G10 FX Views

### Euro

In the months ahead, the market may start to more aggressively price a hike by the Fed, which should provide support for the dollar. Indeed, the dollar has fared well against euro, yet partly because of this performance we would be cautious in jumping onto a bullish dollar trend. The US swaps market appears to be raising some concerns over US sovereign risk and US real yields appear too low given the size of the US's "twin deficits". Of course, the market may ignore sovereign risk and instead focus on cyclical issues in the months ahead. Even there, despite higher US growth, capital is flowing as well to the Euro-area as it is to the US and Euro-area growth pulse has risen. The offsetting forces of US twin deficits and possible Fed hikes should keep the euro relatively range-bound.

### Japan

We recommend buying the yen against the dollar, euro, and pound. All four currencies belong to countries or regions that have poor debt dynamics. But we believe Japan's current account surplus and deflation backdrop makes it the least likely to suffer a fiscal crisis. So maintaining a core long JPY position should benefit whenever sovereign risk rears its head as the major market theme. Indeed, the return of bond risk premia in the US could also see the JPY-yield correlation break down.

On the cyclical side, Japanese growth has been picking up, and we expect it to surprise to the upside over 2010. Already, analysts have been forced to revise up their forecasts (along with the US) in contrast to the static forecasts for Europe. Consequently, Japan is seeing larger equity inflows than both the US and Euro-area. Finally, we must not forget that the yen weakened significantly between 1995 and 2007, the golden period for the yen carry trade, and so far we have only unwound the performance seen since 2004. For the yen to return to its 30-year average level against the majors, it would need to strengthen a further 20%. We think this is a possibility as the world has fundamentally changed since 2007.

### United Kingdom

GBP remains trapped in a battle between UK economic out-performance versus sovereign risk concerns. In the absence of a clear resolution to that battle, EUR/GBP should range trade over the summer. As far as our point estimate forecasts and longer-term views are concerned the combination of solid growth in the UK economy, anticipation of a BoE rate hike cycle, and a backdrop of under-valuation point to EUR/GBP downside. Critically this view also implies on-going progress on the fiscal policy front and also the UK maintaining its AAA rating.

### Canada

From a bigger picture perspective 2010 appears to be a year dominated by sovereign risk issues and also the ongoing recovery in the US economy. Given Canada's linkages to the US and its solid fiscal position both should ultimately be positive for CAD (day-to-day bouts of risk aversion aside). Adding in a solid global growth backdrop and the associated support that should provide to the basket of commodities Canada exports, plus the prospect of significant rate hikes through this year and into next, has us viewing 2010 as a year of significant loonie strength.

### Australia

The global economy has recovered to something like trend-growth in late 2009/early-2010, however AUD has moved to levels on most crosses usually associated with a well-above-trend global economy. This seems premature, especially with the "second-derivative" of the data starting to turn down. Meanwhile the "sweet spot" of growth that is neither too hot nor too cold is increasingly shrinking at these levels of AUD and this far into the recovery. Stronger-than-expected growth would bring earlier-than-expected policy tightening in the major economies. Meanwhile weaker-than-expected growth would also lead to clear downward pressure on AUD. The relative strength of Australia's economy and hence relatively more hawkish central bank will likely fade in 2010. We therefore look for AUD to under-perform CAD, GBP, and NZD. Initially we would expect this most strongly against CAD - with AUD/CAD also likely to suffer from a rotation in growth-leadership from China to the US. On NZD we need to see the real data catch up to the strength in the business and consumer surveys before NZD can start outperforming, while GBP may struggle until we get the UK election out of the way.