26 March 2004

FX Focus remains on Asia

Signs of continued recovery in Asia suggests monetary authorities could allow some currency strength to develop

The focus is now on the Japanese Tankan and FX intervention reports...

...a strong Tankan and confirmation of muted intervention activity will likely add to yen strength

Technical Analysis suggests further near-term corrective pullbacks in GBPUSD provide medium term buying opportunities

FX Strategy – We sell USDJPY and GBPJPY and buy EURUSD

FX Weekly Strategy Summary

Japanese intervention appears to have slowed, allowing Asian currency strength to become a major theme. Indeed, economic indicators suggest brisk growth rates in Asia – in many cases showing initial signs of overheating. The Japanese trade surplus expanded towards a five year high triggered by a 41.3% surge in Asian trade. The implications of the rising trade surplus are straightforward: Japan can afford a higher exchange rate while global demand is expanding. In addition, Japan's trade has become more oriented towards Asia, suggesting that the yen can rally against European currencies and the USD, while having less of an impact on Japanese exports than a couple of years ago. Japan now delivers more than 50% of its total exports to Asia, compared to 38% a couple of years ago. Next week's emphasis will be on the release of the Tankan report and the March intervention data. A strong Tankan report and confirmation that BoJ intervention was muted in March will likely add to yen strength.

Meanwhile, the euro has come under pressure due to increasing signs that the ECB might cut interest rates. Comments by President Trichet and other ECB members point in this direction, citing that Euroland's domestic demand has remained below expectations. Declining interest rate differentials will certainly impact EURUSD in the short-term, but we doubt that reduced rate differentials will reverse the long-term EURUSD uptrend. Relative asset valuation and expected return expectations for financial assets will be crucial for countries funding substantial current account deficits. So far, public and official flows have been more than sufficient to fund the US external deficit, but over recent weeks Asian accounts have been less keen to add USD to foreign reserve portfolios. We doubt that the 'funding gap' left by absence of Asian official accounts can be closed by private flows. Recent flow indicators suggest that foreign accounts are pulling out of US equities and we doubt that US bonds offer any value in the long-term. The USD will stay under pressure and although this pressure will be emphasised against Asian currencies, thus leaving EURYEN under pressure, we expect EURUSD to bounce from levels near 1.19.

Sterling has been volatile, rising early in the week, but reversing its trend thereafter. BoE's King indicated sterling strength risks developing a split economic performance. In fact, booming domestic demand conditions combined with a loose budget suggest the MPC will hike rates aggressively in order to curb domestic demand. If higher rates translate into a higher exchange rate, relative weak exports might weaken further, increasing the divergence between internal and external demand even more. Indeed, sterling tends to follow interest rate trends. The sterling money market curve has steepened and our interest rate model is now showing the largest divergence between the current GBPUSD level and the level predicted by the model, suggesting sterling will rebound.

Emerging Market Summary

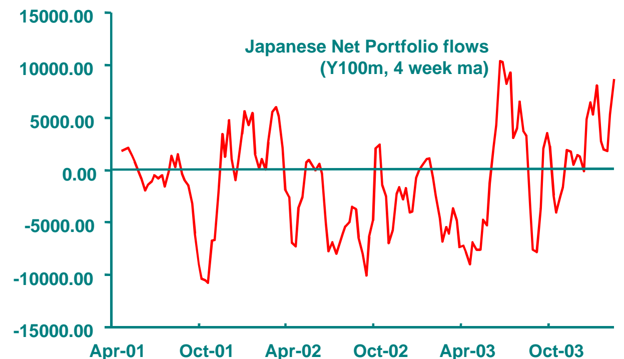
The National Bank of Hungary has begun to take back its insurance policy, cutting rates by 25bp following the sharp appreciation of the forint. Although the move is tentative, it is a reflection that sentiment has improved. EUR/HUF is facing strong support at 250.0, but the yield differential still favours long HUF positions, thus larger cuts are likely. The National Bank of Slovakia also delivered a monetary easing, but in a bolder fashion. Not only were rates cut by 50bp to 5%, but the bank warned SKK's appreciation was too swift, therefore direct intervention could increase. The Polish zloty sold off on uncertainties over Prime Minister Miller's resignation, while the Czech koruna benefited from a surprisingly trade surplus. We view these developments as an opportunity to add on long PLN/CZK positions.

Latam traded on a weak note with USD/MXN unable to break trendline support. We look for a spike in USD/BRL to establish short positions. Finally the South African rand will benefit from the expected euro rebound.

FX Strategy: JPY Rallies as Asia Powers Ahead

- **While the USD is likely to stay weak, it will likely decline most against Asian currencies. EUR/JPY should remain under pressure, but a temporary rebound should be expected from 1.2800.**
- **Japanese intervention has changed style. Ahead of the upcoming G7 meeting in late April we expect only muted intervention, trying to reduce the speed of the yen's advance.**
- **A break of the February USD/JPY 105.20 low should be expected any time soon.**
- **EUR/USD is trading within a range, but its short-term bias remains negative. Nonetheless, a setback to 1.1940 should be viewed as a buying opportunity.**
- **Sterling is expected to remain supported against the USD, but should come under pressure against EUR and JPY.**

Chart 1: Japanese Net Portfolio Inflows



Source: Japanese MoF

Do not fall into the safe haven trap

Fears of terrorism, and the market's perception of increased global growth fears, have increased risk aversion. Equity markets have sold off hard as investors fled to safety, underpinning the typical safe haven currencies such as CHF, EUR and NOK. However, the markets are currently sending divergent signals. While equity and bond markets have priced in increasing global growth risks, the demand for raw materials, including copper and other industrial inputs, has remained strong, indicating that the global manufacturing sector upswing has not yet been challenged. Accordingly, safe haven currency demand is expected to abate as soon as markets see evidence that the global economic upswing is still underpinned. Upcoming data releases, including the US March labour market report and the Japanese Tankan report, and also Q1 corporate earning reports, might finally convince investors to re-establish reflation trades. For currency markets, this means buying JPY and other Asian currencies. Chart 1 illustrates that foreign investor appetite for Japanese assets has increased, and against a strong global expansion, flows into Asia will remain strong. The European currencies that will benefit most from better global growth prospects are GBP and SEK.

EUR/USD trading within a range

EUR/USD has become a mixed bag. While there is a further need for the USD to devalue, capital flows have become euro-negative as foreign investors pull out of euro-denominated asset markets and European companies outsource production to Eastern Europe and Asia. This outflow of capital does not bode well for the EUR, suggesting that it will trade poorly against most EMK and Asian currencies. However, the sharp rise in the gold price over the past couple of weeks might be related not just to increasing risk aversion. There has been talk of Asian central banks buying gold as a diversification of reserves. If this assumption is correct, it would signal that the long-awaited reallocation of reserves by Asian central banks might finally have set in. The implication would be outright USD-negative, and might give EUR some help.

Asian currencies: Upcoming G7 meeting in focus

The Japanese fiscal year-end is in sight, and from April on markets will start to focus on the upcoming G7 meeting on 23/24 April. After two more or less unsuccessful attempts to press Asia to allow its currencies to appreciate, the US and Europe will exert pressure once again. While there might have been good reason for Asia to delay currency appreciation, strong regional growth indicates that Asia is now well positioned to cope with the tighter monetary conditions that would result from currency appreciation.

The Asian economic boom is driven by manufacturing, which is benefiting from competitive cost structures. The Asian manufacturing boom has increased the demand for raw materials, and as long as this remains strong, we must assume that Asian growth is expanding. There have been worries that high energy costs would undermine global growth, and while these are not supportive of growth, it is worth acknowledging that oil prices are largely rising due to increased demand rather than to supply restrictions. China has increased its oil imports by more than 30%, and has tripled its demand for steel. Accordingly, the rise in commodity prices should be viewed in the context of strong Asian demand, but if Asia is expanding strongly, positive spill-over effects will be felt elsewhere. Therefore, there is little reason to get too concerned about high raw material and energy prices undermining the outlook for global growth. However, successful global reflation will push cyclical currencies higher, suggesting a substantially higher yen.

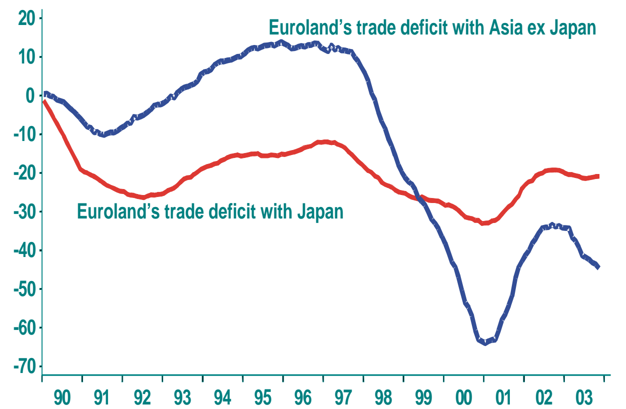
Japan: Domestic demand indications positive

As regards the performance of Asian currencies, Asian domestic demand conditions should be taken into consideration. In previous cycles, Asian currencies saw their strongest gains once export driven demand prompted domestic demand. In many Asian countries (with the exception of South Korea), domestic demand has entered boom-like conditions, and even Japan, which has still to deal with declining consumer prices, is now showing the early signs of consumption picking up. The tertiary index rose by 2.6% in January due to a better consumer climate. However, in the past, it has always been the relative performance of shares in Japanese consumer sector companies that have provided the most reliable signal of whether, and when, domestic demand was picking up. And recently, it has been not only the Japanese and Asian stock markets that have outperformed European and US markets, but consumer sector stocks that have broken higher.

Tankan report will show the way for JPY

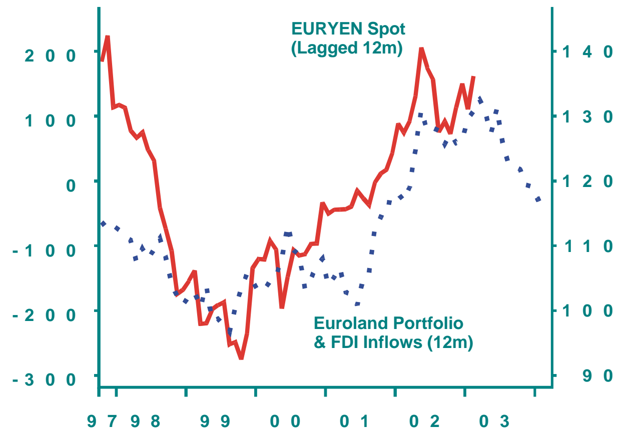
Next week will see several Japanese data releases, including the labour market report and industrial production on Thursday, and household consumption on Friday. The key Q1 Tankan report is due out on 1 April (Thursday), and while in recent quarters the component for large (export oriented) companies has shown the greatest increase in business confidence, we now expect now the index for small and medium-sized companies to report strong gains. Markets will be quick to interpret strong Tankan gains as confirming that domestic demand has finally picked up. Stronger domestic demand conditions will ultimately convince Japan's monetary authorities to tolerate a higher yen. Accordingly, the Japanese authorities will be more open to US and European calls for higher Asian currencies, including the yen, at the next G7 meeting.

Chart 2: Eurozone's Trade With Asia Continues to Accumulate Large Deficits



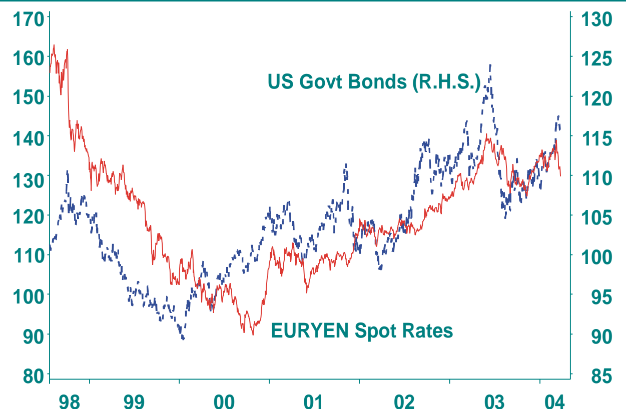
Source: Ecowin

Chart 3: Euroland's Basic Balance Suggests EUR/JPY will Decline



Source: Ecowin

Chart 4: EUR/JPY & US Treasuries



Source: Ecowin

The case for downward momentum in EUR/JPY

January European trade and current account data showed Europe's trade deficit with Asia and Japan increasing (Chart 2). While the eurozone's headline trade balance showed a moderate surplus of EUR 1.2bn, Europe has accumulated high trade deficits with Asia and Japan. It is often argued that cost differentials are so great that an exchange rate adjustment (i.e. lower EUR/JPY) would provide little help in adjusting the trade deficit. However, it must be considered that the eurozone's relative uncompetitive position does effect long-term capital flows. In fact, the eurozone reported large capital outflows in January, with net FDI showing an impressive EUR 11bn outflow. Simultaneously, equity and bond related flows turned negative (Chart 3). While, in the past, European real and financial investment into Asia has been insignificant, investors have now started to look East, seeing higher expected returns on real and financial investment in Asia. We certainly subscribe to this view.

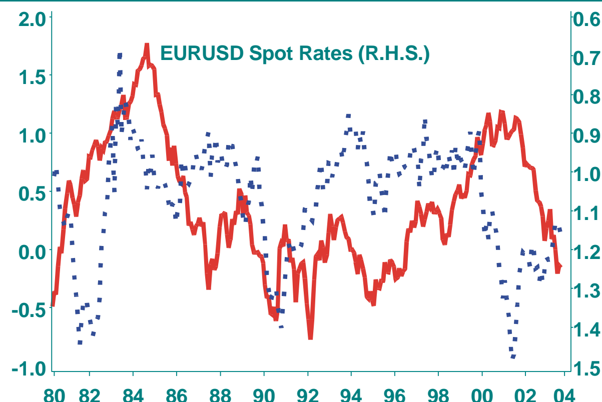
Successful global reflation will push JPY higher

The yen is probably the currency that is most geared to the global and domestic economic cycle. Over recent months, but particularly since early March when the surprisingly weak US February labour market report was released, markets have become concerned that the lack of labour market improvement would undermine the US economy, potentially jeopardising the global economic outlook. These fears are overdone, given that global economic strength does not only depend on only one pillar. Now is probably the first time since the early 1990s that the global economy has experienced synchronised growth. Nonetheless, markets will pay considerable attention to the release of the US labour market report due out on Friday 2 April. Most labour market indicators suggest that payroll employment will increase. The help wanted index has risen, initial claims have fallen and the *Manpower Employment Survey*, to which payrolls data are closely correlated, showed companies boosting hiring plans sharply for Q2. The survey accurately signalled turnarounds in the early 1980s and 1990s, and is giving the same positive message now.

US labour market report: Concentrate on yen crosses

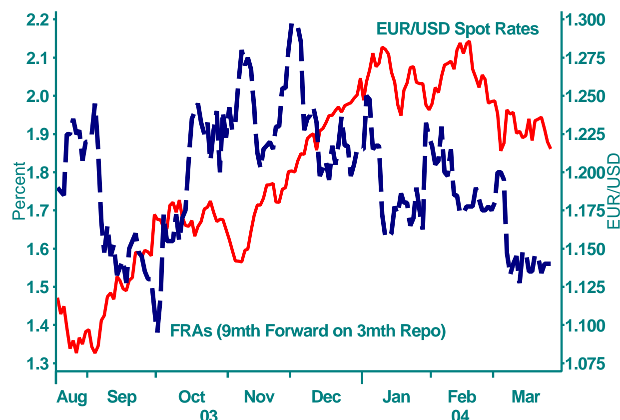
A strong March labour market report is likely to boost equities and will put bonds under pressure - a constellation, which typically boosts the yen on its cross rates, while the near-term impact on USD/JPY might be more mixed. A strong US labour market report supports the yen on a long-term cyclical perspective, but strong payroll data will also steepen

Chart 5: US Payrolls & EUR/USD (inverted)



Source: Ecowin

Chart 6: US Interest Rates &USD (TWI)



Source: Ecowin

the US money market curve, providing temporary support for USD across the board (Chart 5). Accordingly, USD/JPY should trade in a range immediately after a strong labour market report, but upticks to near 108.00 should be viewed as providing a strategic selling opportunity, as we expect USD/JPY to trade around 90.00 at year-end.

Chart 4 illustrates why EUR/JPY might lead the yen advance in the coming weeks. Successful global reflation (a strong US labour report might finally convince investors) will put global bond markets under pressure. Japanese foreign investors are bond market driven, and successful reflation not only means global bond markets will sell off, but it will also identify other investments (namely equities) as being more attractive. Japanese investors are likely to adjust their portfolios accordingly. It was this week that Japan's Government Pension Investment Fund announced that it will reduce its purchases of foreign bonds. Once bonds start to sell-off, Japanese foreign bond investors might even reduce their holdings of foreign bonds.

While Japan is enjoying capital inflows, the eurozone's balance of long-term capital flows has turned to negative. The decline in its basic balance (Chart 3) is due to European corporates increasing their investment spending abroad, with Asia receiving an increasing weighting and foreign investors reducing exposure to European financial markets. These flows suggest that EUR/JPY will come under significant selling pressure. We see EUR/JPY reaching 1.17 early next year.

Sterling: Further strength against the USD projected

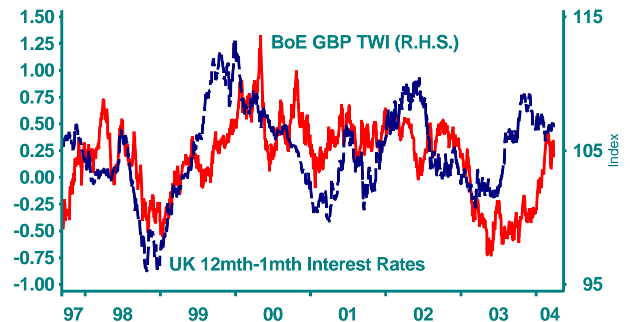
This has been the first time since summer 2002 that the BoE has expressed fears that a strong sterling might undermine the export sector, worsening the current split economic performance. Related remarks by Mervyn King wiped out sterling's gains seen early this week. However, the latest monthly CBI survey revealed a strong pick-up in the UK's export performance and strong global demand conditions will continue to work in favour of the UK export industry.

A loose (pre-election?) budget, strong retail sales, an overheating housing market and strong private credit demand growth suggest the MPC will hike rates. We project a hike in May and August, but emphasise that without recent terrorist fears and related equity market jitters, the MPC would have to rise rates as early as April. Next week's data releases are unlikely to change this judgement. Net consumer credit for February, due out on Monday, should be strong, as consumer credit tends to expand rapidly when the labour and housing markets are strong. March consumer confidence, due out on Tuesday, should feel the impact of the Madrid terrorist attack and the same can be said for the March PMI index, due out on Thursday. However, the overall judgement of the strength of the UK economy should remain unaffected by slightly lower consumer confidence and PMI reports. The sterling money market curve will have to steepen further, and, as Chart 7 shows, the sterling money market is probably the most reliable predictor of GBP.

Oil prices support sterling

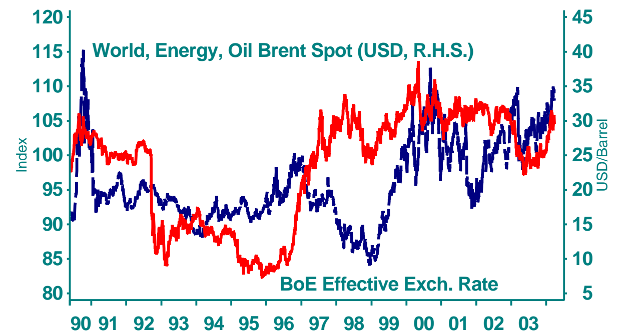
Next to cyclical (interest rate differential) factors, sterling should find additional support from the recent rise in oil prices. The UK is only a marginal oil exporter, but the rise in oil prices is not a negative factor for the economy to the same extent that it might dampen activity in major oil importing countries - not to mention the direct exchange effect working via the trade balance. While in the UK's case higher oil prices do not weaken the trade balance, this is the

Chart 7: Sterling Money Market Curve Predicts Sterling Will Move Higher



Source: BNP Paribas

Chart 8 Sterling Supported by High Oil Prices



Source: BNP Paribas

case in most other European countries (Norway is the notable exception) and the US. Accordingly, higher oil prices work in favour of sterling predominantly against the USD

Bond market bears buy sterling

Reflation trades remain in favour, and last week's terrorist fears have pushed bond markets into overvalued territory. Positive economic news will allow equity markets to recover, leading subsequently to lower bond prices. The UK is the base for large real and leveraged funds, and UK based investors have been the second most important investor group (after Japan) buying USD denominated bonds. Unlike Japanese bond investors, who are both private and official accounts, in the UK's case it has been entirely private funds that have invested in foreign bonds. These private funds are P+L driven, suggesting that sliding bond markets will lead these accounts to take money off the table. High sterling money market rates will provide a comfortable base to park funds that have been taken out of foreign bonds, pushing sterling higher.

Hungarian HUF provoking the Central Bank

- **The swift appreciation of the forint allowed the NBH to deliver a 25bp cut earlier than expected, and there is more in the offing.**
- **The fundamentals are improving sharply, reducing the downside risk, though fiscal concerns persist.**

Rates are still extremely appetising

By tentatively lowering the base rate to 12.5%, the NBH surprised analysts but not the market. FRAs were already pricing in a 100bp cut and since then have further rallied to price the same amount in the next month. Hungary's hefty risk premium had been built up with a view to shelter a sliding forint and in turn put the lid on inflationary expectations. This first tentative attempt also answers repeated calls from the government and clearly indicates the bank's willingness to alleviate the consequences of excessively high front end rates (on both growth and fiscal expenses) while securing a more stable HUF. Indeed, the move has not significantly reduced the interest rate differential, keeping the interest of carry trades alive.

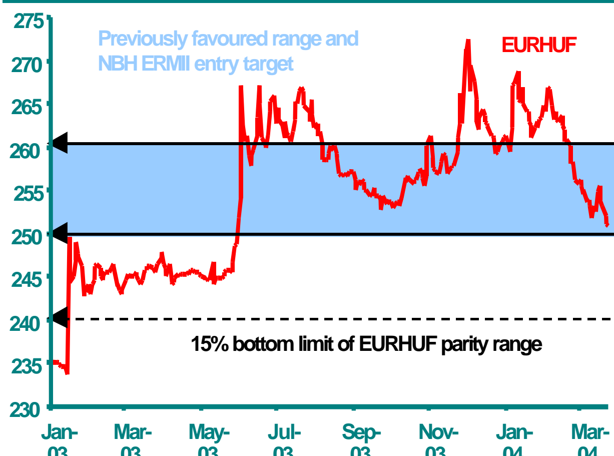
Additionally, the commencement of what is expected to be a new monetary easing cycle could help restore the confidence of long-term fund investors, many of whom were scared away from Hungary last year after a string of unpredictable policy moves from the authorities triggered bouts of extreme market volatility. Real money seems to be already on its way back, particularly in the bond market with foreign investors holding on the rise.

Improving fundamentals to help stronger HUF

Although to some extent, the recent forint rally has forced the NBH to promptly deliver, the key factor behind the rate cut is strongly improving fundamentals of the Hungarian economy.

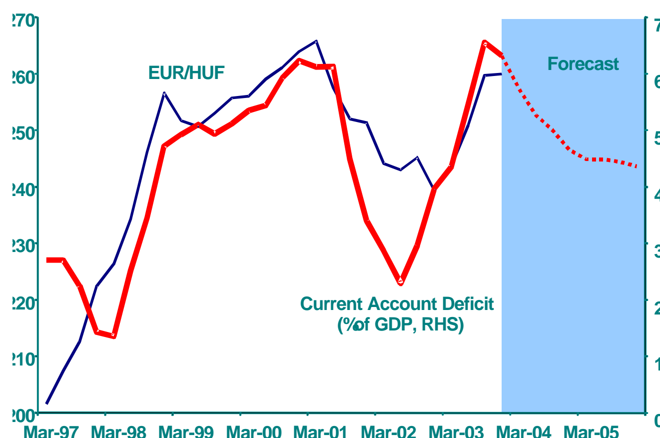
We share the NBH's optimistic assessment of recent changes in the Hungarian economy. Real wages fell sharply in the final quarter of 2003 and, given the wage agreement, they will continue to fall in 2004 (partly thanks to higher headline inflation). This will improve corporate results (as wages will grow less than productivity) and reduce excessive private consumption, which was a major factor behind the wider current account deficit in 2002-2003 and greater demand-driven inflationary pressure. It is also worth noting that a sharply negative fiscal demand effect will be seen in 2004 and 2005. According to the recent NBH *Inflation Report,* that effect will amount to –1.7% in 2004 and –1% in 2005. Thus, despite the budget deficit remaining high (largely due to EU membership

Chart 1: EURHUF testing bottom of previously favoured range



Source: Central Bank of Turkey.

Chart 2: Falling current account to underpin HUF



Source: Central Bank of Turkey. *USD/TRL+ 0.77 EUR/USD

fees and higher debt service costs following last year's 600bp monetary tightening), the central bank does not regard fiscal policy as being loose.

While domestic demand growth, and private consumption in particular, will slow considerably this year, the accelerating EU economy bodes well for export growth. Recent trade and current account data confirm that foreign sales are accelerating rapidly and that deficits have started to fall. We expect this to continue in 2004 and 2005 despite recent signs of slow EU growth. A widening current account deficit in the absence of sufficient FDI inflows was the major fundamental reason for forint depreciation in 2003. Given a rapid transmission of exchange rate moves into inflation, the NBH had to react by raising interest rates sharply. In 2004 and 2005, external imbalances will shrink and Hungary should see stronger net FDI inflows following EU entry.

Weaker consumption growth and a stronger currency will improve the inflation outlook for 2005. With EUR/HUF around 255 and private consumption growth of 1-3% y/y, headline CPI inflation should decline towards 4.0% y/y by the end of next year. Therefore, the NBH will not have to maintain the punitive level of front-end rates and should be able to ease policy gradually. Governor Jarai has said that the central bank will have to be very cautious, since rates cannot be cut significantly when inflation is accelerating. We share this view; but think that further rate cuts will be delivered soon.

The next quarterly *Inflation Report* should present a much better outlook, and the NBH will have the opportunity to explain in detail its optimistic view of the future. This should also be an important step in convincing investors that policymakers will not allow a repeat of the disastrous 2003. Additionally, headline CPI inflation will most likely peak in Q2, before a stronger currency, declining consumption growth and base effects see it fall. Therefore, we expect another rate cut before the end of May.

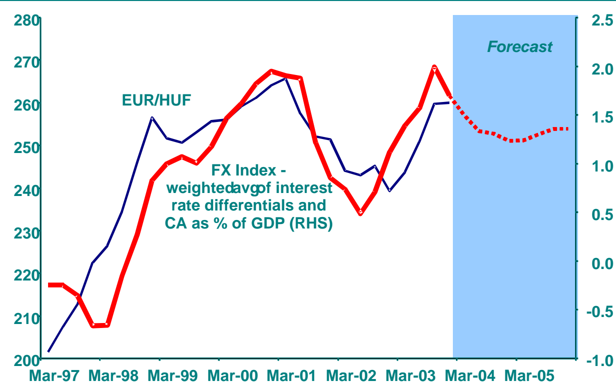
Our index (weighted average) for 2004-2005 comprising the exchange rate (EUR/HUF at 255), private consumption growth (2.0% y/y) and oil prices (USD 30 in 2004, USD 25 in 2005) indicates that inflationary pressures will slow sharply from H2 2004 and bottom in 2005. This will be conducive to a reduction in interest rates to at least 7.5% by the end of next year. By the end of 2004 we expect the NBH to have cut the base rate to 9.5%, removing the last of all the 300bp hike in November 2003.

Hot money and fiscal outlook the main risks

In January, the market failed in its attempts to drive the HUF lower, grew disenchanted and then retreated. This was due to the extremely supportive yield differential coupled to the announcement of the conversion of EUR 1bn from eurobond issuance, directly in the forex. The prospect of discrete HUF buying over the next 11 months had multiplier effects propping up local bonds (lower supply) and pushing the currency back to the bottom of the previously desired trading range of 250-260 against the euro. Although Governor Jarai stressed on the fact that the NBH does not have a particular exchange rate target, speculators still have levels in mind and there is a good probability we could break below there. And after all, the stronger side of the +/-15% official trading range (ERMII like system) will be subsequently just 10 big figures away.

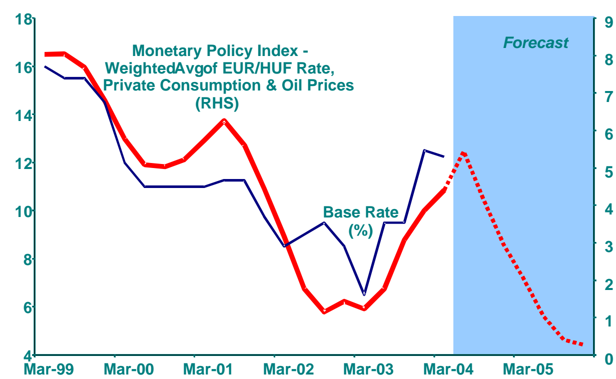
Consequently the NBH will have a delicate task in avoiding both excessive appreciation while limiting risks of sharp profit taking. There is a clear need to lower punitively high front-end rates but a bold move could also trigger reversal given the continuous risk to the budget. Considering that rating agency Fitch is still

Chart 3: EUR/HUF 255 is an equilibrium level



Source: Ecowin, BNP Paribas

Chart 4: Bold Monetary Easing in 2004-2005



Source: Ecowin, BNP Paribas

on negative credit watch a downgrade cannot be excluded.

Short term EURHUF 250 is the focus. Two scenarios are possible. First supported there, the pair is seen rebounding above 251.70, towards 253.10 at first (short term resistance line). Above the latter, a return to 255 is likely. On the central bank's calculations, the long-term equilibrium exchange rate is within the 250-260 range. Such a rate neither hinders competitiveness (the corporate sector complained only when EUR/HUF was around 240), nor does it constrain disinflation. Consequently we expect the 255 level to be the central point of this year's trading pattern, with swings below/above tending to revert towards what we consider the current EUR/HUF fair value.

But the appeal of hefty yield is still very much in place and the market appears to be daring. Hence the second and most probable scenario is another downward leg, straight from the 250 level, towards 248 first and the 240 bottom of the band later on, potentially triggering accelerated monetary easing.

BRL weakness despite strong trade data

- **February's balance of payments figures confirmed that Brazil's external accounts remain robust.**
- **The adjustment of the current account continues and foreign direct investment is returning to the country.**
- **The base scenario for 2004 is very constructive, but the risk factor that must be monitored is the rollover rate of external debt.**

Chart 1: USDBRL struggles to break lower

Source: Ecowwin.

Dollars continue to flow into the country

February's figures confirmed that Brazil's external accounts remain very robust. The surplus on the current account rose from 0.91% of GDP to 0.98% (12-month total). Foreign direct investment reached USD 2.0bn in January-February, remaining stable at 2.1% of GDP (12-month total). The very strong performance continues to be driven by a much-depreciated currency in real terms, high global growth/low inflation, and abundant financial liquidity. We do not anticipate a significant change in these factors in 2004. Thus, the outlook for Brazil's balance of payments should remain benign. But the balanced accounts depend heavily on the rollover rate of external debt. USD 39bn will mature in 2004 and the recent rollover figures indicate that this account could be a source of pressure on BRL.

Surpluses in the current account

In January-February, the USD 0.9bn surplus in the current account was supported by the outstanding performance of the trade balance, which recorded a USD 3.6bn surplus. The performance of exports, up by 17% y/y in the first two months of the year, supported our base scenario for the trade balance for the year: exports of USD 81.5bn (+14% y/y) and imports of USD 54.3bn (+9% y/y), resulting in a USD 27.2bn trade surplus. This would see the current account post a USD 3.9bn surplus in 2004.

But the capital account requires attention

Benign figures were also seen on the capital account. Foreign direct investment reached USD 1.02bn in February, topping expectations, and USD 650mn up to 22 March. The 12-month flow stabilised at 2.1% of GDP, supporting our USD 12bn FDI forecast for 2004. This is a very low level, but high enough to cover Brazil's external financing needs, as shown in Table 1. Additional flows were seen in the portfolio account, which posted a USD 1.1bn inflow in the first two months of the year. But external balance depends greatly on the rollover rate of external debt falling due. In January, the bullish sentiment in the region pushed the rollover rate to 191%. But in February, a political scandal involving key members of the government caused the rollover rate to fall to 85%. For March, the BCB has already announced the rate to 22 March – it fell to 45%. Our base scenario assumes a rollover rate of 80% for the rest of the year, netting a 77% rate for 2004 and resulting in a net outflow of USD 9.2bn. Based on this scenario, and despite the net outflow on the debt front, the USD 9.8bn USD surplus for the year will allow the BCB to work on the rebuilding of international reserves and the improvement of the profile of domestic debt (there is USD16bn fx hedge instruments coming due this year that the BCB should roll-off). But everything will depend on demand from foreign investors for Brazilian assets.

Risks to be monitored

The rollover rate of external debt from now on should be monitored by investors. It will depend on developments on two different fronts:

- Economics – a booming trade balance, low inflation and high growth. These were the developments on the economic front in Q1 04. The conditions for a good year in terms of growth are in place.
- Politics – President Lula has built a robust alliance in Congress, and has set a microeconomic reform agenda for 2004. But everything changed when a political scandal broke in February. The government has managed the situation very poorly, such that a high level of political uncertainty persists. And the greater such uncertainty is, the greater is investors' risk aversion.

Based solely on economic factors, the outlook for Brazil, including the BRL and external debt, is very bullish. Consequently we look to establish short USDBRL positions on weakness potentially around 2.97, into March 31st, once pressure from FX derivative instrument has eased.

GBPUSD Weakness to be Short-lived

- The near-term technical picture for sterling remains bearish and some further losses are now expected
- GBP/USD corrective pullback from the 1.9135 level appears incomplete, suggesting a deeper pullback...
- ...it needs to be seen if it can hold 1.7910. A break of this level confirms a 'head & shoulders' formation, opening downside momentum to 1.7465
- The EUR/GBP rebound is approaching down trendline resistance at the 0.6745 level, with a break above suggesting some further gains to 0.6845. A long-term trend change might be in its early stages
- GBP/JPY has developed a long-term trend change, suggesting impulsive losses in coming months

Sterling has come under renewed downside pressure over the past week, triggering some further near-term bearish signals, suggesting that the current sterling corrective phase is not yet complete, and implying that some further near-term losses are still likely.

Indeed, in the case of GBP/USD, the recent attempt to recover has failed to overcome initial resistance at the 1.8585 level, suggesting that the broad corrective phase from the 1.9135 high is not yet complete. A break below the initial 1.7990 support will trigger a further decline, targeting major medium-term support at 1.7910. A move below 1.7910 confirms a 'head & shoulders' formation initially targeting 1.7790 represented by the 38.2% retracement of the entire rally from the 1.5615 September lows. In this case, GBP/USD would fall back to 1.7465 where weekly trend line support intervenes. However, despite the current short-term bearish signals, the medium-term outlook remains bullish and we would view a pullback into the 1.7375 area as a medium-term strategic buying opportunity. At this stage, renewed gains above the 1.8100 resistance would have to be achieved to stabilise the near-term outlook. But a break above 1.8540/85 would be needed to confirm that a major corrective bottom has been established, putting the focus back on the 1.9135 high and then the 1.95 area over the medium term.

Sterling looks bearish on its crosses. EUR/GBP has rebounded sharply from the 0.6645 level and is likely to put 0.6745 under pressure. Within the next few days, EUR/GBP is likely to consolidate Thursday's sharp gains, taking this currency pair back below 0.6700. However, we view this setback as providing a buying opportunity and once it has breached 0.6745 it will test upper channel resistance at 0.6805. A break of this level would catapult it above the 0.6845 early March high. The change in technical picture suggests altering the trading strategy.

Sterling's technical position against the yen looks even worse. The advance witnessed since summer 2000 (148.70) has developed a corrective structure, but recent highs have not been confirmed by long-term momentum indicators, developing negative divergence. Shorter-dated charts show that the ascending trend coming up from the 179.50 low has been breached, warning that a significant trend change might have taken place.

Chart 1: EUR/USD – Setback to 1.1900/40 represents strategic buying opportunity

After developing a corrective triangle formation since early March, EUR/USD has finally left this pattern to the downside.

Prior triangle support now provides resistance at 1.2250, and a move above this level is required to put a bottom in place.
Strong support at 1.1990/40 is expected to hold.

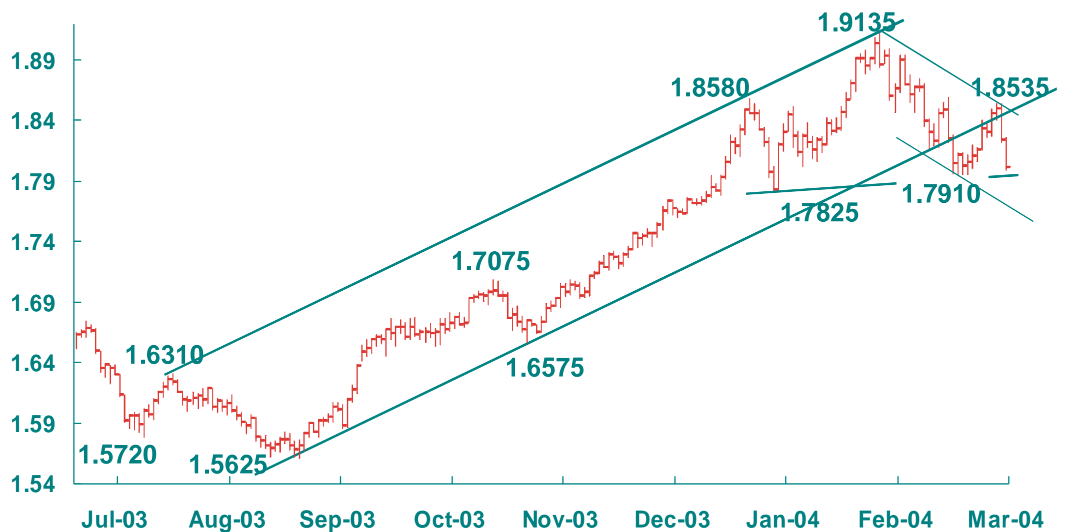
Source: BNP Paribas

Chart 2: GBP/USD – Head & Shoulder formation not yet confirmed

Cable has failed to recapture the ascending trend coming up from the August lows, triggering a sharp setback from 1.8535.

Key support is now located at 1.7910, but a break of this level targets 1.7465.

A daily closing price above 1.8100 is required to stabilise the outlook.



Source: BNP Paribas

Chart 3: EUR/GBP – A rebound towards 0.6845 expected

EUR/GBP has rebounded from 0.6645, suggesting an initial test of 0.6745 and once above here it will move to 0.6845.

Momentum indicators have moved up, suggesting a strong risk of breaking 0.6845, targeting 0.7090 or even 0.7150.
Only limited setbacks should be expected.

Source: BNP Paribas

Chart 4: GBP/JPY – major trendline support broken, implying further losses

The decline from 208 to 191.00 must be viewed within the long-term chart picture.

The advance since September 2000 from 148.70 to 208.00 has not been confirmed by momentum indicators, warning that a long-term impulsive decline might have started.
Upticks to 199.00 are viewed as a sell.

All Technical Charts Source: BNP Paribas

FX Strategy Trading Positions

We remain bullish on Asian currencies and next week could potentially see big moves. The Japanese fiscal year ends on Wednesday and the quarterly Tankan report is due on Thursday. While the end of the fiscal year reduces the intervention risk, a strong Tankan report will provide the fundamental justification for a strong yen. Security flows data suggest foreign investors are buying Japanese equities, while Japanese investors have been busy reducing foreign bond holdings. Flow pressure has built up, and with the market not having established aggressive yen positions, indicated by IMM position data, the yen might have a long way to go.

We have established yen long positions against the AUD and the EUR, and although the euro is likely to correct higher in the week ahead, we intend to add to EUR/JPY shorts near 132.00. GBP/JPY has given a sell signal as this currency pair breached its uptrend, which had been in place since summer 2003. While the chart implications of this break already target significantly lower levels, the bearish long-term chart picture warns that a long-term trend change might have taken place. Bear in mind that GBP/JPY and AUD/JPY were currency pairs where it was profitable to use the yen as a funding currency. Accordingly, AUD/JPY and GBP/JPY liquidation pressure might be substantial, especially if Japan's fundamental data comes in strong, as we assume.

The EUR/GBP turnaround has been convincing, and a setback below 0.6700 is viewed as a buying opportunity. EUR/USD downside potential is limited from current levels, and we re-establish strategic long positions. The rebound in European equity markets looks encouraging given that foreign investors have returned to the market, using attractive valuations to re-establish positions. Equity related flows should help the euro

PNL/CZK has moved sharply higher, breaking the downtrend witnessed since August 2003. The previous downtrend has converted to support currently intervening at 6.90, and we remain long from 6.94, targeting 7.2055.

Currency	Spot	Trade Recommendations	Date
AUD/JPY	79.00	Short at 80.00, stop at 80.80, target 77.50	19 Mar 2004
EUR/GBP	0.6720	Close shorts from 0.6740, buy 0.6680, stop 0.6630, target 0.6900	26 Mar 2004
PLN/CZK	6.9400	Long from 6.94, stop 6.8600, target 7.20	19 Mar 2004
USD/JPY	106.00	Sell 108.00, stop 110.50, target 0.90	26 Mar 2004
EUR/JPY	131.00	Short at 139.00, lower stop to 133.00, target 125.00	4 Mar 2004
Gold	405	Long from 403 and 412 , stop 410, target 450	19 Mar 2004
EUR/USD	1.2100	Buy 1.1980, stop 1.1900, target 1.2700	26 Mar 2004
GBP/JPY	192.00	Sell 197.00, stop 201.00 target 180.00	25 Mar 2004

Implied Option Volatility Analysis

26 March 2004

Chart 1 : EURUSD

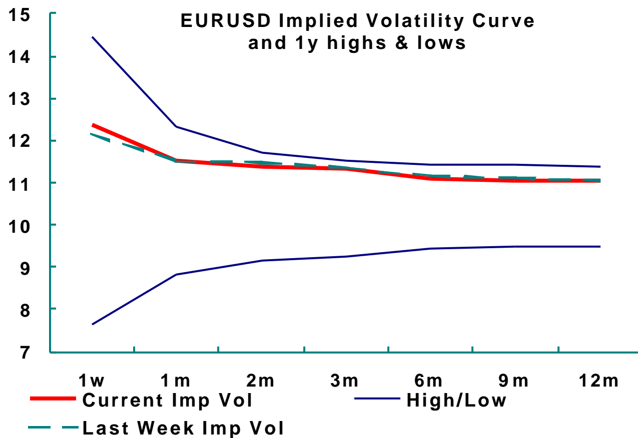


Chart 2 : USDJPY

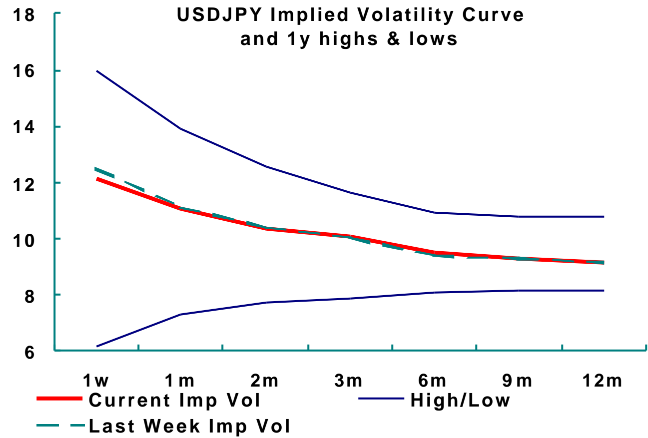


Chart 3: USDCHF

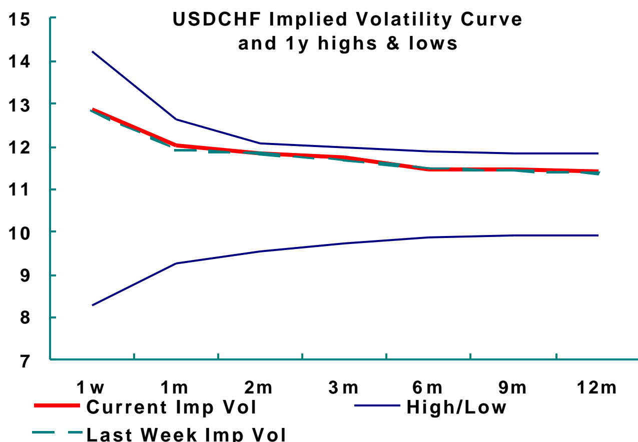


Chart 4: GBPUSD

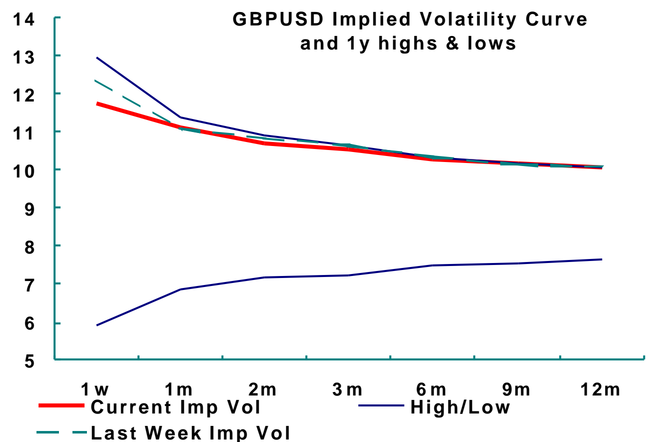


Chart 5: AUDUSD

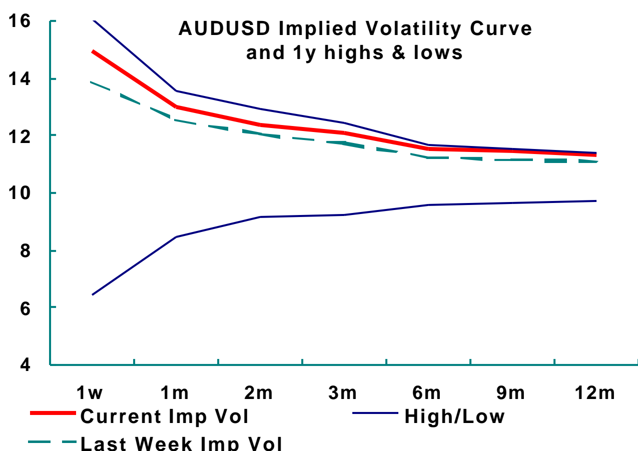
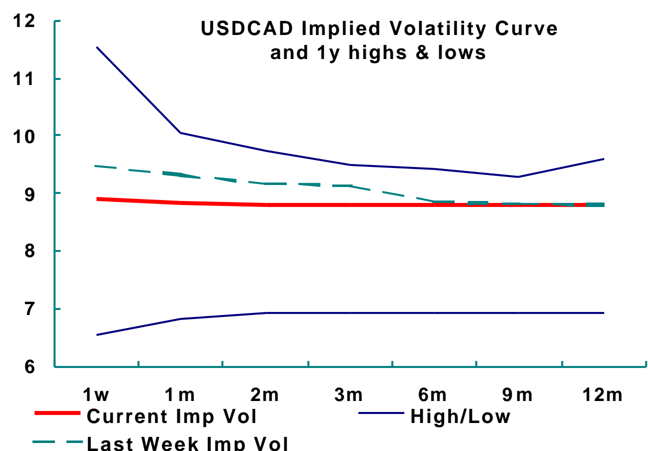


Chart 6: USDCAD

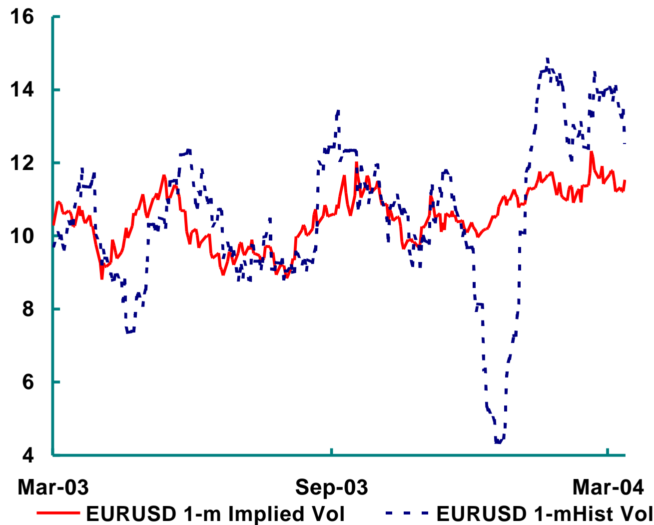


**BNP Paribas FX Strategy: The above charts show the current volatility curves (1-week through to 1-year) for the major currency pairs in relation to the 1-year highs and lows for each of the tenor.*

BNP Paribas FX Options

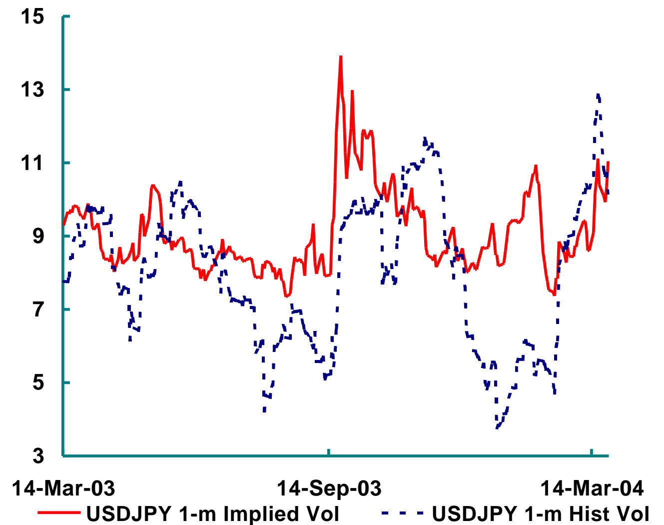
26 March 2004

Chart 1 : EURUSD 1-m Implied and Historic Vol



Source: BNP Paribas

Chart 2 : USDJPY 1-m Implied and Historic Vol



Source: BNP Paribas.

Weekly Option Market Update

Implied FX volatility at the longer end of the curve remains close to the highs of the past year for most of the majors. At the front end of the curve, however, there has been a slight decline in volatility for most of the major currency pairs over the past week. But, that pullback in short-term volatility may well becoming to an end, for the time being at least.

Indeed, in the case of EURUSD, the decline in 1-month implied volatility from the recent 12.30% peak seems to have stalled in the 11.20% area from where a renewed increase in volatility is looks likely. A move back above the 11.75% area would open the way for a further increase in volatility towards the 12.30% high. Indeed, EURUSD spot moved sharply lower over the past week, but there is increasing evidence to suggest that the spot market is starting to develop a bottom. It is interesting to note that the EURUSD 1-month risk reversal moved sharply lower over the past week, back to the -0.25 recent range bottom, from where a strong rebound is currently being witnessed. This behaviour is also consistent with a bottom developing in EURUSD spot.

The sharp decline in USDJPY spot over the past week has resulted in another strong move higher in the USDJPY 1-month implied volatility. Indeed, the 11.10% high has been re-tested and a break above here would open potential for volatility to rise towards the 11.90% area, especially if spot moves sharply lower again. The 1-month risk reversal remains close to recent lows, deep in negative territory.

Table 1 : FX Option Implied Volatilities and Risk Reversals

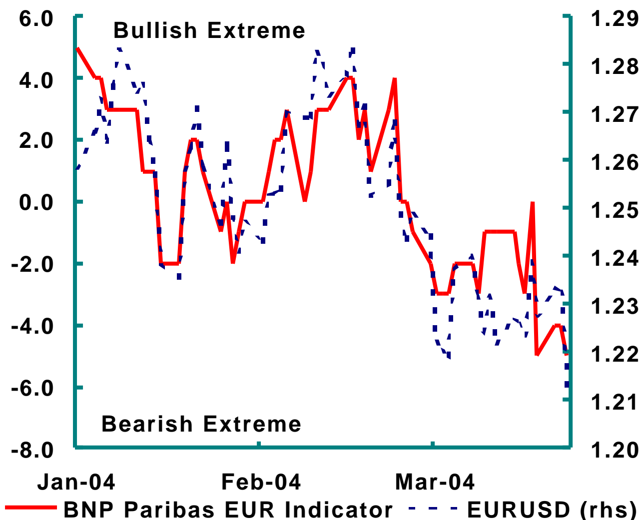
	EUR/USD		USD/JPY		USD/CHF		GBP/USD		EUR/JPY		EUR/GBP		EUR/CHF	
1W	11.2	12.0	10.6	11.6	11.4	12.4	10.9	11.9	12.1	13.1	6.6	7.6	4.0	5.0
1M	11.1	11.3	10.2	10.5	11.5	11.8	10.6	10.9	11.6	11.9	7.1	7.4	3.9	4.2
2M	11.1	11.3	9.8	10.1	11.5	11.8	10.6	10.8	11.2	11.4	7.2	7.5	4.0	4.2
3M	11.0	11.2	9.5	9.7	11.2	11.5	10.2	10.5	10.8	11.0	7.3	7.5	4.0	4.3
6M	10.9	11.1	9.1	9.3	11.2	11.5	10.1	10.3	10.5	10.7	7.4	7.6	4.1	4.3
9M	10.9	11.1	8.9	9.1	11.2	11.4	9.9	10.1	10.3	10.5	7.3	7.5	4.2	4.4
12M	10.9	11.1	8.8	9.0	11.1	11.4	9.8	10.0	10.2	10.4	7.4	7.6	4.2	4.4
R/R	-0.01		-1.79		-0.27		0.15		-1.63		-0.03		-0.38	

Source: BNP Paribas.

BNP Paribas FX Strategy Global Bias Indicator*

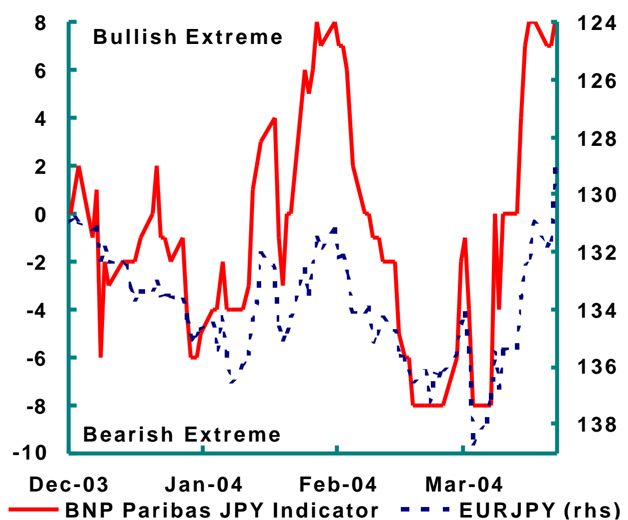
26 March 2004

Chart 1 : EUR Bias Indicator and EURUSD



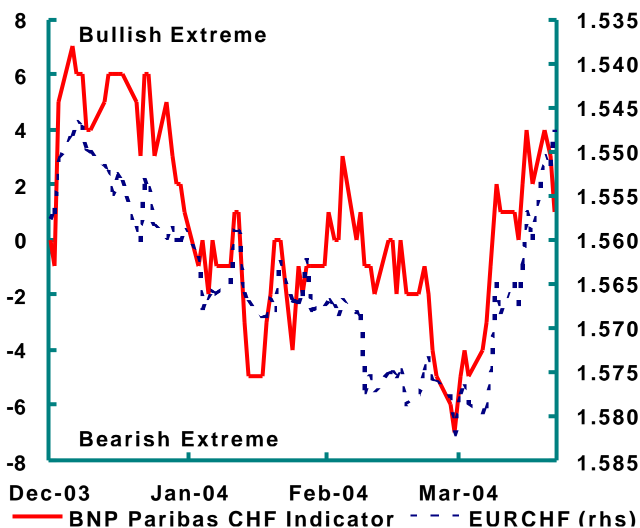
Source: BNP Paribas, Note: The EUR Bias Indicator has maintained its move lower into negative territory, which is consistent with the recent sharp decline in EURUSD. A further move lower cannot be ruled out given that a bearish extreme has not been reached.

Chart 2 : JPY Bias Indicator and EURJPY



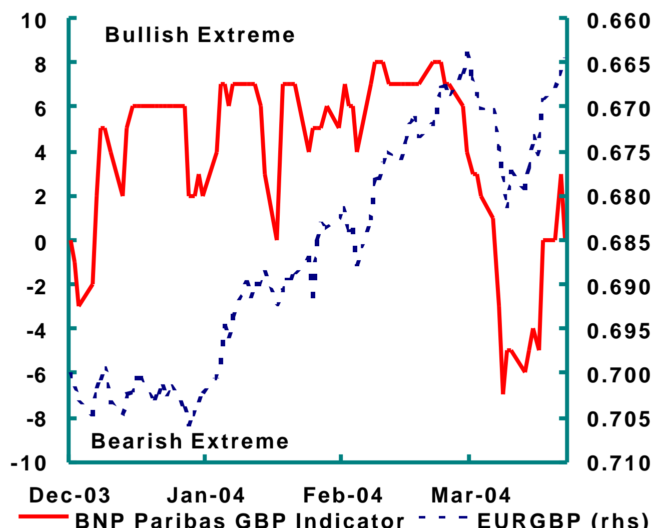
Source: BNP Paribas, Note: The strong rebound in the JPY Bias Indicator has now reached a bullish extreme, suggesting that the EURJPY decline is likely to be limited at this stage and is vulnerable to a corrective rebound when the indictor turns lower.

Chart 3: CHF Bias Indicator and EURCHF



Source: BNP Paribas, Note: The move higher by the CHF Bias Indicator appears to have stalled and is now in neutral territory, suggesting that the recent EURCHF decline is vulnerable to at least a correction, suggesting a EURCHF rebound.

Chart 4: GBP Bias Indicator and EURGBP



Source: BNP Paribas, Note: The GBP Bias Indicator has rebounded, but failed to sustain a move into positive territory. This is consistent with the current EURGBP pullback failing ahead of the recent 0.6610 lows.

****BNP Paribas FX Strategy Global Bias Indicators** are derived from our system of technical trading models and are designed to provide an indication of the overall strength of individual currencies. Bias Indicators at extreme bullish or bearish levels have historically proved to be good leading indicators of corrections or turning points in the underlying spot rate.*

Economic Calendar: 28 March – 2 April

	GMT	Local			Previous	Forecast	Consensus
Sun 28/3			**Europe**	Clocks Change (forward 1 hour)			
Monday	08:00	10:00	**Norway**	Retail Sales (sa) y/y : Feb	4.4%	4.7%	n/a
29/3	07:30	09:30	**Sweden**	Consumer Confidence : Mar	9.1	7.0	9.0
	08:30	09:30	**UK**	Net Consumer Credit : Feb	GBP1.9bn	GBP1.5bn	GBP1.6bn
	09:00	11:00	**Eurozone**	New Orders m/m : Jan	5.7%	-3.7%	-3.0%
	09:00	11:00		New Orders y/y : Jan	13.4%	7.2%	4.3%
Tuesday	23:30	08:30	**Japan**	Unemployment Rate : Feb	4.9%	4.9%	4.9%
30/3	23:50	08:50		Industrial production m/m : Feb	3.3%	-2.8%	-3.6%
	23:50	08:50		Industrial production y/y : Feb	4.8%	5.1%	5.9%
	06:45	08:45	**France**	PPI y/y : Feb	0.2%	0.0%	0.1%
	06:45	08:45		Housing Starts (3-mth y/y) : Feb	13.7%	13.0%	n/a
	07:30	09:30	**Italy**	Unemployment Rate : Jan	8.5%	8.6%	8.4%
	08:30	10:30		PPI y/y : Jan	0.3%	0.1%	0.2%
	10:30	12:30		13 Cities CPI y/y : Mar	2.3%	2.3%	2.3%
	09:30	10:30	**UK**	Gfk Consumer Confidence : Mar	-2.0	-4.0	-2.0
	09:30	11:30	**Belgium**	CPI y/y : Mar	1.3%	1.3%	1.3%
	15:00	10:00	**US**	Consumer Confidence : Mar	87.3	88.0	86.0
				Fed's Guynn & Poole Speak			
Wednesday	01:30	11:30	**Australia**	Retail Sales m/m : Feb	0.7%	0.8%	n/a
31/3	06:45	08:45	**France**	Unemployment Rate : Feb	9.6%	9.5%	9.6%
	06:45	08:45		Job seekers (ILO def. sa) m/m : Feb	-0.9%	-0.4%	n/a
	09:00	11:00	**Eurozone**	Economic Sentiment : Mar	96.0	95.8	96.0
	09:00	11:00		Consumer Sentiment : Mar	-14	-15	-13
	09:00	11:00		Industrial Sentiment : Mar	-6	-7	-6
	09:00	11:00		Business Climate Indicator : Mar	0.01	-0.05	n/a
	09:00	11:00		HICP (Flash) y/y : Mar	1.6%	1.7%	1.6%
	15:00	10:00	**US**	Chicago PMI : Mar	63.6	62.0	61.0
	15:00	10:00		Factory Orders m/m : Feb	-0.5%	0.8%	1.5%
			OPEC	130th Meeting			
Thursday	23:50	08:50	**Japan**	Tankan : Mar	7	12	10
1/4	06:00	08:00	**Sweden**	***Riksbank Rate Announcement***			
	06:00	08:00		***Riksbank Inflation Report***			
	08:30	09:30	**UK**	PMI Manufacturing : Mar	53.2	53.5	53.5
	09:00	11:00	**Eurozone**	PMI Manufacturing : Mar	52.5	52.2	52.6
	09:00	11:00		Unemployment Rate : Feb	8.8%	8.8%	8.8%
	11:45	13:45		***ECB Rate Announcement***			
	12:30	14:30		***ECB Press Conference***			
	13:30	08:30	**US**	Initial Claims	339k	341k	n/a
	15:00	10:00		ISM : Mar	61.4	60.1	59.7
	15:00	10:00		ISM Prices Paid : Mar	81.5	78.0	81.0
				Fed's Moscow Speaks			
Friday	05:00	14:00	**Japan**	Household Consumption y/y : Feb	2.4%	5.6%	n/a
2/4	09:00	11:00	**Eurozone**	Retail Sales (Final) m/m : Jan	2.4%(p)	2.4%	2.4%
	09:00	11:00		Retail Sales (Final) y/y : Jan	1.0%(p)	1.0%	1.0%
	09:00	11:00		Retail Sales (Prel) m/m : Feb	n/a	0.3%	0.0%
	09:00	11:00		Retail Sales (Prel) y/y : Feb	n/a	1.4%	0.9%
	09:00	11:00		PPI m/m : Feb	0.2%	0.2%	0.2%
	09:00	11:00		PPI y/y : Feb	0.3%	0.0%	0.0%
				Ecofin Meeting			
	13:30	08:30	**US**	Unemployment Rate : Mar	5.6%	5.6%	5.6%
	13:30	08:30		Non-Farm Payrolls (Chg) : Mar	21k	125k	100k
	13:30	08:30		Average Earnings m/m : Mar	0.2%	0.2%	0.2%
During		(28/3 – 2/4)	**Germany**	Retail Sales (Real, sa) m/m : Feb	3.1%	0.4%	n/a
Week				Retail Sales (Real, sa) y/y : Feb	-2.9%	-2.3%	n/a

Release dates and f0recasts as at c.o.b. prior to the date of this publication. See our Daily Spotlight for any revision *Source: BNP Paribas*

Long-term FX Forecasts*

USD Bloc	Q2 '04	Q3 '04	Q4 '04	Q1 '05
EUR/USD	1.25	1.28	1.35	1.30
USD/JPY	102	95	90	90
USD/CHF	1.28	1.27	1.22	1.17
GBP/USD	1.87	1.88	1.90	1.81
USD/CAD	1.35	1.34	1.24	1.15
AUD/USD	0.65	0.66	0.70	0.76
NZD/USD	0.57	0.57	0.61	0.67
USD/SEK	7.04	6.80	6.37	6.31
USD/NOK	6.96	6.56	6.15	5.94
Eur Bloc				
EUR/JPY	128	122	122	124
EUR/GBP	0.67	0.68	0.71	0.72
EUR/CHF	1.60	1.62	1.64	1.61
EUR/SEK	8.80	8.70	8.60	8.20
EUR/NOK	8.70	8.40	8.30	7.72
EUR/DKK	7.46	7.46	7.46	7.46
Central Europe				
EUR/PLN	4.65	4.80	4.70	4.75
EUR/CZK	32.50	33.00	33.50	33.00
EUR/HUF	250	255	260	255
EUR/SKK	40.00	40.50	40.50	40.00
USD/ZAR	6.10	5.90	5.50	6.30
USD/TRL	1300	1550	1300	1.25†
Asia Bloc				
USD/SGD	1.65	1.63	1.60	1.60
USD/MYR	3.80	3.80	3.80	3.80
USD/IDR	8200	7900	7700	7800
USD/THB	37.50	36.00	35.00	35.00
USD/PHP	55.00	54.00	53.00	53.00
USD/HKD	7.80	7.80	7.80	7.80
USD/RMB	8.28	8.28	8.28	8.28
USD/TWD	32.50	32.20	32.00	32.00
USD/KRW	1150	1140	1130	1140
USD/INR	44.50	44.00	43.50	43.00
LATAM Bloc				
USD/ARS	2.90	2.97	2.95	2.95
USD/BRL	2.90	2.93	2.95	2.97
USD/CLP	600	570	565	573
USD/MXN	11.12	11.39	11.66	11.77
USD/COP	2669	2661	2653	2686
USD/VEB	1920	1920	2300	2300

*End Quarter † From January 2005 The Turkish Lira will be re-denominated: **1YTL=1mn old TRL**

Revisions highlighted in Bold Italics

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RECOMMENDATION SYSTEM

Type	Terminology	Horizon
Credit Trend (1)	Positive/ Neutral/ Negative	6 months
Relative Value (2)	Outperform/ Market Perform/ Underperform	1 month
Investment Recommendation (3)	Buy/ Hold/ Reduce/ Sell	Up to 6 months

(1) Credit trend is based on underlying Credit fundamentals, business environment and industry trends;
(2) Relative Value is based on expected market performance relative to sector;
(3) Investment Recommendation is based on BNPP Credit Trend and Relative Value opinions.

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