Blue FX Markets
Outlook for Foreign Exchange Markets in 2010

January 2010

As we start a new decade with the global economy emerging from the worst recession of the post war era, 2010 is expected to be a pivotal year on the path to economic growth and development for the next decade. 2009 maybe behind us but the road in front is still hard to navigate.

Several key themes will dominate the ebb and flow of foreign exchange rates in 2010. In recent months, the US, Europe and even Ireland have shown prospects of recovery and people are on the whole bullish for the new year. Interest rate rises and exit from stimulus programme are likely to be on the agenda, which will strengthen currencies.

Headwinds are forecast in the sovereign (government) debt markets. Turmoil has already resulted in Greece and Dubai being headline stories in late 2009. This will be the key risk for 2010 as countries such as the UK, Spain and Ireland face up to mounting deficits and increased borrowing needs and costs. The UK and the Pound may suffer substantially from fears over financial health in 2010.

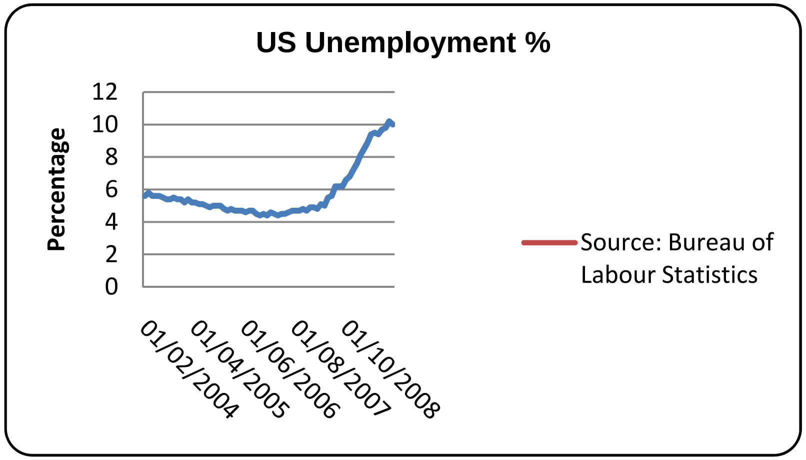
Political risks are also likely to raise their head especially in the UK and the US. The former is expected to have an election before the end of May and the Pound is likely to experience volatility in the run up to this as the various parties outline their economic manifestos. Iran has continued to sabre rattle in the Middle East and the US will introduce new sanctions early in the New Year. Continued uncertainty in the region will result in dollar buying, as people look to secure funds in what is seen as the ultimate safe haven.

United States

After over two years of economic contraction the US has started to stabilise. Key metrics to watch in this market are unemployment and house prices.

The former has improved markedly with the recent Non Farm Payroll data showing just 11k jobs were shed in November 2009, shifting the unemployment rate from 10.2% to 10%. Expectations are that job creation is on the cards for 2010 and if the current trend continues this is likely to be early 2010. In this event, inflation expectations will rise and rates will rise. However, a lot of job creation in the latest payroll reports was temporary or seasonal so it is likely there be a blip or two before we witness real job creation at the end of Q1. US Unemployment is the single most important economic event to watch in 2010. The quicker unemployment falls, the quicker rates will rise and the dollar will increase against the Euro and Pound.

This recession started with mortgage defaults and will end when the housing market stabilises. House prices are central to the US economy as they bear on consumer confidence and also bank willingness to lend. The tide has clearly turned in this respect. House price affordability is at a 30 year low in the US and inventories are down by 26% from their peak. Low interest rates for the foreseeable future also bode well for US house prices but stabilisation in property will boost economic confidence and the banking sector, boosting the dollar.



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United States

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A key risk to the US and the Dollar is the ongoing tensions in the Middle East, particularly in Iran. The US has engaged with Iran and has tried to negotiate in relation to the recent Uranium enrichment process but so far success has been limited. Ultimately, negotiations will fail and 2010 will see sanctions imposed on Iran as Obama builds a coalition of European, Russian and Chinese support. Israeli sabre rattling will make the situation urgent.

No strike is likely to take place in the first half of 2010 as the countries wait to see how sanctions work. Israel is also unlikely to strike during the summer, as the holy month of Ramadan takes place in August, so it makes a strike in late 2010 a possibility. This will impact the Dollar as any major geopolitical events such as this will lead to swift and strong increase in the dollar against the Euro and the Pound as US Treasuries are seen as the ultimate safe haven.

An increase in employment and further stabilisation in the housing market will prompt the Federal Reserve to raise rates in 2010. Signs of this, especially the former, will result in material dollar strengthening against the Euro and Pound.

Key Event to watch

The timing of interest rate hikes in the US is the topic of most discussion on 2010 at present. Current projections indicate that the Federal Reserve will raise rates in the latter part of 2010 (Q3) but sooner than some expectations of early 2011. If rates move earlier, the dollar will strengthen considerably against the Euro beyond year end levels (1.43) to below the 1.40 mark.

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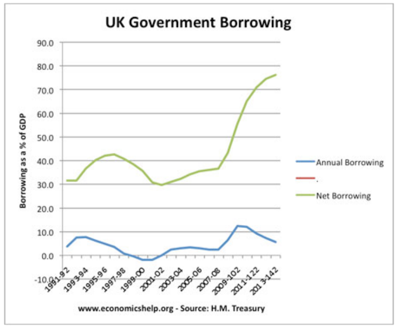
United Kingdom

The UK is one of the sick men of Europe and will remain so in 2010. Economic recovery in 2009 has relied on quantitive easing and a weak exchange rate to prop up performance and stimulate exports.

The Bank of England (BOE) has indicated that they will begin to withdraw stimulus in early 2010 and may wish to weaken the Pound further as an unofficial stimulant. Inflation expectations are high for the UK in 2010 at 3%, which has implications for the Pound. The BOE has a target of 2% inflation and will overshoot this in Jan 2010, which, if continued in the early part of next year will put pressure on them to raise interest rates. When interest rates rise so does the currency and these expectations have offered support to the Pound over recent months.

However, the UK will need to borrow substantially in the debt markets next year and will be one of the most indebted nations in 2010, along with Greece, Ireland, Italy and Spain. The UK Treasury will want to keep rates low in order to trim their borrowing costs so the BOE may obtain a reprieve from inflation targeting. This will put pressure on the Pound and is likely to weaken it against the Euro.



A general election is due for the UK in the first 5 months of 2010. Recent polls have pointed to a hung parliament with no clear majority going to either side. In this event, sterling will weaken as this scenario will dilute the resolve and ability of any new government to deal effectively with the ballooning deficits.

The Pre Budget report that Alistair Darling gave this month set the tone for the election with vague promises on reducing the deficit without saying how. The two most memorable aspects to this pre budget report were a tax on bankers bonuses (highly political) and a reduction in bingo tax (highly irrelevant)!
The media interest in the former cleverly disguised the fact that Budget Report was scant on detail and ideas.

The UK is likely to be the new Greece in 2010.

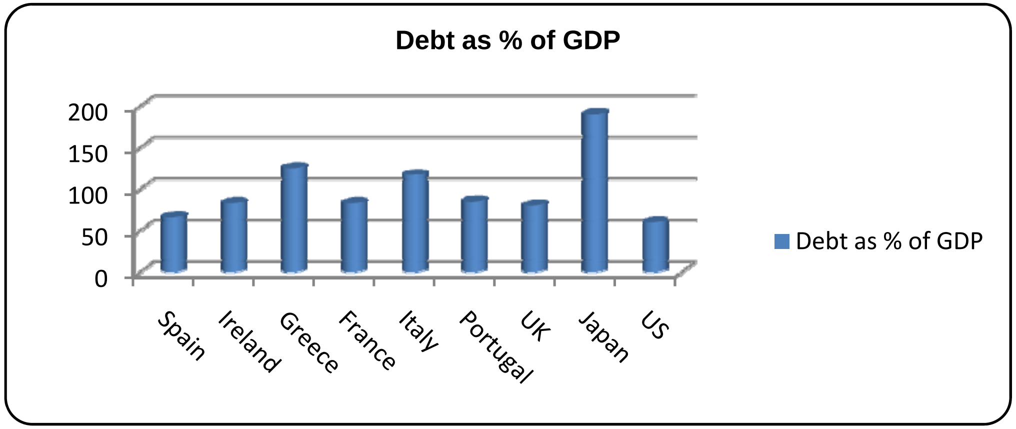
Key Event to watch
Exiting stimulus – mixed messages have emanated from the BOE members over the past few months.
Raising Public Debt – Ongoing travails in sovereign debt markets will weaken the Pound overall. However, bear in mind that this will weaken the Euro also, so may not impact the EURGBP cross that much.
Election – Who will win? Will it be an overall majority?

Eurozone

Despite a exhibiting an early array of ‘green shoots’ akin to the Chelsea Flower Show, the wheels fell off the Eurozone ‘recovery’ story after the German election. The cash for clunkers schemes in Germany and France provided a temporary lull in economic decline, which has since dissipated in Q4.

The Eurozone exited recession in the second half of 2009, largely driven by good news from Germany and France. This was largely behind the strength of the Euro against the Dollar and the Pound. Recent developments, in particular Greece, have weakened the Euro.

The key issue impacting the Euro next year will be sovereign debt. Ireland, Greece, Portugal, Spain, Italy, France all demonstrate huge public debt ratios relative to GDP[see chart below]. The impact of these ballooning borrowings will be a downgrade of more countries which in turn will put pressure on the Euro as a currency. It is likely to weaken the currency in the market and lead to renewed question marks over its existence and success. If Germany have to bail out Greece out for example, they will want a say in how they get back to fiscal health. This is unlikely to go down well in Athens and will lead to a highly politicised standoff in the Eurozone. This may lead to exits from the Euro, especially for Ireland, Greece and Spain.



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Eurozone

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Any further worries over the UK or Eurozone will result in weakening of the Pound and Euro respectively, particularly in relation to the Dollar. Due to further political issues in the UK, Euro/ Pound should remain between the £0.85 and £0.92 mark for most of the year. [See separate section on rate forecasts]. Sovereign debt issues will make this rate volatile – if they arise in the Eurozone the Euro will sell off and will fall below £0.85 – if they arise in the UK, swift moves towards parity will be back on the cards.

Aside from this, German economic performance will be largely driven by economic recovery worldwide. Germany is heavily reliant on exports so if the US, China and other European companies continue to etch out economic growth then Germany will continue to prosper. Germany is less sensitive to a strong Euro. An additional recent development in Germany in a slow down in bank lending to companies and individuals. This has sparked discussion over a renewal of the credit crunch as the German banking industry still has a lot of deleveraging to do.

Key Event to watch
Sovereign Debts as discussed above
Renewal of the Banking and Credit Crisis especially in Germany

Ireland

Recent data illustrated that Ireland technically left recession in the third quarter of 2009. However, the numbers were nothing to shout about. Ireland did receive rare positive headlines in the latter part of 2009 for a credible effort in tackling the country's budget deficit. Discomfort about the Greek situation led to a question marks over Irish debt, which were allayed after a stringent budget.

There is no secret or surprise that the principle driver of the economic environment in Ireland next year will be the banking industry.
Firstly, the main banks will need to raise capital, estimated at approximately €8bn between them. However, this is roughly 3 times their market capitalisation and with banks across Europe queuing for equity, investors may decide to go elsewhere. It is not beyond the imagination to expect one or maybe both of the banks to be nationalised in 2010, which will put further pressure on Ireland's sovereign debt grading.

Secondly, bear in mind also that the government guarantee on liabilities expires in Autumn 2010. If bank recapitalisation has not taken place or is not underway, this could result in an outflow of corporate deposits (and personal) from the Irish banks, which will be of further detriment to their financial and funding positions.

Credit availability will remain weak throughout next year, which will restrain economic recovery.

One bright spot in 2009 has been the remarkable resilience of the Irish exporter. Irish exports held up better than any other Eurozone economy despite the strong Euro. As economic recovery takes place in Europe, the US and the Far East, this is likely to pick up.

Overall, 2010 should shape up to a successful business year for many companies as 2009 is put behind them.

Key Event
The bank recapitalisation story is the pivotal one of 2010. A botched attempt at raising finance will put pressure on the Irish banking system and may result in Irish sovereign debt downgrades as nationalisation becomes a greater possibility.

Interest rates and Exchange Rates

These predictions are based on consensus estimates from various investment banks, brokers and economic research.

Central Bank Base Rates in 2010

2010	Q1	Q2	Q3	Q4
UK	0.5	0.5	1.00	1.00
US	0.25	0.25	0.25	1.00
EU	1.00	1.00	1.00	1.50

Foreign Exchange Forecasts in 2010

Base scenarios:
- Interest rates as above
- Renewed dollar weakness in first half of 2010 as Central Banks cools early rate hike expectation
- No political risks such as Iran or sovereign defaults built in

2010*	Q1	Q2	Q3	Q4
EUR/USD	1.50	1.46	1.40	1.40
EUR/GBP	0.92	0.94	0.87	0.83

***These rates should only be taken as an indication. Rate expectations are quick to change with political events, economic news and unforeseen events.**

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