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Presents

Forex Outlook Q1 2012

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Introduction

Welcome to the second quarterly forex outlook from Forex Crunch. This follows the previous report for the fourth quarter of 2011.

The essay commences with a quick summary of the Q4 2011, which saw rising global tensions, rising uncertainty and a significant worsening of the economy situation. It then continues with a deep analysis of the main market themes.

The themes section now leans towards scenarios for every theme with possible impact on relevant currencies.

Specific currency outlooks follow. Each currency outlook consists of two parts: a fundamental overview and a high time-frame technical analysis. A timetable of key events in Q1 and some extra additional notes for forex traders wrap up the report.

Following some feedback, there are some small changes in this report. As always, feedback is more than welcome. I'd love to hear your comments at yohay@forexcrunch.com. One question of higher interest is the frequency of this type of reports: should it remain quarterly? Or monthly?

Contents

Summary of Q4

The last quarter of 2011 can be summarized by more leg dragging and a downturn in many countries. But not all the countries experienced the same effect.

In addition, the new tensions in the Middle East kept oil prices from dropping, despite lower demand. The price of fuel adds fuel to the fire.

US Avoids Recession

The US posted a 1.8% annual growth rate in Q3 and showed many encouraging signs in Q4. This included upbeat retail sales and durable goods orders, positive PMI numbers and a gradual yet meaningful drop in unemployment.

The Federal Reserve didn't change policy in its meetings during Q4. Operation Twist, to lower long term bond yields continued as planned. The pledge to keep interest rates at low rates until mid-2013 remained unchanged. Both measures were taken in Q3.

The political scene was more quiet, as expected. The "Supercommittee" failed to reach an agreement regarding cutting the long term deficit of the US. Nevertheless, this wasn't accompanied by too much noise from the media, so the dollar wasn't bothered. Automatic cuts will now be applied.

The political scene saw more action from the payroll tax issue, but also this had a limited effect. The presidential campaigns are now of higher importance.

European Endless Summits

Yet another stormy quarter was seen in Europe. EU Leaders needed two consecutive summits in October to reach a deal on a 50% haircut for Greece and leveraging of the EFSF bailout fund.

Yet the expected failure materialized fast. It took a few weeks to understand that China will not really help with leveraging, and that no financial tricks will work. It took only days until the Greek Prime Minister George Papandreou announced a referendum to approve the deal.

Frustration with this move sent money fleeing from Greece. It also triggered a rebellion within the ruling party in Greece and an unprecedented public threat by Germany and France to expel Greece out of the euro-zone.

Lukas Papademos, an ex ECB banker was appointed to replace Papandreou with a national unity government. The aim was to bring forward reforms with the trust of the Greek public.

Trust is fading fast and reforms are deep in the mud. Greek unemployment continues rising, budget deficits are missed and the promised 50% haircut (**P**rivate **S**ector **I**nvolvement) is stuck in negotiations. With the current deterioration, 50% won't be enough.

Central Bank Activism

The distrust in Europe was clearly seen in banks. Interbank loans dropped, and banks parked more and more money with the ECB. In addition, European banks were starved out of dollar funding.

The Federal Reserve, ECB and 4 other banks made another coordinated move and cut swap rates for dollars by 50 basis points. This gave some help to troubled French and German banks, although they remain on the edge.

In addition, the ECB under Mario Draghi changed course. It didn't launch direct US/UK QE. Germany objects that. But Draghi reversed the damaging rate hikes imposed by Trichet in his two rate decisions.

The bigger action was opening the doors of liquidity: the central bank increased its cheap lending to banks and offered two new three year loans, with "full allotment" – this means that it gives money to everybody and accepts lower levels of collateral – lower graded sovereign debt.

The first operation saw almost €500 billion of loans taken by banks. This might have saved them from an outright "Lehman moment" – a terrible credit crunch.

But there also was another goal: encouraging banks to buy sovereign debt, especially of Italy. This didn't happen, and Italy pays a dear price in every auction. Every recycling of debt sends Italy deeper into the mud.

On the other hand, Spain managed to decouple from Italy. Spanish yields rose towards the November 20th elections but dropped back quickly afterwards. In the primary market, Spain had quite a few successful bond options.

It seems that the ECB is rewarding Spain for better compliance with austerity but also Spain's lower debt-to-GDP ratio.

More Cuts and a Recession

The sovereign debt crisis, banking squeeze, austerity and low trust weigh on the economies of all euro-zone countries. S&P warned all of them about a credit rating downgrade. France could get a two notch downgrade, and Germany is not immune.

Even the country at the core of the core had one bad bond auction and is seeing significant drops in confidence. Germany sticks to its stand against QE and funding other countries but adopted a different approach to fiscal union: balanced budgets, by law.

The last summit for 2011, held at the beginning of December saw a declaration to put automatic debt reduction schemes into laws in all countries. Only Britain stayed out and prevented a treaty change.

In the long run, this may be the road to stronger unity and mutual help. In the shorter term, this doesn't solve the current crisis and could only worsen it.

British QE2, Japanese Intervention and Chinese Landing

The Return of the King

The ECB isn't alone in activism. After many months of no change in policy, the Bank of England expanded its QE program by 75 billion pounds. The move by Mervyn King and his colleagues comes despite high inflation, but in fear of the deteriorating situation. The effect on the pound wasn't that strong.

Unemployment is indeed on the rise in Britain, but the country could still escape recession. House prices and PMIs have stabilized in the UK during Q4.

Japan Helps Exporters

In a move that seemed to aid exporters at the end of October, Japan intervened in currency markets once again. The move managed to lift USD/JPY to a higher range but the pair's trading froze.

Exporters are indeed in trouble, and this was seen in a surprising trade balance deficit seen in Japan.

China Reverses Policy

The Chinese housing bubble is bursting at an alarming speed. House prices are falling everywhere and more sad stories are heard about loan sharks and suicide.

After lifting the Reserve Ratio Rate several times in order to curb inflation, China changed course and cut it.

Global Themes

Most of the themes seen in Q4 are relevant in Q1. The roundup of themes goes from West to East, starting in the US.

US Locomotive

American Reverse Decoupling

The US managed to continue growing throughout 2011 while the rest of the world slowed down. The 2008 financial crisis gave birth to the "decoupling" theory where China continued growing rapidly while the West was sinking.

Indeed, while China and other Asian countries were slowing down during the end of 2011, and while Europe most likely entered a recession, the pace of growth picked up towards the end of 2011. Q3 saw an annualized growth rate of 1.8% and estimations for Q4 stand on 3%.

What are the reasons for this growth?

1. **Successful Sales Season**: Since Thanksgiving, American consumers are busy buying. This is especially seen in purchases through the internet and through mobile phones. While this was often pushed by significant discounts, consumption is around 70% of GDP.
2. **Tax Incentives**: At the same time that manufacturing purchasing indices (PMIs) dropped into contraction levels in Europe and flirted with these levels in China, the US saw continued growth. One of the drivers is tax incentives offered to manufacturers.
3. **Stability in home prices**: There are arguments about whether the US housing market has already reached a bottom. There is gap between multi-family homes and single family homes or between apartment buildings and villas if you wish. Multifamily homes are probably doing better and are perhaps off the bottom in terms of prices while single family homes are left behind and dragging prices lower.
4. **Private Sector Employment**: Recent months have shown a steady trend of job gains in the private sector. At first, the pace was enough to counter the government layoffs and to keep the unemployment rate from rising. It now

seems that this gain in jobs is gaining traction and managing to push the unemployment rate down.

All these have contributed to growth in the economy. The first quarter of 2012 will see publications of data from the Q4 2011, especially with the three publications of GDP. The question is: Will this continue?

More Growth in Q1

Some of the positive factors will continue and some will diminish:

1. **Sale Season Over, But Wait**: While the traditional sales season is over, there is still hope due to one factor in recent economic activity: inventories. Inventories are also part of GDP and they have been dwindling down. Replenishing of inventories in Q1 could replace strong consumption and provide more economic activity.
2. **No more tax incentives**: Apart from incentives that have expired, the payroll tax cut has only been extended till the middle of the quarter. With the political deadlock in Washington, any measures that need to be taken will probably not be taken, and this will weigh on the economy.
3. **Home prices trend to continue**: US banks will likely suffer from the European troubles, but with the deleveraging process well underway, this isn't likely to stop the recovery, or at least the bottoming out of the US housing sector. Some regions will do better than others, but the encouraging trend will likely continue.
4. **Employment Trend Likely to Change**: The political deadlock in Washington will likely weigh on the economy in two ways – more government layoffs that will drag Non-Farm Payrolls lower and no new tax incentives.
5. **External Headwinds**: The "reverse decoupling" cannot last too long. With a European recession likely confirmed soon and the escalating debt crisis, the US locomotive will have an uphill struggle. In addition, higher oil prices for a longer period of time also add to the struggle. Both topics are detailed later on.

There is one highly regarded research center that is predicting a full blown US recession. Lakshman Achuthan of ECRI repeated this call, based on "contagion in forward looking indicators". Puzzled by this term? You're not alone.

Things look positive now, but the political deadlock and global trouble weigh on the US. So what will the bottom line be?

A slowdown in US growth in Q1 2012 compared to Q4 2011, but no economic contraction. Not yet. The US has enough strength to continue growing during this quarter.

In the current environment, strong US growth is bad for the dollar, while US weakness triggers risk aversion which helps the dollar. The middle path of slower growth will likely strengthen the dollar modestly and leave the scene to other themes.

QE or Not QE – Doves to Fly Low

Voices for a third round of Quantitative Easing have been heard since QE2 ended in June 2011. This process, in which the central banks prints money, had a critical impact on currencies: the dollar dropped during the QE2 period and rose after it expired. This was a choppy process but a very evident one.

Buying treasuries or mortgage based assets lowers yields and is supposed to encourage people to lend more from banks and stimulate the economy.

Past QE

- **QE1 Success**: The first round of QE, from March 2009 may have helped in that manner: it stabilized the financial situation and allowed a first wave of recovery. QE2 already had a different purpose: prevent deflation. A situation where prices are falling discourages people to buy, as they are waiting for prices to further drop and this weighs on the economy.
- **Lending Cannot Be Extended**: QE2 succeeded in preventing deflation but didn't encourage lending. Banks are still in the process of deleveraging and licking the wounds from the financial crisis. In order to maintain more balanced and less leveraged balance sheets, they lend less money, contrary

to what led to the crisis. In addition, the Federal Funds Rate is almost at 0%, and will stay there for a long time, at least until mid-2013, according to the Federal Reserve. And still, lending is weak and will likely remain so.

- **Commodity Inflation**: QE2 also had problematic side effects: apart from pushing bonds higher (thus lower yields) it pushed up commodity prices – oil and food. So sure, deflation was prevented, but these high oil and food prices leave spare income for people to consume.

Why No QE

Yet there are still voices that support a third round of QE. Why?

1. **Doing Something**: The Federal Reserve doesn't want to show it is out of bullets. In addition, with the political deadlock in Washington, many look to the central bank for some decisive action.
2. **Tackling Mortgages**: With government bond yields so low, the Fed can now move to lowering mortgage based assets and try to encourage people to recycle their mortgages. This has some logic in it, but it cannot happen with a push of a button: too many homeowners are "underwater" – with mortgages exceeding the current price of their homes. On the other side, banks might be reluctant to look into these assets, many of them being toxic.
3. **European problems**: The last FOMC statements expressed concern about the situation in Europe, and it sometimes seemed that the Fed is looking for a reason to hit the QE3 button.

The composition of Federal Reserve voting members changes every year. Various researches have shown more monetary doves have a voting right in 2012.

But QE3 isn't likely in Q1 2012. Why:

1. **Deflation not a threat**: Oil prices remain elevated and with current tensions in the Middle East, they have more room to rise and push prices up.
2. **Employment is still rising**: The Federal Reserve has a dual mandate of maintaining price stability and maximum employment. No significant

deterioration employment is expected in Q1. Even we do see a downturn, the Fed will likely wait before acting – wait also with hints to after the first quarter.

3. **Doves not alone:** The voting members in the FOMC are not alone. They are influenced by other members, some of them hawks that objected Operation Twist and the pledge for low rates until mid-2013. In addition, despite the call for "doing something", there is growing opposition towards excessive monetary activism, especially with hopeful presidential candidate Ron Paul preaching to "end the Fed".

The chances of QE3 that leans towards mortgage based assets exists, but this is likely a theme for the second quarter of 2012 rather than the first.

US Politics Heating Up

The United States entered an election year. I'll try to keep the debate focused on the impact on the economy and the dollar, without diving too deep into American politics.

The question for the dollar is the level of uncertainty. If the picture will clear up, this will help the dollar, while high uncertainty will weaken it.

On one hand, incumbent president Barack Obama wants more economic stimulus to boost the economy or please voters (depends on your point of view). His candidacy is secure as he is the only one running in the Democratic Party.

The heat comes from the Republican side. The primary season began and might also see a clear winner in Q1. The leading candidate is Mitt Romney. He might provide strong pre-election rhetoric towards China and may be labeled as a conservative due to his Mormon religion affiliation. Yet the differences between him and the president on economic issues aren't that great. Both support healthcare in some way or another, and both lean to the mainstream in regards to foreign policy, supporting banks, etc.

The candidacy of Romney is secured during Q1, especially on "Super Tuesday". Romney seems to be working quite wisely, and has a lot of cash to spend. If he becomes the clear winner of the primaries during Q1, political uncertainty will take a break. Finding the differences between Obama and Romney will wait for Q3 and Q4.

Underdogs

Yet Romney is not alone. In Iowa, he won by only 8 votes. The runner up, Rick Santorum, can give a fight. Santorum is a more conservative politician. His chances of beating Obama are small. If he emerges as the winner during March, this will clear the uncertainty. Yet Santorum doesn't have the money to really beat Romney. If he gives up a good fight and the Republican candidacy question remains open, this uncertainty could weigh on the dollar.

Ron Paul, that came third, is by far the most fascinating candidate. His talk about the gold standard appeals to fiscal hawks, yet his rejection to the military gets him votes from the left.

Paul has a smaller chance of winning than Romney, yet he might run as a third independent candidate. This is certainly an option. If Paul puts up a fight in the Republican race or hints towards running independently, the level of uncertainty will certainly rise. The media finds a hard time digesting Ron Paul.

European Cliff Hanger

Europe will certainly remain in the limelight in Q1 2012. The Greek debt crisis began at the end of 2009 and has spread to other countries. Apart from countries, European banks are also on the edge. Nothing is secure and trust is hard to find.

How long can this leg dragging continue? Perhaps we will see some tougher decisions in Q1 2012.

Greece

All the themes discussed in the Q4 outlook continue. Let's review them:

- **Austerity doesn't work**: Greece missed more budget targets and its economy continues to shrink at faster-than-expected paces.

Unemployment is on the rise. Some blame the old and new governments in Athens that are incapable of delivering on their promises. Others say that the austerity imposed by the EU and the IMF was too harsh, and placed Greece in a spiral of lower growth, lower taxes, higher debt, more loans, more austerity, rinse, repeat. There is some truth to both sides of the story. Bottom line: if adjustments are needed each quarter, the program doesn't work. All over again.

- **Greeks are fed up**: The installment of the Papademos government calmed down Greek protests a bit. But this new government with some old ministers is losing popularity fast as suffering continues. With every day that goes by with this coalition government, the trust in a political alternative is fading away.
- **Global conditions continue deteriorating**: It's not only Greece and not only Europe. The entire world is slowing down and together with austerity, it kills hope of growth. It's more of a depression than a recession in Greece.
- **PSI Fading Away**: Talks were stuck in Q3, and are deeper in the mud now. With every day that passes, the 50% haircut target seems farther away from being enough, while banks are reluctant to make the "voluntary" move. Spanish hedge fund Vega already left talks.
- **European leaders continue focusing on banks**: France doesn't want another Dexia and Germany doesn't want to babysitter Commerzbank or any other banks. The only serious move in Q4 was the LTRO by the ECB, which helped the banks.

Looking again to the Q4 outlook, the leg dragging scenario won, and Greece indeed remained in the euro-zone. The chances for Greece to stay in the euro-zone during Q1 are dropping:

- **It's on the table**: European leaders said it out loud during November. The Greek authorities are also discussing it out loud and warning that it can happen if PSI is not concluded and if reforms aren't pushed through.
- **Level of trust is lower**: How many times can plans fail? Isn't it time to let go? Despair is rising.

- **Future advantages**: Leaving the zone and adopting an old/new weak currency could help in the longer run.

Three out of four scenarios remain. The elegant orderly default option isn't real anymore, given the lack of capacity of the EFSF.

1. **Non-elegant orderly default**: PSI will eventually be approved this will be the long-awaited voluntary haircut. Together with massive support from the ECB, banks will be able to absorb the shock, Greece will stay in the euro-zone and European leaders will be able to celebrate success. The euro will strengthen in such a scenario, but these gains will be limited due to massive euro printing by the ECB and fear of a domino effect. The level of uncertainty will drop. This has some chances.
2. **More leg dragging**: Another summit or three, followed by temporary aid to Greece from the IMF and a long troika visit will keep the country afloat for some more time, but without success in PSI and without hope for a change. In this case, the euro will continue moving lower, together with the economies. The level of uncertainty will remain high. This has equal chances to the previous scenario.
3. **Disorderly default**: The chances are less slim than they were earlier. Markets move faster than politicians. Greece will leave or will be forced out of the euro-zone upon defaulting on its debt. This will cause chaos in Greece and in financial markets. Not all the pieces in the puzzle are known, with Credit Default Swaps being the most worrying part. ECB money can help, but in a limited manner in such a storm. The euro is still expected to survive, just with different members and a much lower value. In the long run, this scenario is good for Greece, the European economies and eventually for the euro, as it loses its weakest link. But until things will get better, they will get much worse, and **Greece will likely be only the first domino**. The political will across the continent mean low chances for this scenario, but the chances certainly rose.

Italy

Italy is becoming too similar to Greece: unsustainable debt, a technocrat government run by an ex-banker and slow moves on reforms.

Yet contrary to Greece, Italy is too big to bail. And contrary to Greece, Italy's problem is mostly a liquidity problem rather than a solvency problem. Italy can certainly avoid PSI, IMF intervention and default.

Liquidity to Solvency

The key lies in bond yields. Italy's big redemptions in 2012 mean that every new bond auction enlarges the debt pile of Italy, which stands on around 120% of GDP. The prescription by the European Union is austerity, and Mario Monti, an ex Goldman-Sachs banker, is up for the task.

More austerity means smaller GDP, in a country with a stalling population and low growth. Italy cannot grow its way out of spiraling debt through austerity.

What can be done is more active action by the ECB to lower yields. It doesn't need to intervene directly in the primary markets, but move in the secondary markets and send a clear message.

ECB

The Italian head of the European Central Bank, Mario Draghi, another ex-banker, is reluctant to act, and is under pressure from the dominant German central bank (Bundesbank).

The ECB buys Italian bonds only to keep yields from jumping to extremely high levels. This is enough to keep Italy dragging its feet and to **put pressure on the government to act**.

The ECB already introduced a bigger step: LTRO which is an indirect way of QE, as it encourages banks to buy low grade sovereign debt and pledge it as collateral for the money it gets from the ECB. This nice arbitrage had a small effect.

Here are three scenarios for this quarter:

1. **Another LTRO**: The ECB has another operation planned on February 29th. This might give the necessary boost for banks to buy sovereign debt, including Italian and lower the yields but isn't likely to push them to low levels. The impact on the euro depends on the success of this operation. Given the almost inexistent impact of the first operation, the euro will probably drop. Chances are high.
2. **More leg dragging**: Also here the chances are high, as this behavior is classic. With Italy paying 7% on long term debt, the burden will rise, and so will the chances of a default. An Italian default in Q1 2012 seems very remote, yet more expensive auctions will lay the foundations for this later in the year. The euro will drop on more bad auctions.
3. **Bond Buying En Masse**: With rising chances of Italian debt getting out of control, the European banks are at great risk. Will this convince Germany to give a green light to act aggressively in the secondary market and lower the yields? The chances are low. In this scenario, the euro will likely rise on serious action, even if this means performing American style QE – something that weakened the US dollar.

Spain

A new government came into power in the last days of 2011. Prime Minister Rajoy announced new taxes and fresh cuts. Europe's fourth largest economy has a much lower debt pile than Italy and enjoys lower yields.

Yet Spain faces a recession. It will be hit hard during the winter which is low season in tourism. In addition, austerity measures and higher taxes will exacerbate the situation.

Even before the elections, Rajoy discussed some form of aid with Angela Merkel. An option for IMF help or ECB help for banks is at stake.

Spanish banks suffer from the burst of the real estate bubble and has overvalued assets on its balance sheets. By exposing the situation outright, the banking system could suffer badly, and the economy can get another blow.

But without exposing the banks, they remain in zombie mode, not willing to lend until thing get better. Rajoy hasn't said too much about his plans regarding banks, nor any other issue, expect making general optimistic promises.

Rajoy and Luis de Guindos (**ex-Lehman Brothers banker**) might be smart by getting external help from banks while cleaning up their balance sheets. But this might not work out.

In addition, the recent elections have not only given an absolute majority to the PP party, but have also exposed regional tensions, with Catalan and Basque parties gaining many seats in parliament.

Regional Friction

Spain's regions are much more problematic in terms of debt than the central government. The planned cuts will create fresh friction with the regions (or autonomous communities). In addition, also provinces within the regions (such as the region of Barcelona within Catalonia) have debt issues, and so do municipalities.

Any cuts could be viewed through the nationalistic glasses, whether rightfully or not. This may put Spain back in the limelight.

In general, Spain doesn't face a solvency issue and also its liquidity issues are certainly reduced. The impact of Spain on the euro depends a lot on the level of noise the country produces during the quarter and this also depends on Italy.

If the new policy by the government runs into trouble and if the recession severely deepens, this will weigh on the euro.

If Spain stays in the current dire situation and headlines focus on Italy, it will have no impact on the common currency.

Portugal

Spain's neighbor in the Iberian Peninsula already received a bailout program and is struggling to keep up. The hidden debt in the island of Madeira as well as the ongoing recession could make Portugal the second domino to fall after Greece does.

Here are three scenarios for Portugal:

1. **Meddling along**: The common scenario has the highest chances. This will be terrible for the Portuguese, but will not impact the euro.
2. **A second bailout program**: Like Greece, more economic downturn brings less revenue, a bigger deficit, more austerity and more economic downturn. Portugal could follow the Greeks with talks about additional aid. This will weigh on the euro. Chances are medium.
3. **Default / leaving the euro-zone**: This will likely happen only after it happens in Greece, but could happen very fast. The chances are slim but real. It will weigh on the euro, and the next domino will be sought.

Ireland

This country is different from the other bailed out countries in many ways: it had a real estate and banking bubble, not a government debt issue. When it backed the banks, the back was broken and the bailout arrived.

The Irish bailout story is considered a success story, **but it's hard to believe that this is what the people in Ireland feel**.

Ireland managed to keep up with the plans so far; its economy grew, and so did tax revenue. Ireland's bond yields dropped. This even prompted politicians to declare that the country will return to the markets earlier than expected.

Not So Good

Well, Ireland still suffers from emigration and rising unemployment. So, normal people aren't really bailed out. In addition, the economy turned around and contracted once again. So where's the success?

There is small chance that Ireland will be in the news during Q1. If it does, this will be bad news and a nail in the bailout coffin. If Ireland seeks more aid or gets into conflict with Europe, this will hurt the euro as well.

France

Europe's second largest economy has multiple fronts. The economy is stuck, as seen in consumer spending. It's perfect AAA status is all but gone. This immediately risks the AAA status of the EFSF bailout fund.

In addition, France holds presidential elections in April. Expectations are for an ousting of incumbent Nicolas Sarkozy by socialist Francois Hollande.

French risks:

1. **Credit downgrade**: The downgrade of France is long awaited, but it this is still likely hurt the euro, especially in case of a two notch downgrade. This is on the cards according to S&P. There are two more large rating agencies and every announcement will hurt. A "sell the rumor, buy the fact" reaction isn't likely.
2. **Big Banks**: The worst issue is the bloated banking system. Dexia was only partially French, but the big French banks have a high exposure to peripheral debt and are over leveraged. The LTRO operation certainly eased some pressure, but wasn't enough. A downgrade of the sovereign is usually followed by a downgrade of the banks and this will add to pressure. There were already rumors of failures of different French banks. This could certainly happen in Q1, with the French government providing aid. This in turn, will weigh on the rating of the government, and also on the economy.
3. **Recession**: Figures released during Q1 will show if France contracted in Q4 2011. Chances are high and even higher for contraction in Q1 2012.

All these things together, can break the Paris-Berlin bond that is the core of the euro-zone. The shockwaves will have a strong and negative impact on the euro. It's hard to see anything positive coming out of France during Q1 2012. Each scenario is negative. Any news coming out of France seems to be bad news.

Arab Winter

The Arab Spring was one of the main news themes of 2011. The ousting of the regime in Tunisia triggered moves around the Arab world. Egypt's Mubarak was overthrown in a matter of weeks.

Uprisings began in Libya and ended successfully after a bloody civil war. The tensions there (and also in other countries) pushed oil prices higher. This weighed on the US dollar.

Bahrain saw huge protests. Only external and intensive military intervention by Saudi Arabia brought down the demonstrations. Even Saudi Arabia witnessed a "Day of Rage" which was silenced.

Blood still fills the streets of Syrian cities since spring. A full scale civil war is feared.

Protests were also silenced in Iran. But this isn't the main issue in the Islamic Republic. According to a UN report, Iran continued pursuing nuclear weapons, and this raised fears in Israel and in the West.

In Israel, demonstrations for social justice rocked the streets during the summer. Protesters were inspired by the Arab Spring and by European demonstrations.

Summer is over.

The Israeli government has an interest to divert public attention from social justice to an external enemy. Iran, facing elections for parliament, also wishes to avoid domestic protest on rising prices and the harsh regime to outside enemies.

Apart from the UN report on Iran's nuclear weapons, there have been other escalations: Iran captured a sophisticated US drone on a spy mission, announced it achieved higher nuclear capabilities and tested missiles.

For the US, an Iranian bomb is bad, but closing the Straits of Hormuz could be worse. A significant part of global oil flows through this narrow water channel. Iran has threatened to close it and warned the US of leading an aircraft carrier through the straits.

A full scale confrontation between the West and Iran is unlikely, but there are quite a few scenarios to be aware of:

1. **Proxy war**: The situation in Syria has an impact on Lebanon's Hezbollah, which gets arms through Syria. When Hezbollah is under pressure, it could divert attention to Israel. That's one of the things that triggered the war in 2006. Also Syria might be involved this time, with Iran's backing. Such a confrontation will push oil prices higher, help the yen and weaken the dollar but the impact will not be huge.
2. **Standoff at Hormuz**: The threats could become real with no oil flowing in this critical region. This will send oil prices way higher, and will also hurt Europe, which is more dependent on oil from that region. It will also hurt Iran. In this scenario, risk aversion trade can be triggered to support the US dollar and counter the rise in oil prices. Risk currencies such as the Aussie and Kiwi could rise, while oil producing Canada could see its loonie balanced between risk aversive trading and higher oil prices.
3. **Full Scale War in the Middle East**: If Israel proceeds with attacking Iran, the whole region could be set ablaze. Despite higher oil prices, the level of risk aversion will see the dollar, yen and also the Swissie (in a comeback) rise as safe haven currencies while all the others, including the Canadian dollar, fall.

Far Eastern Trouble

The Chinese landing issue rose in Q4 2011. Chinese manufacturing PMI is flirting between contraction and growth, around the 50 point mark.

We'll start with China, but it's not only the world's No. 2 economy that is suffering.

China

China suffers from:

- **Lower global demand**: As the world slows down, demand for Chinese goods drops.
- **No diversification to domestic consumption**: In order to counter a drop in demand for its exports, China should have seen internal consumption. The

opposite happens: the share of consumption out of GDP is falling in the economic giant.

- **Bursting housing bubble**: Not all cities are ghost cities, but prices are falling in the strongest centers, such as Shanghai and Beijing. This doesn't bode well.

After fighting overheating and inflation, China quickly changed course and went to loosening policy. This might help in having a softer landing, yet risks are quite high.

USD/CNY has fallen very gradually but in general, the yuan continues appreciating. **This might change in Q1 2012, as China may wish to help its exports**. The US may be angered, but given the slowdown in China, helping exports seem logical. QE2 indirectly helped US exports with a softer dollar.

As the yuan cannot be freely traded, the news from China continues having a strong impact on the Australian dollar and also indirectly on the kiwi.

- **The Australian dollar** depends on building demand from China – demand that impacts Australia's iron ore exports. If prices continue falling, this will have a strong impact on the Australian dollar.
- **The New Zealand dollar** depends more on internal consumption of food. A weaker yuan means less Chinese demand for food from New Zealand and weaken the kiwi.

Japan

The second largest Asian economy saw its currency move mostly on safe haven flows. This may change in 2012.

The currency agreement between China and Japan may indirectly weigh on the yen, as it creates an opportunity for selling Japanese yens and buying Chinese yuans. The impact of this agreement will likely wait for later in the year.

Japan has a bigger worry: a debt mountain. Japan's debt-to-GDP ratio is over 200%, worse than Greece. Japan has less corruption, and a much more developed economy, yet its biggest advantage is who holds the debt: it isn't shaky European banks, **but rather its own citizens**.

This has kept Japan quite strong so far. But, the horrific earthquake, tsunami and nuclear disaster on March 11th 2011 added pain to the economy. Japan plans on raising more debt in 2012 and even if the price is cheap, the mountain is growing.

On the other side of the formula, GDP is hardly growing and is unlikely to do so given a stable population.

At one point or another, this debt mountain will be of importance. Japan isn't likely to see rising yields in Q1 2012, but the growing talk about Japanese has to be watched and can hurt the yen.

Other Asian countries are experiencing downturns as well. India has seen its currency drop. South Korea went from a policy of weakening the Korean Won to a policy of strengthening it. Both currencies are likely to depreciate during Q1.

Currency Outlooks

This section consists of a fundamental country specific outlook and a high time frame technical analysis for each currency against the US dollar. The situation in the US has already been discussed, so the first part concerning the US dollar is only technical, referring to the US Dollar Index. Also for Europe, see the in-depth fundamental coverage for more.

- All the charts are weekly charts.
- A description on the lines follows each section.
- For shorter term outlooks, please follow the weekly outlooks on Forex Crunch, linked in every section.
- If you prefer to view the charts on a web page, just click on the image.

US Dollar Index

The US dollar index retraced some of its gains made in Q3 and then resumed its move higher, in a very healthy fashion.

Uptrend support seen in the chart is relatively sharp, but quite sustained.

Lines

88.70 is the peak seen during the surge in 2010 but this line is still far. 85 is a round number that provided some support when the index was trading at a high level during 2010.

83.50 was the peak of an upwards move in the middle of 2010, before QE2 became reality. 81.31 served as peak at the beginning of 2009, at the beginning of 2010 and at the end of 2010 / beginning of 2011. This is a very strong resistance line and it's getting close.

The round number of 80 also served as a bottom twice in 2010 and is now support. 77.50 is the next big support line. It worked as both support and resistance in 2009.

76 capped the long range trading of the pair in 2011 and is strong support. 73.50 was the bottom border of that range. The year to date low of 72.69 is the last line.

For the major market movers, see the Forex Weekly Outlook.

Euro

Recession in the euro-zone

The debt crisis is taking its toll not only on the financial sector and this recession will probably be confirmed now. It has already forced two rate cuts..

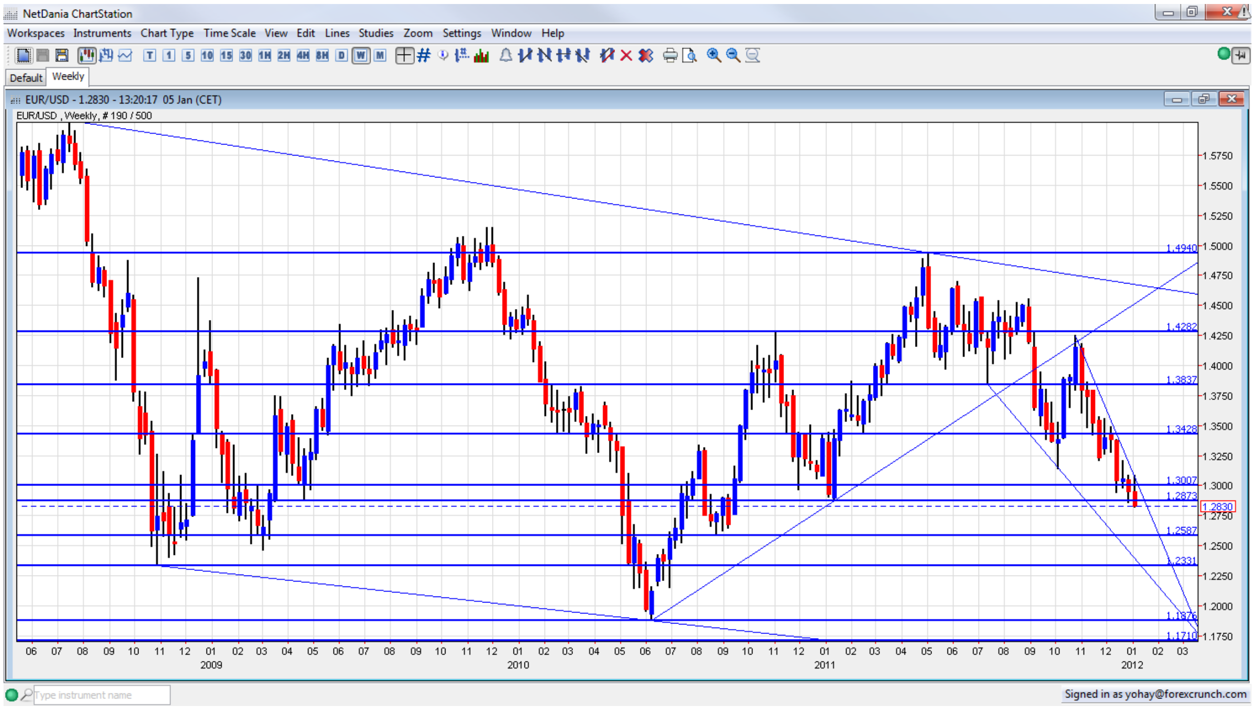
Recession

Q3 saw stronger growth, but all indicators point to a recession in Q4. Italy contracted already in Q3, Ireland dropped sharply and Spain stalled. Germany might escape a recession, given its better PMI numbers, but the overall number will likely be bad and will send the euro lower.

Rate Cuts

Mario Draghi already reversed the two rate hikes in two meetings. He now faces a dilemma regarding cutting the rates below 1%, the lowest level ever. In the current environment, a rate cut might aid the euro in the short run as it will aid the economy. He might cut the rates during Q1.

EUR/USD Technical Outlook



The very wide channel that begins in 2008 is trending down, and the pair is in the middle of it. Uptrend support which accompanied the pair since mid-2010 was also broken to the downside. The pair is currently dropping in a sharp narrow downtrend and non-parallel channel that should be watched.

Lines

The 2011 peak of 1.4940 is a significant line as well on the upside. 1.4282 was the peak of the surge in November 2010

The swing low of 1.3838 seen in mid-2010 was also of important at the beginning of 2010 as a cap and as a separator back in 2008. The 1.3430 was also an important separator and the failure to recapture this line is another bearish sign.

The round number of 1.30 is more of a pivotal and psychological line. 1.2873 was the trough of 2011 during most of the year and its break is important, although needs to be fully confirmed.

1.2587 is important support below after providing support during 2010. The first post crisis bottom at 1.2330 is becoming old, but still worth mentioning.

Below 1.20, the 1.1876 bottom seen in 2010 is a very strong line. The last line is symbolic: 1.17. This the launch price of the euro in 1999.

For more on the euro, see the **EUR/USD Weekly Outlook**.

British Pound

Easing in a Quantitative Manner

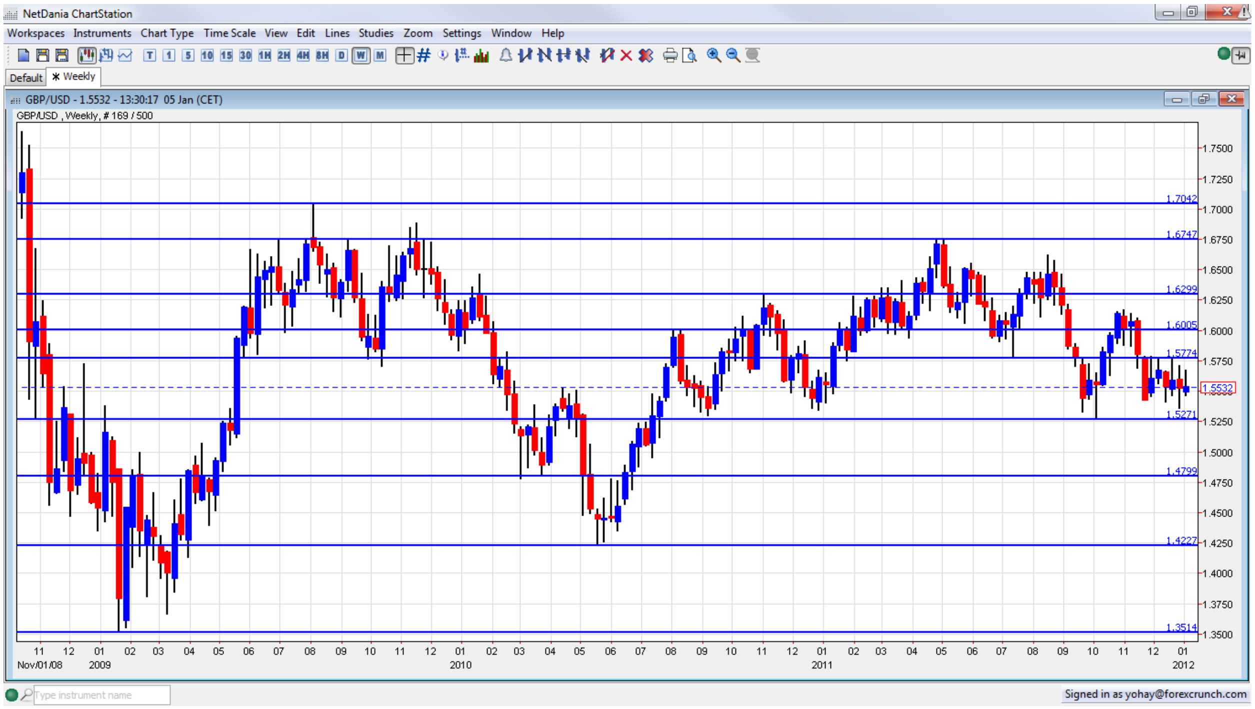
In Q4 2011, the BOE decided to expand the Asset Purchase Facility (QE program) by a large sum of 75 billion pounds, more than the most dovish member, Adam Posen, had voted for during many months. This was probably only the first expansion, and more are due in Q1 2012, most likely in February, after the current expansion runs its course.

Similar to the US, there is little that the central bank can do at this stage. Yields are already low, and austerity measures are hurting the British economy. The only positive result will be for British exporters, which will likely enjoy a weaker pound.

The overall situation in the economy is somewhat better than expected. Austerity and Europe weigh on the pound, while housing and services stabilize it.

All in all, the pound is likely to carry along with a tendency to drop against the greenback. The key is unemployment.

GBP/USD Technical Outlook



Pound/dollar tends to trade in ranges, and it is now in a lower range.

1.7042 is the post crisis peak reached during 2009 and never sought since. It is right above the round number of 1.70. Below, 1.6750 was the peak of 2011 and also had a similar role during 2009.

1.63 was a peak in 2010 and later worked as a pivotal line. The round number of 1.60 also had a significant role and a recapture of this line can be a bullish sign.

The trough of 1.5780 was of high importance in 2011 and also in 2009. The recent bottom of 1.5270 is just below a similar bottom seen in 2010.

Below the round number of 1.50, we find 1.48, which provided an important cushion at the beginning of 2010. The bottom of 2010 at 1.4227 is significant on a big downfall. Last but least, we find the post crisis low of 1.3514.

For more on the pound, see the **GBP/USD Weekly Outlook**.

Japanese Yen

Intervention to Prevent Falls

Japan found itself in an uncommon trade deficit during Q4. A strong yen could exacerbate this phenomenon and eventually trigger the opposite effect: a weaker yen.

Japan's problem is its safe haven status. When the world is in trouble, the yen is sought. This comes despite the high debt mountain. No wonderful solution is likely for the euro-zone, so the safe haven status will prevail.

The debt mountain will likely begin causing some headache, but as aforementioned, its gradual appearance in the news isn't likely to bring a collapse in this quarter.

The Japanese authorities have increased the frequency of currency interventions and there's a good chance this will happen again to prevent falls below 75.

It now seems that Japan will not have the success that the Swiss had in their huge intervention to weaken the franc and Japan doesn't even think of trying.

In the long run, USD/JPY has a potential of rising to much higher levels, but Q1 2012 will likely see more range trading between 75 and 80.

USD/JPY Technical Outlook

Dollar/yen is in a long term descent that began many years ago. Yet its current trading is very flat and very stable. Could this be the bottom? Previous zones have proven wrong.

Lines

85.50 was the peak in 2011 after the coordinated intervention. 82.87 was the line where the BOJ intervened in September 2010 and it played a role afterwards as well.

The round number of 80 was strongly guarded for some time and remains of psychological importance. 78.30 is an important hurdle in the shorter term. 77.50 is a pivotal line in the middle of the current range.

76 was a previous all-time low and is now support in the range. The round number of 75, in uncharted territory might test the patience of the BOJ and the low of 75.57.

A failure to guard this line has a potential of throwing the pair towards 70.

For more on the yen, see the **[USD/JPY Weekly Outlook]**.

Swiss Franc

Safe Haven Could Return, Peg Could Fall

The franc weakened against the US dollar during Q4 2011 and behaved like any other risk currency. The safe haven status that was lost hasn't returned.

There were rumors about lifting the floor under EUR/CHF from 1.20 to 1.25 or 1.30, but this didn't materialize. Nevertheless, the SNB successfully defended this floor, in one of the uncommon cases of a successful currency intervention.

Things could change in Q1:

1. As we've seen around the outbreak of the uprisings in Egypt and Libya, higher oil prices cause "diversification" of petrodollars to Swiss francs. A confrontation in Iran could push the franc higher once again.
2. The European debt crisis is worsening. Flows to Switzerland, geographically in the heart of the euro-zone could happen once again and send the franc higher.
3. Hildebrand's trouble: The governor of the SNB is suspected in tipping off his wife just before the big intervention. These allegations of insider trading risk the credibility of the central bank. If these charges are cleared or if Hildebrand is replaced, the peg has better chances of surviving. If he holds on, the reduced power could send vigilantes to test the central bank. In any case, damage has been done.

On the other hand, the Swiss economy is still in deflation and suffering from the global downturn. Together with an improved situation in the US, the franc could fall and USD/CHF could continue rising, especially if disasters in Europe and the Mid-East are avoided.

USD/CHF Technical Outlook

The steep downtrend channel that the pair encountered during 2011 was broken and replaced by a now more moderate uptrend support. Also note wider uptrend resistance. Volatility is extreme.

Lines

High in the sky, 1.17 was a stubborn peak in mid-2010. Given the strong intervention and high volatility, it is worth mentioning. 1.09 capped the pair during 2010 and provided support beforehand.

1.0435 was support in 2010 and an area of struggle. Just above parity, 1.0066 was an important attempt to recover, and the beginning of the downfall.

0.9783 was a double top and provides strong resistance. The round number of 0.95 worked as support and has psychological importance as well. It is now pivotal.

0.9315 worked recently as resistance and as support beforehand. The round number of 0.90 has a similar role, just on the downside.

0.8567 is worth mentioning on the downside. It served as support on the way down and then switched to resistance.

Further below, 0.8330 was a strong line of support. 0.7820 is the final frontier before the big plunge to the all-time low at 0.7066.

For more on the Swiss franc, see the **USD/CHF Weekly Outlook**.

Canadian Dollar

Less Hope for the Loonie

The Canadian dollar is once again in an interesting situation, with changing forces moving it in different directions.

- **High dependency on the US**: The Canadian economy moves with its largest neighbor. Higher demand from the US means a stronger economy and a stronger Canadian dollar, while a US recession will take the loonie down with it. This is a much stronger factor than oil.
- **Negative economic signs**: After a good third quarter, things have turned for the worse in Canada. Employment is dropping and other indicators also point to weakness. This weakens the C$.
- **Rising price of oil**: The aforementioned Mid-East tensions push oil higher and this bodes well for oil-producing Canada. On the other hand, a worsening global situation reduces the demand for oil.
- **Housing bubble?** After avoiding the fate of its southern neighbor so far, Canada may experience a significant downturn in home prices, something that will hurt the economy badly.

The bottom line of this complicated situation isn't too good for Canada in this quarter. It will need the US to pull it forward, and this isn't certain.

USD/CAD Technical Outlook

The Canadian dollar managed to weather the dollar storm in Q4 2011, but this isn't likely to continue. Note the uptrend support line.

Lines

1.1124 was a stubborn area of resistance during 2009 and is still far. 1.0850 capped the pair in 2009 and 2010 and remains of high importance.

1.0677 also worked as strong resistance for many days, and was tackled again ini Q3. The round number of 1.05 is now a top in the range.

1.0263 worked as resistance several times, and remains pivotal. USD/CAD Parity is an obvious line.

0.99 was a bottom in 2010 and also in Q4. 0.9667 is a pivotal line on the way down, after working as support.

0.9406 was the lowest post crisis level, and is the ultimate support line.

For more on the Canadian dollar, see the **USD/CAD Weekly Outlook**.

Australian Dollar

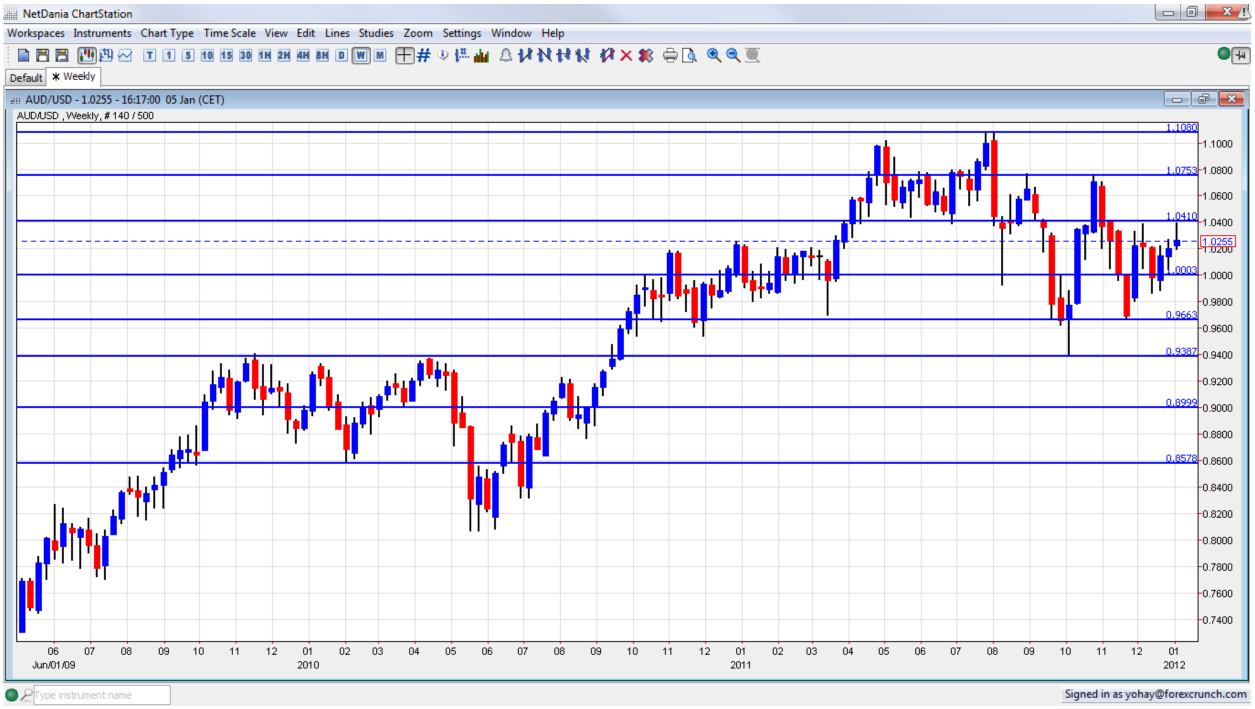
Landing with China

The Australian dollar continued moving very sharply and provided many trading opportunities. It managed to remain surprisingly resilient.

- **Australia is highly dependent on China** and is sometimes perceived as proxy for trading China. The Chinese landing with lower demand for iron, can hurt Australia.
- **Retail Exhaustion**: Australian manufacturers are having trouble selling as their high prices and reluctance of consumers begin weighing. This includes surfing gear among other stuff.
- **Dropping interest rate**: This used to be an advantage for Australia, drawing money looking for high yields and the carry trade. But when the tables turn, this also means that rates have a lot of room for falls. The rate was cut already in Q4 to 4.25% and will likely continue in Q1.
- **Housing bubble**: There is a heated debate of whether Australia has experienced a housing bubble. The fact that prices were rising during a period where house prices crashed in other parts of the world, and the low level of AIG's construction index point to a bust now. Even without a bust, dropping house prices do not support the economy.

All in all, the Australian dollar faces strong headwinds that aren't strongly reflected in the value of currency.

AUD/USD Technical Outlook



With the high volatility of the Aussie, there are many lines to pick from. The Aussie fell off a cliff, but is now bouncing in the air.

Lines

The float-era high of 1.1080 is the ultimate line high in the sky. It wasn't a swing high but rather a significant hurdle. 1.0750 capped the pair several times during 2011 and is strong resistance.

1.04 capped the pair during Q4 and earlier served as support. AUD/USD Parity is an important psychological line.

0.9666 had a historic role in support the pair in 2010 and 2011. 0.94 is an important trough and also the cap of a long term range that lasted in 2009-2010.

The round number of 0.90 will is of psychological importance. 0.8578 was the bottom border of the aforementioned long term range and a very distinct line.

For more on the Aussie, see the **AUD/USD Weekly Outlook**.

New Zealand Dollar

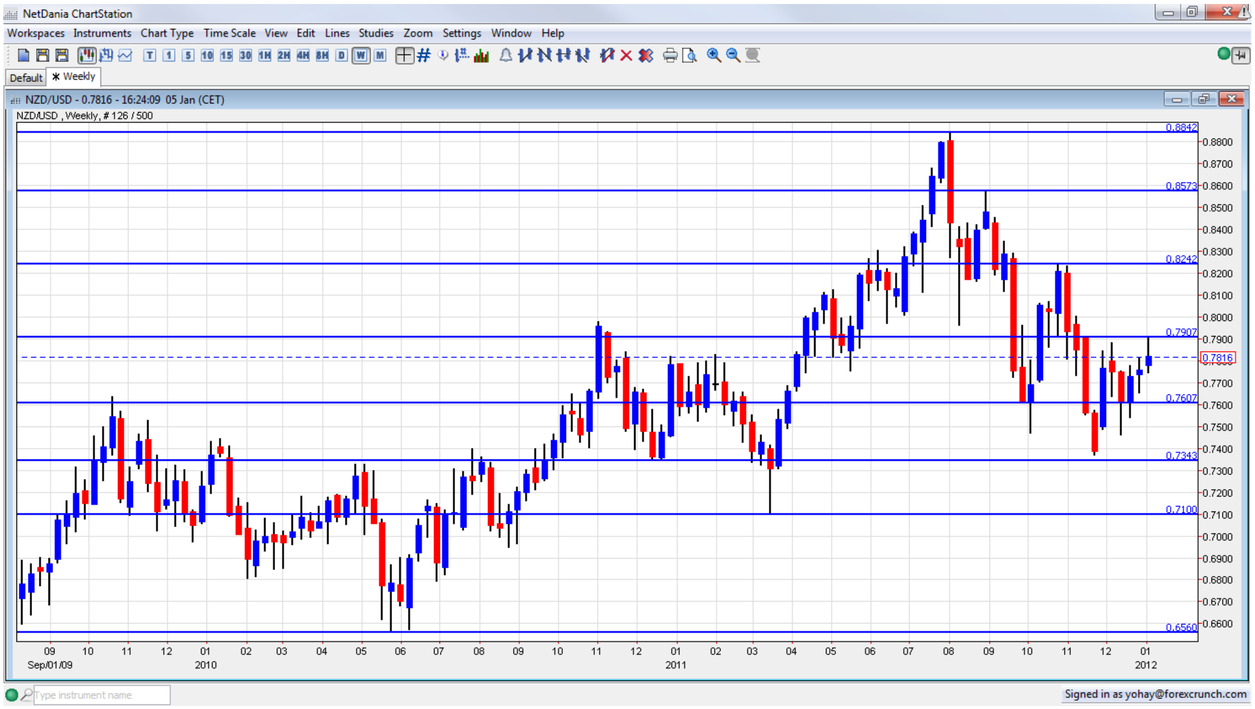
Kiwi flying low

While a Chinese downturn can hurt New Zealand, the country managed to overcome two painful earthquakes in Christchurch and its economy is doing OK.

- **Commodities**: Similar to its neighbor Australia, New Zealand is dependent on demand for commodities from Asia. But contrary to Australia, a big part of exports are of agricultural products. A slowdown hurts demand for these products at a lower scale than the demand for metals. People still need to eat!
- **Tourism**: This is an important sector as well, and may suffer from the global situation. This factor weighs against the kiwi.
- **Interest rates**: After the RBNZ lowered the interest rates to 2.5% following the last earthquake, the economy improved and there were prospects of a rate hike. With the current turn of events, the chances are lower. There are higher chances for no policy changes. A still high rate of 2.5% on the backdrop of rate cuts in Australia can help the kiwi.

All in all, the New Zealand dollar is unlikely to escape the global headwinds, but will likely weather the situation quite well as in Q4.

NZD/USD Technical Outlook



After falling below 0.50 in the aftermath of the financial crisis, the kiwi made a long and steady recovery in an uptrend channel. It now seems that some kind of downtrend channel is emerging. This depends on where you draw the lines.

Lines

The float-era high of 0.8842 is the ultimate resistance line. 0.8573 was the last recovery attempt before the recent downfall.

0.8242 capped the pair on the way up and stopped the pair from rising recently. Under 0.80, the next round number of 0.79 provides support.

0.76 was a recent cap. 0.7350 is significant on the downside. The pair got close to this line during Q4. The round number of 0.71 was a swing low earlier in the year and a break lower would be a bearish signal. Far below, 0.6560 is the low of 2010.

For more on the kiwi, see the [NZD/USD Weekly Outlook](#).

Key Events

Here are the key events that are set to impact currencies all over the world, larger than the scope of any individual country. Note February 29th, which is a rare date on the calendar and has a special event.

- January 12th: European rate decision – more extraordinary steps could be announced.
- January 19th: Chinese GDP for Q4 – How hard was the landing?
- January 25th US Rate decision – first one for the year with the new voting composition.
- January 27th: US GDP, First release.
- January 30th: Tentative EU Summit.
- February 3rd: First Non-Farm Payrolls for 2012 – Will the US suffer from a hangover after the tax incentives expired?
- February 9th: ECB Rate decision: a rate cut could be seen here.
- February 12th: Japanese GDP (first release) for Q4.
- February 15th: Euro-zone GDP. Did the zone contract in Q4?
- **February 29th: Second large ECB LTRO Operation**
- February 29th: US GDP, Second release. Big revisions have been seen in previous quarters.
- March 7th: Australian GDP (final).
- March 8th: ECB Rate decision before Greek deadline.
- March 9th: US Non-Farm Payrolls, Note the revisions.
- March 13th US Rate decision
- March 20th: Critical Greek deadline for debt redemption.

Sources for this report:

- Forex Factory Calendar
- FX Street Calendar (available on Forex Crunch).

Additional Notes For Forex Traders

Here are some additional notes for forex trading during this quarter.

High Volatility

The sharp movements seen in currencies during recent months will likely be seen now as well. Choppy trading is likely to be seen throughout this busy quarter. Yet it is important to note that unknown events can surprise us anytime, also during the most boring hours of the day.

Trade with care! High volatility with high leverage and wide stops can be disastrous to your trading account. When volatility is higher, reduce position sizes and minimize your risk. Don't gamble.

There are still some traders who widen their stop loss points when the trade is open. Having success with such a move can lead to more dangerous actions later on and is only more dangerous. So stop moving your stops!

Choosing a More Predictable Pair

Some pairs follow the rules of technical analysis in a better way, while others are quite unpredictable. This depends a lot on your trading system and on your style and these patterns change all the time. Nevertheless, here is an updated list of the **5 Most Predictable Currency Pairs – Q1 2012**.

Resources

General Articles

- **5 Points on When to Go Pro** – Successful at forex trading and considering of doing it full time? There are a few steps on the way.
- **How to Choose a Forex Broker in 2011** – There are quite a few tools you can use before making this important decision.
- **How About Investing in Forex?** – Foreign exchange doesn't necessarily have to involve active trading, but can be
- **Risk Factor Explained** – A deeper explanation about why the dollar falls on good figures and vice versa and under what conditions this will end.
- **Trading in Range or Catching Breakouts?** – What is your style? And what to look out for.

Recommended Sites:

- **TradingNrg** – For all you need to know about gold, oil and other commodities.
- **BO Crunch** – All you need to know about trading binary options.
- **ForexStreet.Net** – A great forex social site where you can interact with others.
- **Forex Live** – For the fastest updates on the web.

That's it! As I've mentioned at the beginning, I welcome feedback, comments, suggestions, complaints and anything you wish to tell me about this report. Please send any feedback to yohay@forexcrunch.com.

Happy forex trading!