FOREX CRUNCH

Forex Outlook September 2012

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Introduction

Welcome to September monthly report from Forex Crunch. August mostly saw calm trading, with a dose of optimism regarding the debt crisis in Europe and the situation of the US. As traders return from vacations, September is expected to be far more exciting, as it becomes money time for Europe and as the Fed decision looms.

The report discusses the main themes that impact all currencies. Europe still takes most of the focus, due to the predicted bond buying blitz and the ruling of Germany's constitutional court.

Specific currency outlooks follow. Each currency outlook consists of two parts: a fundamental overview and a high time-frame technical analysis. In addition, the relative strength index tries to predict how major currencies will rank during September. A timetable of key events and some extra additional notes for forex traders end the report.

As always, feedback is more than welcome. I'd love to hear your comments at yohay@forexcrunch.com. The plan is to continue with monthly reports.

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Global Themes

All Eyes on Karlsruhe

The German constitutional court in Karlsruhe is set to rule on the legality of the ESM bailout fund on September 12th. While chances are high that the court will give a green light, it is important to understand the meaning.

The event in itself already causes certain delays, and could limit the scope of the ECB's rate decision.

Importance of ESM

The European Stability Mechanism (ESM) is the permanent bailout fund that is expected to replace the temporary EFSF that has been in use so far in the cases of Greece, Ireland and Portugal. 90% of funds are necessary to establish the ESM, and without Germany, who contributes over 27% of the funds, there's no ESM.

Spain and Italy are suffering from lack of trust in the markets, each one for different reasons (details are in the next chapters). Bond yields are high, making the recycling of debt very expensive, and eventually making their debt mountain unsustainable.

The new mechanism has in initial paid-in capital of 80 billion euros and a total capital of 700 billion euros. This large sum is needed for large countries, but may not be enough – not the "firewall" needed to calm investors.

The Bigger Firepower

The European Central Bank has the authority to create euros out of the thin air, thus making its firepower unlimited. In the recent rate decision, Mario Draghi declared that the current situation in bond markets is "unacceptable" and that it reflects the fear of "convertibility" – the breakup of the euro.

Draghi pledged to buy bonds en masse and even doing it in an unsterilized manner – without draining money out of the markets. This is what the US and the UK are doing – full quantitative easing.

However, Draghi conditioned the usage of this tool on a formal aid request from the countries who need help, mainly Spain. A formal aid request would mean that Spain would have to undertake some conditions (more austerity) and would receive aid from the ESM.

Draghi also said that the ECB would work on the details. Indeed, the internal committees and Draghi himself seem to have been working hard on the details. Quite a few ideas have been leaked, and Draghi himself cancelled a planned trip to Jackson Hole due to "heavy workload".

So, Draghi might be able to present details about the program on September 6th. However, no action is likely. First, Spain took it's time with presenting a formal aid request. But more importantly, the decision of the German constitutional court is awaited.

ESM Ratification

The German parliament already approved the treaty with a huge majority on June 29th in both houses of parliament. However, the final stage is signing the change into law. This usually symbolic stage is done by the president. However, President Joachim Gauck cannot sign the decision into law without a green light from the German constitutional court.

Opposition for the ESM, which indirectly provides transfers of money from Germany to other countries, comes from various citizens, members of parliament from the right and from the left. After an initial hearing in July, the court set the September 12th date for a final decision.

There are various reasons why the court will likely approve the ESM:

- **A previous approval**: Just one year before this decision, the German constitutional court gave its approval to the EFSF. The judges rejected the challenges but did add a warning. President Andreas Voßkuhle said that this "should not be misinterpreted as a constitutional blank check for further rescue packages."

- **Past QE**: An approval of the ESM by the court will likely lead to quantitative easing by the ECB. While this sounds like blasphemy to the orthodox Bundesbank, it is actually the Bundesbank that bought bonds back in the 70s. So, this hurdle isn't likely to stand in the way of approval.
- **Politics**: The ESM was ratified by the German parliament with an overwhelming majority. There was only small opposition from some right wing members in Merkel's coalition that led the move. The main opposition party, SPD, stood behind the decision. It even went one step further and gave its support for Eurobonds (or sharing debt), something the government ruled out on any occasion. With such wide support, it's hard to see the court stand brave against it.
- **Risks at stake**: The judges in Karlsruhe aren't likely to find distinct answers in the law, but have room for analysis. So, they will not be able to ignore the implication of their decision. A decision that the ESM is unconstitutional will trigger huge market turmoil and perhaps could lead to the breakup of the euro. The German Council of experts sees a 3 trillion euro damage upon a breakup of the euro, while the costs of fixing the euro are actually much cheaper than Germans think. German exports continue enjoying the weak euro, as seen lately in Germany's trade balance. These considerations of Germany's interests cannot be ignored.

So, there are good chances that the Constitutional Court in Karlsruhe will approve the ESM. Some analysts see a 60% chance of approval.

What if they say no?

If the judges go with the other scenario and reject the ESM, this will likely send the euro tumbling down very sharply.

An approval is more priced in than a rejection is. Without the ESM at hand, the euro area will be in very deep trouble and the chances of euro breakup will seem quite real. **An immediate drop of EUR/USD to 1.18 and later to 1.15 cannot be ruled out.**

European leaders have no other mechanisms to support Spain and Italy at the moment. The options are:

- **A change in Germany's constitution**: Such a move will not be too popular. Even if German politicians all unite for this cause, it will take a long time in which the situation in Spain could get out of control.
- **The ECB will buy bonds anyway**: Also here, it will be very hard to sell it to the bailout weary German public. A move by the ECB without the governments moving first would provide an immediate solution and could be presented as a "transmission of monetary policy" but would be a sharp U-turn from current policy and definitely opposed to the spirit of the EU Treaty – a clear monetization of governments.

So, a rejection would be a doomsday scenario.

Assuming an approval, would could the ECB do?

At the rate meeting on September 6th, there is little scope for action, as Spain hasn't asked for help and the German court hasn't ruled. What is likely is a presentation of more details regarding the bond buying scheme.

The ECB could avoid setting an explicit target for yields or spreads and stick to the lower end in order to keep pressure up and keep the move closer to monetary policy – contrary to operation twist.

More specifically, the ECB could concentrate on buying T-bills to have a de-facto seniority without explicitly saying so. T-bills are safer than other types of bonds.

The exact mechanism and technical details are less important. What is important to hear from the ECB is:

- **It is ready to act despite Bundesbank opposition**: The orthodox German central bank expressed its discontent from buying bonds. The discontent could even result in a resignation of Jens Weidmann, the president of the Bundesbank. His fellow countrymen Axel Weber and Jörgen Stark already did that in protest.

- **It is ready to act massively**: So far, Draghi put conditions for action, but gave the impression that if the conditions are fulfilled, the action of the ECB will be very strong, and will even include QE. A repeat of this message will be reassuring.

The Spanish crisis and the ECB's actions are at a critical point, and the situation should start turning around in September. This is not too optimistic, but also not too certain. At least hedge funds are optimistic, cutting back euro shorts.

And now, let's see why Spain needs an urgent fix.

Spain Faces Critical Month, Italian Troubles on Backburner

Spain's toxic mix is bubbling and may overspill in September. The euro-zone's fourth largest economy is feeling the heat from all directions: banks, regions, bond markets and also rating agencies.

Is it just darkest before dawn? Spain took its time (one month and counting) with asking for aid from its peers – a move that will include new austerity as well as ECB help. The country can wait for the German court's ruling, but not much further.

Spain's fronts:

- **Bankia**: The troubled bank reported another loss and the government announced another capital injection, without waiting for European funds. This weighs on the government's budget, which already surpassed the projected 2012 budget. The link between sovereigns and banks is just getting stronger instead of being broken. One anecdote is that Cristinao Ronaldo could be transferred to the ECB. Other banks could ask for money as well. Spanish banks suffered from the bust that followed the real estate boom. With house prices continuing to fall, the deleveraging process still has a long way to go. An unorthodox solution is forgiving mortgages under a certain rate, as Iceland did, but this isn't on anybody's agenda at the moment. **The capital flight from Spain continues at full speed.**

- **Regions**: The list of regions asking for help is growing. Spain's most populous region, Andalusia, was the most recent to ask for aid from the government. All regions are shut out of money markets. Andalusia joins Murcia, Valencia and Catalonia, which is a more complex case.
- **Catalan discontent**: Catalonia is a rich region that feels that it is mistreated both economically and politically. Many Catalans feel that they are subsidizing other regions for many years and feel that asking for help from the central government is absurd. The recent crisis raised separatist aspirations, as seen in various opinion polls. Various anti-crisis and pro-Catalan demonstrations are being held. The demonstrations will reach a peak on September 11th, Catalonia's national day. Catalan nationalism is triggering some counter reaction. A Spanish colonel said that Catalan independence will come over his "dead body". Spain's democracy is still young and memories of the dictatorship and the civil war are still present.
- **Internal discontent**: The government already announced austerity measures, which include a raise of the VAT. In endless appearances, politicians explained why raising the VAT is bad, until they took the decision to raise it. The government's political capital is suffering a serious deficit, only 10 months after winning a landslide victory. The higher VAT is a reaction to weak tax collection: this fell by 3.5% instead of a projected 4.3% rise. The slow response to summer fires in the Canary Islands was also partially blamed on government cuts.
- **Rating**: On this background, Spain is paying high prices in the bond markets. Draghi's announcement at the beginning of August helped in lowering yields, but this honeymoon is over. During September**, Moody's is expected to downgrade Spain's credit rating to junk status** (after warning in June), and this will send more funds away from the country.

All in all, the picture is quite depressing. The path to lowering yields in the secondary market is via the ECB. For the ECB to buy bonds, a Spanish aid request is needed. PM Mariano Rajoy opened the door to asking for aid, but didn't walk through this door. **He will probably do that in September.**

While the ECB has unlimited buying power, conditions apply. After making a U-turn on VAT, Rajoy will find it hard to make a U-turn regarding asking for aid. In addition, new austerity will be hard to sell in the current situation.

Rajoy's moves haven't been that smart so far, and he has a tough job tiptoeing between getting help but keeping his country's economy afloat. September is a critical month for that.

But let's end the chapter about Spain with two positive numbers:

- Spanish tourism breaks records: 7.7 million foreigners in July, up 4.4% YoY.
- Spanish labor costs fell 2% while exports are growing – a weaker euro is helping Spain. This is a small fruit of austerity, drowning in a toxic sea.

Italian Issues

The euro-zone's third largest economy isn't doing much better, but continues hiding behind Spain. Italy's debt-to-GDP ratio is worse, over 123%, but it doesn't have issues with regions. Italian banks are also doing better than their Spanish peers.

- **Italy's tough austerity** got praises from many leaders and officials. For example, EU Commissioner Rehn said that Mario Monti achieved a lot in a short time. Indeed, **the Italian economy is contracting fast**, and its unemployment rate is surging fast.
- **The rise in unemployment** could be also due to the labor reserve scheme, which allows putting workers on paid holiday for some time before firing them. The expiration of this scheme in many places could have pushed unemployment higher.
- **Weak tourism**: Contrary to tourism in Spain, Italy isn't that well. Store in Rome suffered from horrible sales during the summer tourism season.
- **Political discontent**: 44% of Italians see joining the euro as a mistake, against 30% that support it. The Eurosceptic camp led by Beppe Grillo is gaining traction. Also former PM Silvio Berlusconi sounded some doubts about the euro, and he is planning a comeback to politics.

The current technocrat government led by Mario Monti is set to step down in the spring, but they could be brought forward to as early as November. This seems too early at the moment, but if Italian politicians go for early elections, Italy's negative headlines could surpass those of Spain.

Greek Issues Likely to be Swept Under the Carpet

In August, Greece managed to avoid a default thanks to a revolving door act by the ECB. The central bank bent its rules and accepted some Greek bonds as collateral. The Greek government issued these bonds, which were bought by the Greek banks and then pledged as collateral with the ECB. With the newly raised money, the Greek government managed to pay the August 20th bond repayment to… the ECB.

A different form of buying time is expected in September. The EU / ECB / IMF troika is returning to Athens and will discover unsurprisingly that Greece didn't meet the bailout requirements. The delegation will likely take its time during the month and present the results only towards the end of the month or in October.

It seems that the Spanish issues now top the agenda in Europe. Once Spain is stabilized, the leaders will take their time to deal with Greece.

Greek PM Antonis Samaras has asked for more time to meet requirements, but not for more money. He didn't receive an approval in his recent tour in Europe, where he heard words of compassion but a clear demand to meet the bailout terms.

The fate of Greece will likely be decided upon in the EU Summit scheduled for October 18-19. If Spain and Italy are stable enough, Europe could let Greece go, following the ominous statements that a Grexit is undesirable but manageable.

This was a statement made by Eurogroup chief Jean-Claude Juncker and was later echoed by the German ECB member Jörg Assmussen. Juncker also said that he sees Greece in the euro-zone "at least until the end of the autumn and probably beyond. So at least in September, a Grexit isn't probable.

Nevertheless, there are still some interesting things going on in and around Greece, and not all of them are negative.

- **German politicians noting Greece's geopolitical importance**. Greece is a member of NATO and may be sitting on untapped resources of natural gas. Cyprus and Israel recently found gas in the East Mediterranean. In addition, Russia might enter the vacuum that will emerge if Greece is thrown out of the euro-zone. Some German MPs have talked about Greece's importance with statements such as "just look on the map" and "this shouldn't be looked only from an economical perspective". Is there a growing will to keep Greece in the euro-zone?
- **Analysts looking more optimistic**: According to Reuters, more economists now see Greece staying in the euro-zone. This is a positive note.
- **0% interest rate?**: With rates so low in Europe, one possible compromise could be 0% interest rates for Greece, as well as a time extension which Samaras asks for. Such moves could allow Merkel to say that no more money was granted – just some minor details.
- **Germany still plays tough**: On the other hand, there are reports that Germany may seek a delay in new funds for Greece, until it complies, keeping the pressure up.
- **Greek suffering continues**: Unemployment continues rising rapidly in Greece and reached 23.1% in May. Greece may soon surpass Spain. Greece decided on freezing all unnecessary payments – it is not easy being a supplier to the Greek government.
- **Some small positive signs**: One sector is doing really well in Greece: shipping. Shipyards made smart moves before the crash and are now better positioned than their German counterparts, which are struggling with funding. This is quite a rare case. In addition, the Greek banking sector is stabilizing after a mini bank jog during the turbulent months of May and June. During the good years, Greece actually benefited from the euro, in rising income and smaller inequality. Nevertheless, Greece remained a poor country within the euro-zone. Things have changed since then, and perhaps a Greek exit from the euro-zone could stop the economic misery so many

are suffering in Greece. So far, the same mistakes made in Latin America during the 80s are repeated with Greece. Here are some more positive signs from Greece.

- **New austerity still not finalized**: Greek PM Samaras, leader of the New Democracy party, is still struggling to reach an agreement with his coalition partners regarding the new austerity measures. These are expected to be presented during September. Samaras promised the Greek public that this austerity drive will be the last one. Perhaps the last in the euro-zone?

All in all, some artificial stability has been reached in Greece, but the overall situation remains grim: the economy is squeezing fast, targets are missed and there's little hope at the end of the tunnel.

In order to keep Greece in the euro-zone, Germany will likely have to pay a dearer price than it paid so far. Apart from the aforementioned geopolitical considerations, keeping Greece in the euro-zone is critical for the "irreversibility" of the euro – avoiding a precedent where a country leaves the euro-zone – a move that will start a domino effect.

In that context, it's important to note that another peripheral and "bailed out" country may need a second bailout like Greece: Portugal. If Greece leaves, Portugal could soon follow and the pressure on Spain will mount.

The assumption that Portugal will not be able to return to money markets remains intact, despite an improvement in Portuguese bonds.

Euro Skepticism Could Grow in the North

On the same day that the German constitutional court makes its ruling (September 12th), one of Germany's closest allies will also face a critical decision. Citizens in the Netherlands will go to the polls in general elections after the current government collapsed on proposed austerity measures.

Sentiment against the European Union and its rules is growing in Holland, which has preached Greek austerity in the past. The fiscal compact which consists of automatic penalties to countries who miss targets isn't favored. The country usually stood by Germany in its past austerity drive.

The most anti-euro figure, Geert Wilders, brought the government down, but isn't expected to make the biggest gains. His anti-Islam sentiment limits his party's traction. A more moderate candidate on the other side of the political map is likely to make gains: Emile Roemer. The charismatic leader of the Socialist Party (SP), isn't anti euro, but rejects the fiscal compact.

He manages to gain votes from Wilders's Freedom Party and also from the mainstream left leaning Labor Party. It is currently head to head with the party of the current Prime Minister Mark Rutte of the mainstream right leaning VVD party.

The new parliament is expected to be fragmented like the current one, and negotiations for a coalition will likely last for a long time. If Eurosceptic parties make gains, the next government will likely be a less reliant ally of Germany. Similar to the election of François Hollande in France, it will not be a total change, but rather a change in sentiment across the continent.

Hollande's victory enabled Mario Monti of Italy to demand more, and indirectly helped the ECB become "less German". A "less German" political landscape in the Netherlands will impact Germany.

Finnish Discontent

The small northern country is also an ally of Germany, but has its own reservations about bailouts. Finland demanded collateral from Greece and Spain and some of its leaders already flirted with the idea of leaving the euro.

Finland has significant trade with other Scandinavian countries and with Russia, so trading with the euro isn't that important. On the other hand, the relatively weak euro (in comparison with the currencies of Sweden, Norway and Denmark) makes Finnish exports more attractive.

And regarding Russia, also here there is a geopolitical aspect: fear of Russian dominance in the Putin era helps Finland cling to the euro despite the skepticism.

Finland does enjoy the European political back, even if this sometimes means paying others' debt.

Euro skepticism has grown in Finland recently, but is certainly in control: a recent poll shows that support for the euro remains relatively strong.

However, it is important to note that the Finnish skepticism could still grow and reach a level where the country may leave. A possible trigger would be the seniority of ESM funds. If there is no full guarantee that money in the ESM bailout fund is safe, Finland could leave. The parliament in Helsinki passed a law on this, and changing this law in the current atmosphere seems impossible at the moment. A lack of seniority could break Finland's back, according to some politicians.

With the Greek bond restructuring, private bondholders paid the full price, while bonds bought by the ECB were made exempt from losses. While "public" ECB money was guarded, the move angered many market participants, who lost trust in European bonds. This seniority means the subordination of private bondholders.

ECB President Mario Draghi promised that the issue of seniority will be addressed. Perhaps the aforementioned T-bills will provide implicit seniority without scaring private bondholders – a compromise that will also make Finland happy, but this topic is still very sensitive.

A Finnish exit will weaken the single currency, as Finland is a rich country. In addition, it could accelerate moves by other European countries to leave, notably Germany. There are low chances for this to happen in September, but it's important to note the implication of ESM seniority for Finland.

US - QE3 Now? Really?

Ben Bernanke's speech at Jackson Hole at the end of August was somewhat vague, a common practice of the Federal Reserve. Many found hints for QE3 in the upcoming FOMC Meeting on September 12-13th.

Expectations are very high once again, a situation which could lead to disappointment, as the Fed has other tools. Any decision that the Fed makes in the middle of the month will have a strong effect on all currencies until the end of the month and beyond.

The meeting minutes from the July 31st-August 1st meeting were very dovish, especially as many members wanted more monetary stimulus "fairly soon". Since then, some economic indicators have improved. Retail sales rose, housing indicators such as building permits and news home sales were on the rise, and a positive sign was also seen in the weak manufacturing sector: Markit's PMI rose.

Jobs, jobs, jobs

Most notably, the US gained 163K jobs in July. In the Jackson Hole speech, one of the less vague expressions heard from Bernanke was the reference to employment as "grave". So, employment remains the key.

Recent weekly jobless claims numbers have been OK: lower than those in the second quarter of 2012, but still not good as at the beginning of the year. The Non-Farm Payrolls report of September 6th is highly important. A strong number will lower QE3 expectations, while a weak one will strengthen the prospects.

FOMC member Dennis Lockhart already said that the meeting minutes are "stale" after the recent positive signs. Non-Farm Payrolls for August will not be stale when the FOMC meets.

Will QE3 really help?

With yields at record low levels, the effectiveness of more printing and bond buying is questionable. Yields continued falling well after QE2 ended in June 2011. One of the reasons was the threat of more QE – **many investors bought bonds in anticipation of the Fed following up and buying these bonds from them. Other investors followed, and the yields remained low even as the Fed didn't budge**.

In fact, the Fed's balance sheet actually shrank recently – not exactly QEish.

European situation

One of the things potentially weighing on the US economy is the situation in Europe. It's important to note the calendar: **the Fed begins the meeting after the German constitutional court will present its verdict**.

If the judges in Karlsruhe reject the ESM, there is a far greater chance that the Fed will act. An expected approval will lower the pressure off Bernanke.

Deflation / Inflation

The motivation for QE2 was to prevent deflation – a situation where prices are falling, consumers stop buying in anticipation of more falls, prices continue falling, etc. The Fed cares about core inflation, which is slowing down, but still doesn't look deflationary. However, there is a danger that headline inflation will rise due to droughts in the US and rises in oil prices. QE2 certainly pushed commodity prices higher. Another boost in already rising prices could be counterproductive, as it will leave less money in the pockets of Americans.

Politics not a serious consideration

There is a strong backlash against Bernanke in the Republican camp, and the political noise is becoming louder towards the elections. Bernanke, a registered Republican, isn't likely to take this too seriously as a consideration against QE3. If Bernanke and the FOMC will come to a conclusion that QE3 will help, they will act, ignoring politics. The bigger question is: will it help?

It's also important to remember that QE3 will push commodity prices higher, hurting incumbent Obama. So, Bernanke can either anger both parties or not anger either.

If the Fed opts for QE3 now, with yields at such low levels, one can suspect that it is **trying to inflate debt away**.

What can the Fed do apart from QE3?

Another option is to extend the guidance regarding interest rates. The Fed currently has a conditional pledge to keep rates low until "late 2014". The pledge was introduced in the summer of 2011 and was up to "mid 2013". The extension came in January.

Is it time for another extension? There were some very subtle hints about it in Jackson Hole. So, this option is on the table. With positive news from Europe and a solid jobs report, this option could be used as a good compromise between hawks and doves.

How are hawks and doves split?

There are members who want open ended QE: Rosengren and Evans are the most dovish ones, and also Williams leans towards the doves and Bernanke is a known dove. Lacker is quite hawkish and he is not alone. A lot depends on James Bullard, but it's hard to tell at the moment.

Goldman Sachs sees QE3 only at the turn of the year, and this analysis makes more sense than QE3 now.

An unconventional policy option that is not on the cards is an opposite tactic: threatening higher rates in a set date, in order to encourage lending now. This "only today" is unconventional and isn't likely, but it's just another idea.

Bottom line: Assuming the jobs report is OK and the judges in Karlsruhe don't surprise, a compromise of an extended guidance seems more likely than outright QE3.

Chinese Landing

Towards a regime change in China, the economic giant is slowing. To counter the slowdown, several Chinese provinces introduced new and huge projects. However, many of these statements seem to contain nothing new, but are just a repetition of old programs.

The Chinese slowdown is affected by Europe, but also affects Europe and is a result of excessive activity in the past. The headlines from China have a strong impact on the Aussie, but also other currencies feel changes in the world's No. 2 economy.

Chinese PM Wen Jiabao promised more stimulus to combat the weakening economy. As aforementioned, some announcements are really news, and Chinese stimulus has a few hurdles:

- China cannot use its vast foreign reserves for stimulus plans.
- Manufacturing slowdown: The official PMI returned to contraction zone, and the unofficial HSBC / Markit figure fell to deeper lows within the contraction territory. Also looking further out to the future, to investments, shows a worrying picture: Foreign Direct Investment fell by 8.7% in July, year to date: 3.6%.
- Hard to find the balance: Manufacturing weakness is seen in many indicators, but housing may be on the rise once again. This is actually a burden that could limit stimulus which could encourage an even bigger housing bubble. In the recent past, China tried to curb house prices, but it hurt the industry as well. It is now trying to loosen.
- Food prices: The rise in food prices is a problem for China – both economic and political.
- Stockpiling: Coal stocks have soared by 48% over the past year and are now at a 4yr high.
- Stimulus could focus on technology and consumption rather than infrastructure. Construction is 12% of GDP, more than 10% that Japan had at the peak, and similar to levels seen in Spain. Squeezing this sector without having shock waves means that technology and consumption development need to speed up. They have been slow so far.

Not all is bad in China: the economy is still growing at a plausible pace and the leadership can manage to steer the ship as it did in the past.

In addition, China still competitive: prices of Chinese goods imported to the US rose by only 5% in the past 7 years, despite the currency strengthening by 30%.

We could see China introduce new monetary easing measures during September: these could include rate cuts, RRR cuts and also a weakening of the Chinese yuan.

In the wake of the financial crisis of 2008, many migrant workers lost their jobs and left China. **Watching migrant workers movements in China could indicate strength or weakness of economy in the future**.

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 – Staying in Uptrend Channel

The US Dollar Index fell within the wide uptrend channel that is accompanying is since the middle of 2011. During August, it fell to the bottom end of the channel. Will it break or bounce from here?

Lines

89.62 is the post financial crisis high and is the final frontier on top. 88.70 is another peak, seen in May 2010, when the Greece received the first bailout.

86.87 is a minor line, serving twice as resistance in the early stages of the crisis. 85 is a round number that provided some support when the index was trading at a high level during 2010.

83.68 was the peak of an upwards move in the middle of 2010, before QE2 became reality. The line was challenged in August, but the index couldn't settle above this line. 81.80 served as support in 2010 and as resistance in early 2012 and now switches once again to resistance.

81.12 provided support in June 2012 and also had a minor role as resistance in the past. It is of higher importance as it is close to uptrend support. Above the round number of 80, 80.23 is another important support line that was tackled twice in the spring of 2012, serving as the top border of a tighter range.

The bottom border of this range is 78.59, which was a cushion in April and also in January. 77.50 is the next big support line. It worked as both support and resistance in 2009.

76 capped the long range trading of this index in 2011 and is strong support. 73.50 was the bottom border of that range.

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

Euro – Close to Downtrend Resistance

See detailed information about Europe in the global themes.

EUR/USD Technical Outlook

The pair had a positive August. The very wide channel that begins in 2008 is trending down.

More importantly, the pair continues trading in the steep downtrend channel that began in late 2011 and was formed at the beginning of 2012. This channel is highlighted in the graph, with downtrend resistance being far more important that downtrend support at this time. Note that the pair moved from downtrend support to downtrend resistance and is at a critical juncture now.

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. 1.34 is the top border of the sideways range and remains strong despite a temporary breach early in the year.

The round number of 1.30 is not only a psychological line but also strong resistance. It was strong support and its break triggered a big fall. 1.2587 is now a pivotal line that was seen in August and will continue being important in September. It provided support during 2010.

The first post crisis bottom at 1.2330 is now left behind after a struggle. It worked well as support. Despite being an old line, it is of importance. 1.2150 played an important role in May 2010 as a clear separator. It also worked as resistance back in 2006. It worked as a separator very nicely in August 2012 as well.

1.20 returns to play an important role after the pair got close to it in July 2012. Below 1.20, the 1.1876 bottom seen in 2010 is a very strong line.

The next line is symbolic: 1.17. This the launch price of the euro in 1999. It is closely followed by 1.1670, which was a trough in the middle of the 2000s.

Even lower, important lines are the round numbers, as these levels were visited a long time ago.

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

British Pound – Time for a Change in Policy?

For over two years, the British coalition government pushed through a policy of austerity. After many months of denying there is a Plan B for growth, there are some signs of a change in London.

The Chancellor of the Exchequer George Osborne lost support from the prominent economists that called for austerity before the elections. In addition, Nick Clegg the head of the junior coalition partner discussed some growth plans.

What can the UK do? One option is investment in infrastructure, such as adding a third runway in Heathrow. Fiscal expansion may certainly help the economy but may hurt the UK's safe haven status seen recently in very low bond prices.

Another option is using use the profits from the Bank of England's QE program to fund a cut of 20 billion pounds in taxes.

Many accuse the various QE programs around the world as debt monetization. So far, central banks bought government bonds in order to lower yields, indirectly lowering costs for governments upon raising money.

Using the QE profits (made from creating money out of thin air) for fiscal means in a much more direct way of debt monetization. However, this will allow Osborne and Cameron to make a popular move, in line with their ideology and without increasing debt. If this move is made, other governments could follow.

During August, the pound made some gains. MPC Member Weale expressed worries about the stronger value of the pound of late. This could hurt British exports, but in fact, exports are weak despite a very long time of favorable exchange rates – actually since the crisis broke out 4 years ago.

The UK and the pound are still enjoying the positive atmosphere from the Olympics that continued also in the Paralympics. However, with house prices turning back once again, construction falling and manufacturing still contracting, the economy is still looking for a direction.

As long as the focus remains on Europe and on the US, the pound could enjoy some relative calm and make some more gains. The Bank of England isn't expected to act anytime soon, especially not on the rates.

Speculation about rate cuts came to an end when Mervyn King ruled that out. Rates are already at a record 0.50% low for over 3 years.

GBP/USD Technical Outlook

In the bigger scheme of things, pound/dollar traded is well within long term ranges, and has recently moved higher within this range. Wide downtrend resistance caps the pair since early 2011 but is still far. It could be challenged if cable leaps. Since mid-2012, uptrend support has emerged, and with the recent surge, it isn't that close either.

1.7440 was a stepping stone on the way down during the peak of the crisis. 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 failure to break above this level ignited the fall.

The round number of 1.60 also had a significant role in the past, but it is weaker now. The trough of 1.5780 was of high importance in 2011 and also in 2009. It proved its strength as resistance in June 2012.

Quite close by, 1.56 had an important role as a support line in 2012, and it now works as a pivotal line in the current range. The double bottom of 1.5270 seen at the end of 2011 and the beginning of 2012 is the lowest points since 2010 and remains strong.

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 – QE3 Hopes Balance Trade Balance Deficit

The yen suffered from outflows of previous safe haven flows, as the situation in Europe improved. However, the yen still made some limited gains against the dollar on hopes for QE3.

Hopes for QE3 and its potential materialization can push USD/JPY even lower. On the other hand, Japan continues suffering from quite a few issues:

- Trade balance deficit: Japan traditionally enjoyed a trade surplus, but since the horrible earthquake, tsunami and nuclear disaster in March 2011, it is relying on imports of energy that tip its trade balance to a deficit. This continues weighing on the yen.
- Industrial output fell 1.2% in July, and shipments are expected to fall by no less than 3.3% in September.
- Deflation returning: As mentioned in the previous outlook, this Japanese disease seemed to have moved away, and Japan was getting closer to the modest target of 1% inflation. However, with fresh falls in consumer prices, this target seems far.
- Debt ceiling issues: Similar to what happened in the US during the summer of 2011, the government hasn't passed the necessary legislation regarding funding, and this could result in automatic spending cuts.

USD/JPY Technical Outlook

At lower levels of USD/JPY, we could see the BOJ act once again to increase the dosage of QE, although this hasn't really worked well. A direct FX intervention is always on the cards as well, but also here, a bump higher would be limited.

In order to move the pair higher, rejection of QE3 by the Fed would be the most powerful tool.

USD/JPY Technical Outlook

Dollar/yen remained very stable in range, and could now "explode". However, explosions in this pair aren't that large.

Lines

85.50 was the peak in 2011 after the coordinated intervention. 84.20 is the peak reached and challenged in March 2012.

82.87 was the line where the BOJ intervened in September 2010 and it played a role afterwards as well. It is currently a minor resistance line. The 80.60 line is becoming more notable on the weekly chars, just above the round number of 80. It served in both directions during 2012.

The round number of 80 was strongly guarded for some time and remains of psychological importance. The break below is significant. 78 proved to be strong in the month of August as well.

Minor support is at 76.60, which worked as support early in 2012. 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 – Celebrating a Year to the Successful Peg

With the Swiss economy unexpectedly squeezing in Q2, there seems to be no change in policy in the horizon. One year after the SNB imposed the 1.20 floor under EUR/CHF, this intervention is clearly a success in FX terms, even if the economy isn't growing.

Assuming that the situation in Europe will continue improving, there will be less pressure on the Swiss National Bank. It could have an easier time diversifying its vast stock of euros, and perhaps we could even see EUR/CHF move away from 1.20, as we've seen in the early days of the peg, before it flatlined.

If the German constitutional court rejects the ESM, it will be a nightmare also for the Swiss authorities. They will be left alone bidding on the euro, and the levee could break.

This scenario has low chances, but it is important to remember that a break of the peg has implications for all currencies, given the vast amount of shorts awaiting EUR/CHF under 1.20.

USD/CHF Technical Outlook

Yet again, it's important to note that USD/CHF is practically a mirror of EUR/USD due to the peg. However, it's nice to see that the technical lines hold quite well despite the peg. Note that uptrend support was broken as the pair remained slid in range.

Lines

1.17 was an important and stubborn peak in 2010 and remains an important cap above. 1.11 worked as support at the end of 2007 and also a cap in 2009 and 2010.

1.09 capped the pair during 2010 and provided support beforehand. 1.0435 was support in 2010 and an area of struggle.

The round number of parity returns to the scene. It is backed by 1.0066. 0.9783 was a double top and provides strong resistance. It showed character in August 2012.

The round number of 0.95 worked as support and has psychological importance as well. It is now critical support after the slide. 0.9315 worked recently as resistance and as support beforehand. If 0.95 is broken, this is the next stop.

0.89, very close by is another significant support line that proved its strength early in the year and also back in 2011. 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 – Strong and Stable

The Canadian dollar strengthened during August, and the government even feels confident about it. Finance minister Jim Flaherty says currency strength partly reflects fundamentals

Also the central bank maintains its hawkish tone. BOC's Carney said that Canada is seen as a safe haven, and this boosts the loonie, even though growth is expected to be slower in the future.

Canada still has debt concerns: household debt is an issue, as well as prices of homes, especially in Toronto.

The recent surge in oil prices has also been a blessing for the Canadian dollar: the loonie didn't suffer when prices slid beforehand, but certainly gained when they rose. If they rise too high, this could be counterproductive.

It's important to remember that Canada's economy is much more dependent on US demand than on oil prices.

Regarding oil prices, one of the things that pushed prices higher was tension between Israel and Iran. There are initial signs that Israel is backing off. If these signs will continue, prices could ease. As aforementioned, the impact on the loonie will not be that bad.

USD/CAD Technical Outlook

USD/CAD continued falling in the downtrend channel, but is now a bit struggling on low ground. Is more consolidation needed?

Lines

1.1130 is an old line dating from 2009. It is still high. 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 in Q3 2011. The round number of 1.05 is now a top in the range and can be challenged in the near future.

The round number of 1.03 was a battle line, and it seems that the pair overcame it. The 2009 low of 1.02, another round number, returns to the limelight.

The ultimate line of USD/CAD returns to have a major role after working as support. 0.98 is an important cushion on the downside, where the pair bottomed out. Note that 0.9840 has to be taken out first.

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.

The 2007 of 0.9056 is way down.

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

Australian Dollar – Pressure is Mounting

The Australian dollar retreated from highs, but didn't really lose too much so far. Looking at the wider charts, it can be seen that the **Aussie makes big moves in big ranges**: around 0.95 to 1.06. We might be seeing the downwards leg right now.

There are quite a few reasons for a downwards move:

- **Overcapacity of mining**: It's hard to be 100% sure that Chinese demand is nose-diving, but there are better signs that there is overcapacity in mining. Both reasons cause a plunge in commodity prices. The price of iron ore exports from Australia to China has plunged 38% in the past year. Coking coal fell by a quarter
- **Profits falling, projects cancelled**: BHP Billiton reported 35% drop in profits in H2 – indicator of Australia's mining. New projects have been cancelled. Official projects are for investment to peak somewhere at the end of 2013, but it seems that the fall in investment is already happening.
- **Negative talk**: Australian resources minister Martin Ferguson declared that the resources boom is over. Others say that the boom is "moderating" or that only growth in commodity prices is over while there's still strong investment there. Some predict recession as mining boom ends. In any case, there's a very lively debate down under.
- **Other negative signs**: Corporate insolvencies leap in Western Australia and in Queensland, where the mining industry sits. Retail sales are falling and so are building approvals.
- **Rate cuts**: From predictions for rate cuts only in 2012, there are now predictions for one or two cuts until the end of the year. This could weigh on the Aussie. Room for rate cuts in 2013

In general, falling commodity prices will force austerity or more debt issuance in Australia, eventually leading to lower yields and downwards pressure on the Aussie.

AUD/USD Technical Outlook

The Aussie fell off from the **uptrend, widening channel**, highlighted in the chart and a steep downtrend channel is emerging.

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. 1.0850 was a double top at the beginning of the year and is now resistance on strong upside moves.

The round number of 1.06 worked as support during two periods when the Aussie was trading higher. 1.0480 provided support during 2011 and it is only minor resistance at the moment.

1.0230 proved to be a critical separator, working as support earlier in the year, as resistance later on and now as somewhat weaker support, backed by 1.02.

AUD/USD Parity is an important psychological line, although not so strong. 0.96 provided an important cushion in September 2011 and also in June 2012.

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.

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

New Zealand Dollar – Will Surprising Strength Continue?

The kiwi performed quite well, especially in comparison with the Aussie. While Chinese demand for metals might be falling, people still need to eat, and New Zealand's commodities such as dairy products and meat are in abundance.

The high value of NZD is still worrisome to officials. The finance minister is worried about Chinese demand and the central bank is worried about NZD.

A rate cut will be deferred as long as the economy remains stable and NZD doesn't climb too much. QE3 in the US could push the vulnerable kiwi higher, and this could lead to a cut. Otherwise, there is a lot of room for falls at current levels.

NZD/USD Technical Outlook

While the kiwi ended the month lower, it was relatively strong when comparing to the Aussie. It is now at critical support.

Lines

The round number of 0.90 is in uncharted territory. The float-era high of 0.8842 is the ultimate resistance line.

0.8470 was the peak in 2012 and remains key resistance. 0.8242 capped the pair on the way up and remains important within the range trading.

0.7975, which was a veteran peak back in 2010 returns to play a major role as the pair stabilizes above the line. A loss would open the door for bigger falls. The round number of 0.78 worked as support in early 2011 and also in mid-2012 and is the next line.

0.7650 capped the pair on recovery attempts and also worked as resistance in 2009. 0.7450 was a stubborn bottom in May 2012 and was also a swing low in the fall of 2011.

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 in 2011 and a break lower would be a bearish signal. Under the round number of 0.70, the next line of support is 0.6815, which worked as such in early 2010.

For more on the kiwi, see the **NZD/USD Weekly Outlook**.

Relative Strength Index

August Revisited

This is how currencies moved in August:

1. CHF – USD/CHF rose 2.2%.
2. EUR – EUR/USD rose 2.2%.
3. CAD – USD/CAD fell 1.7%
4. GBP – GBP/USD rose 1.3%.
5. USD
6. JPY – USD/JPY rose 0.2%.
7. NZD – NZD/USD fell 0.7%.
8. AUD – AUD/USD fell 1.1%.

September Predictions

It's important to stress that this outlook is not a trade recommendation, but just commentary. This will be revisited in the next monthly outlook.

1. **EUR** – I'm betting on a positive outcome from the German constitutional court and a Spanish bailout request that will finally happen and will enable bond buying.
2. **CHF** – Unless the German court rejects the ESM, the SNB will have no problem maintaining the EUR/CHF peg.
3. **USD** – I'm betting that QE3 will not be announced and that the dollar will recover from the QE3 expectations.
4. **GBP** – Improving conditions in the UK could push the pound higher.
5. **JPY** – With USD/JPY at the lower end of the range, the yen could slide to the other side.
6. **CAD** – There is room for some reversal of the strong gains the loonie had, but these could be limited.
7. **AUD** – The Aussie still has room for falls
8. **NZD** – The kiwi was surprisingly strong and could now fall faster.

So is Long EUR/NZD the way to go? There are too many critical events and moving parts. We shall examine this next month.

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.

- August 31st: Ben Bernanke speaks in Jackson Hole. The speech is eventually analyzed as dovish, but there's no clear cut.
- 4th: Australian rate decision
- 4th: Swiss GDP – The fall justifies the peg.
- 5th: Australian GDP.
- 5th: Canadian rate decision
- 6th: British rate decision
- 6th: ECB Rate Decision: The bond buying scheme could be launched here.
- 7th: US Non-Farm Payrolls – Critical for rate decision.
- 7th: Canadian employment data.
- 11th: Catalan National Day – Big demonstrations expected.
- **12th: German Constitutional Court Decision – Approval Expected**
- 12th: Elections in the Netherlands
- 12th: New Zealand rate decision
- 13-14th: G-20 finance minister meetings.
- 13th: Swiss Rate Decision – In this timing last year, they introduced the peg.
- **13th: US rate decision (including press conference with Bernanke) – QE or no QE?**
- 14th: European Council meetings. Will Spain ask for help in this meeting?
- 15th: Eurogroup meetings
- 18th: New Zealand GDP.
- 18th: Spanish 10 year bond auction.
- 19th: Japanese rate decision
- 26th: Italian 10 year bond auction.
- 27th: US Final GDP.

Sources for this report:

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

- Forex Factory Calendar

Additional Notes for Forex Traders

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

Volatility Predicted to Explode

September is the month when traders come back from vacations and the markets return to full speed. In recent years, September has seen unusual action, such as the Swiss move to weaken the franc and of course Lehman's collapse in 2008. As aforementioned, the calendar is fully packed.

Trade with care! 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.

Apart from looking how to win in trading, it's important to limit your risk. Here are three basic methods for this.

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 – Q3 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** – 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!