



Global Foreign Exchange Strategy
Global themes and implications for EUR/USD

June 2008

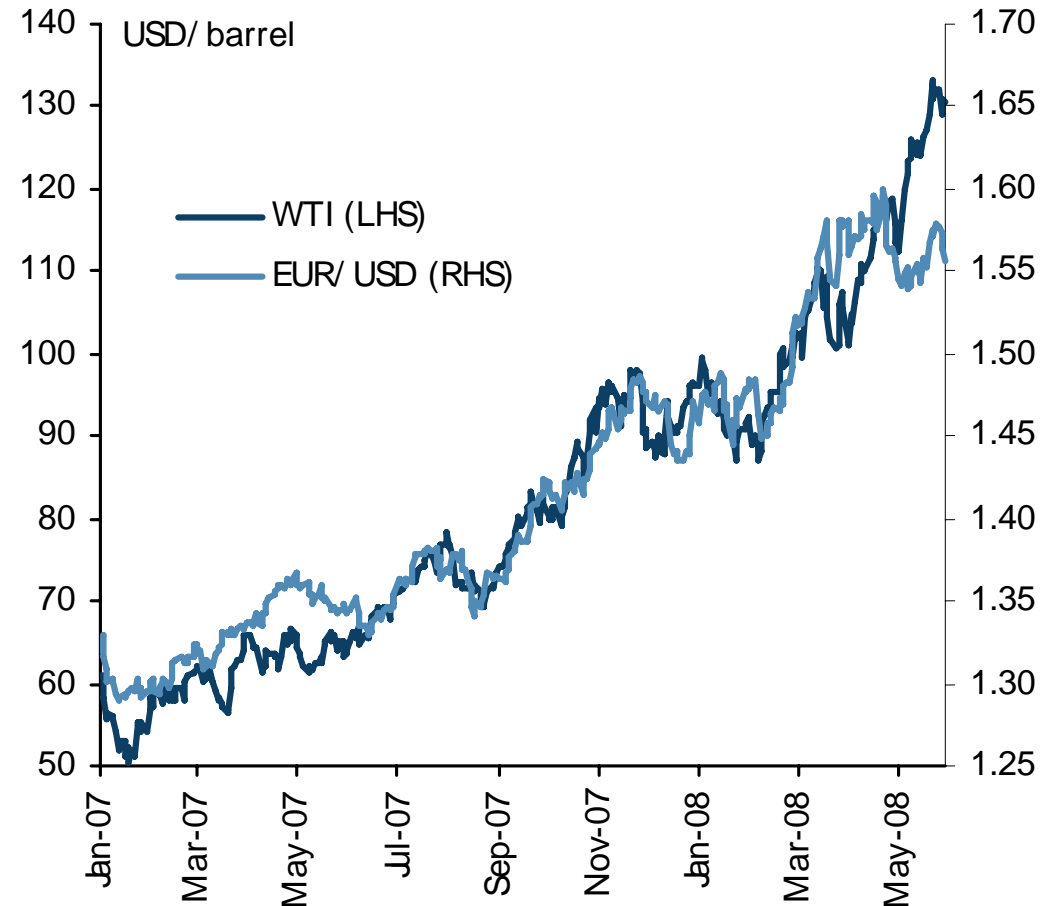
Adarsh Sinha

Outline

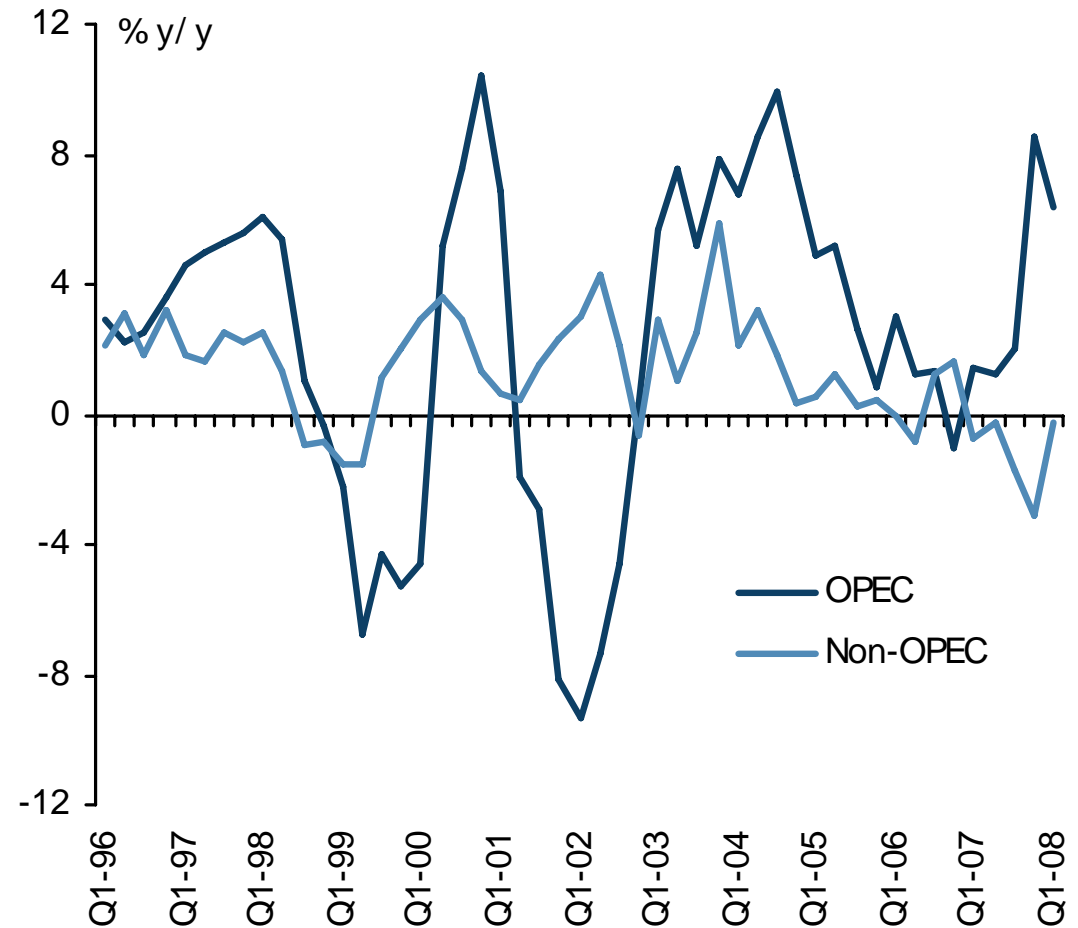
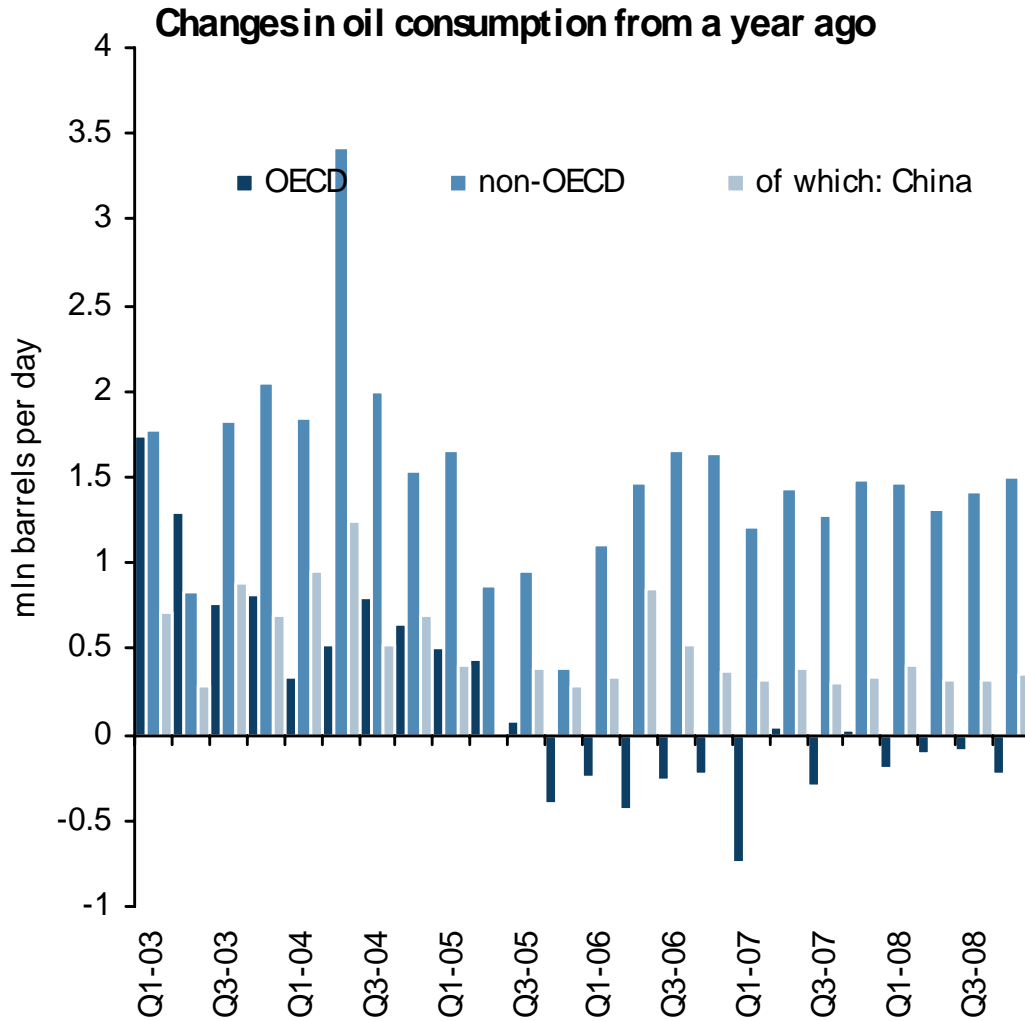
- Major themes
 - ▶ Commodity prices
 - ▶ Global growth and inflation
 - ▶ Risk appetite and other asset classes
- Implications for EUR/USD
 - ▶ Interest rate outlook
 - ▶ Importance of oil prices
 - ▶ Valuation
- FX Forecasts

Theme 1: Outlook for commodity prices and implications for FX

- Commodity prices have taken over from equities as the asset class of primary interest to FX market participants
- However, the previously close correlation between EUR/USD and the oil price has broken down recently
- We expect commodity prices to remain strong, but not to continue to grow so quickly
- The chief loser from high commodity prices has been the USD
- Chief winners: AUD, NZD, NOK
- CAD gains from being a commodity producer but loses in other ways

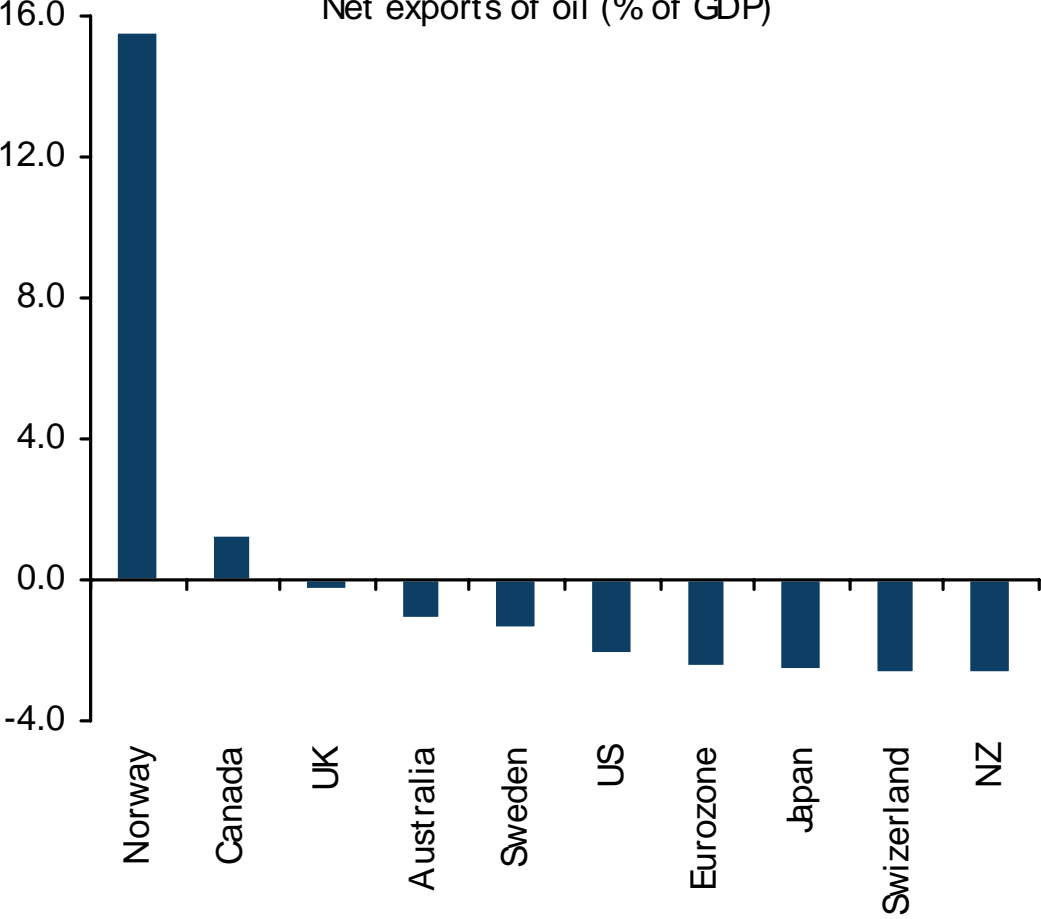


The increase in non-OECD demand is outweighing the fall in OECD demand. Non-OPEC supply is struggling

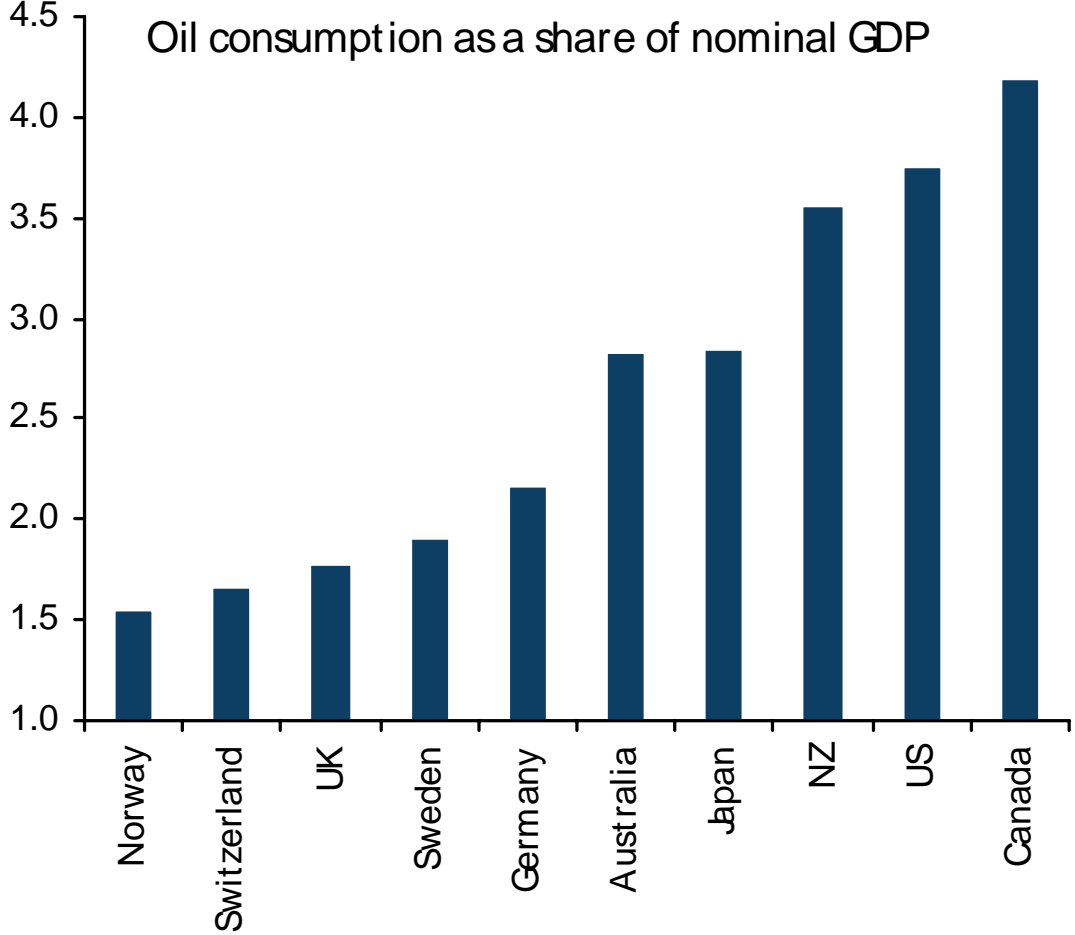


Winners and losers from further oil price rises – four criteria

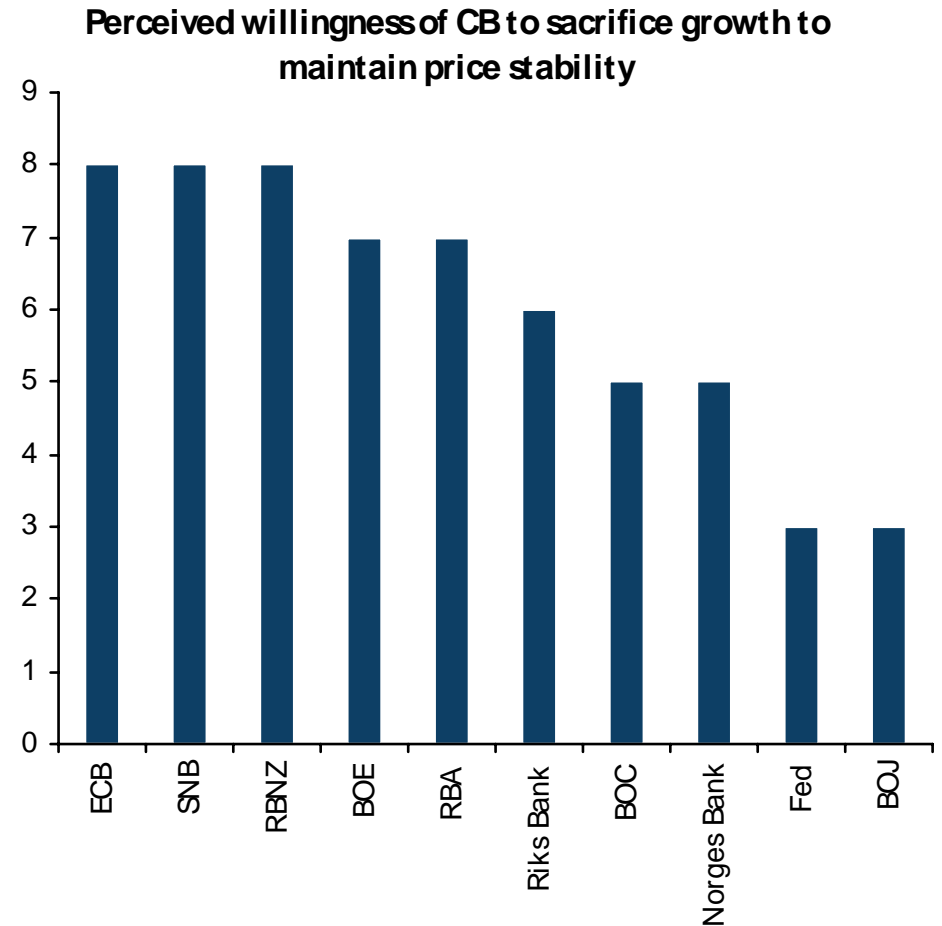
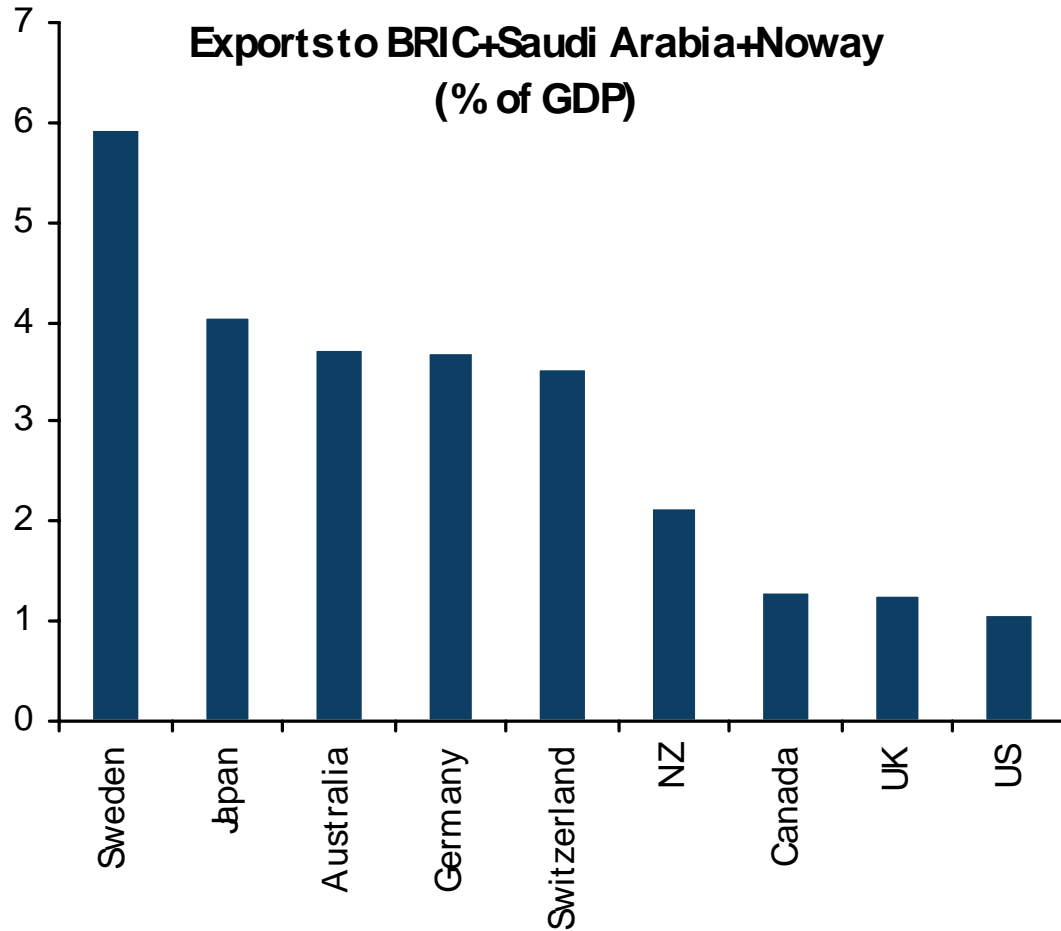
Net exports of oil (% of GDP)



Oil consumption as a share of nominal GDP



Winners and losers from further oil price rises – four criteria

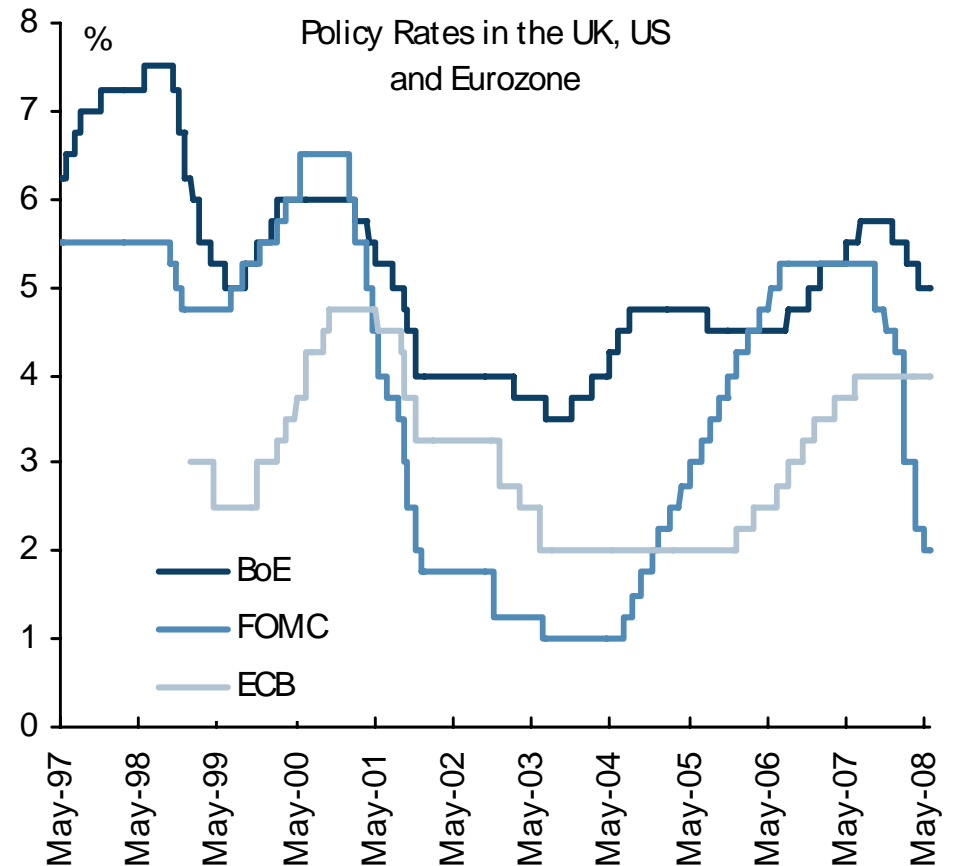


Outlook varies across commodities – but on the whole we don't expect prices to fall back sharply (or rise as sharply as previously)

		2003	2004	2005	2006	2007	2008E	2009E	Long Term	2008/2007
Base Metals										
Aluminium	US\$/t	1.431	1716	1900	2568	2640	3470	4500	3200	31.4
Copper	US\$/t	1778	2865	3682	6731	7129	7916	7175	5000	11.0
Lead	US\$/t	515	886	977	1286	2593	2885	2525	1500	11.3
Nickel	US\$/t	9637	13846	14750	24271	37276	28591	13875	19000	-23.3
Tin	US\$/t	4894	8484	7375	8761	14542	17886	15625	12500	23.0
Zinc	US\$/t	828	1049	1383	3274	3251	2081	1900	2000	-36.0
Base Metal Index		74.7	107.1	121.7	197.6	237.2	245.6			3.5
Precious Metals										
Gold	US\$/oz	364	410	445	604	697	891	840	450	27.8
Silver	US\$/oz	4.9	6.7	7.3	11.6	13.4	15.2	12.5	5.5	13.4
Platinum	US\$/oz	692	844	896	1139	1304	1966	1700	900	50.8
Palladium	US\$/oz	200	229	202	319	354	387	320	350	9.3
Energy										
WTI	US\$/bbl	31	41.5	56.7	66.2	72.3	116.9	123.2	137	61.7
Brent	US\$/bbl	28.5	38	55.1	66.1	72.7	115.2	121.7	135.5	58.5
US Natural Gas	US\$/bbl	5.5	6.2	9	7	7.1	10.7	10.2	10	50.7

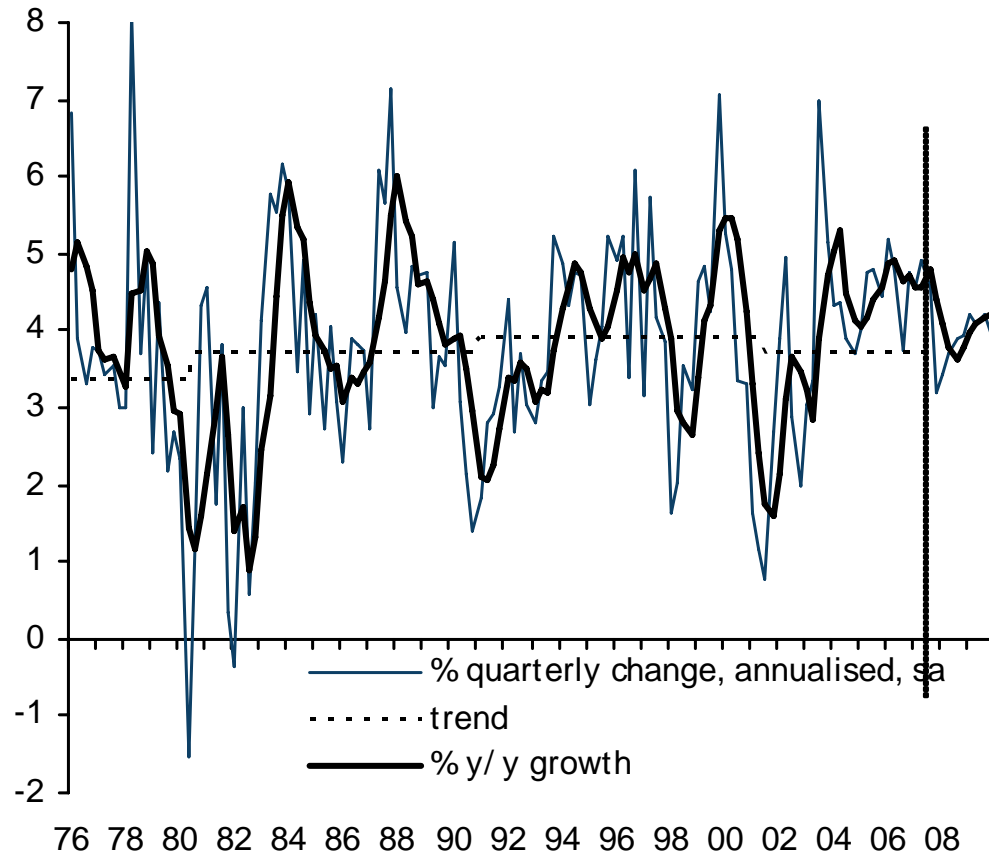
Theme 2: Global growth and inflation

- Inflationary risks have increased and growth prospects deteriorated around the world
- Higher commodity prices, especially if driven by weak supply, add to the after-effects of a prolonged period of loose policy
- The way that economies are positioned to cope with these influences is likely to be key to FX performance going forward
- As is the response of central banks
- Both the ECB and the Fed have surprised market on the hawkish side recently

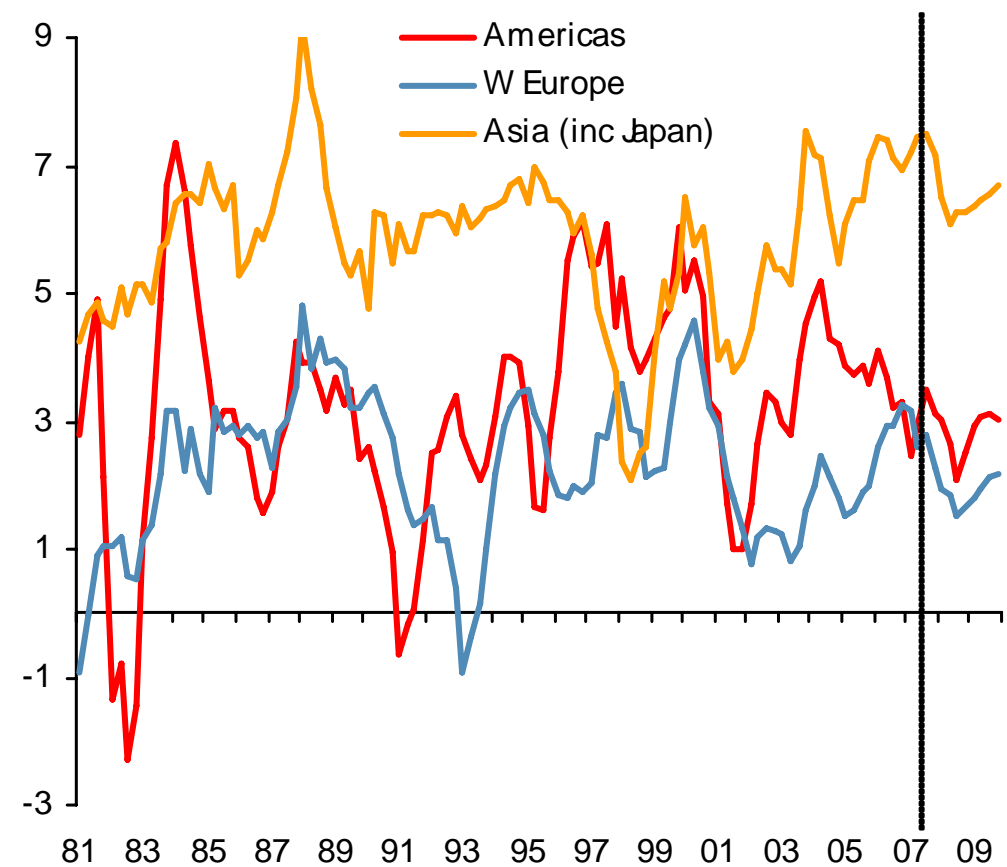


Global GDP growth has been very strong – but has become more imbalanced – and is likely to weaken ahead

Global real GDP growth

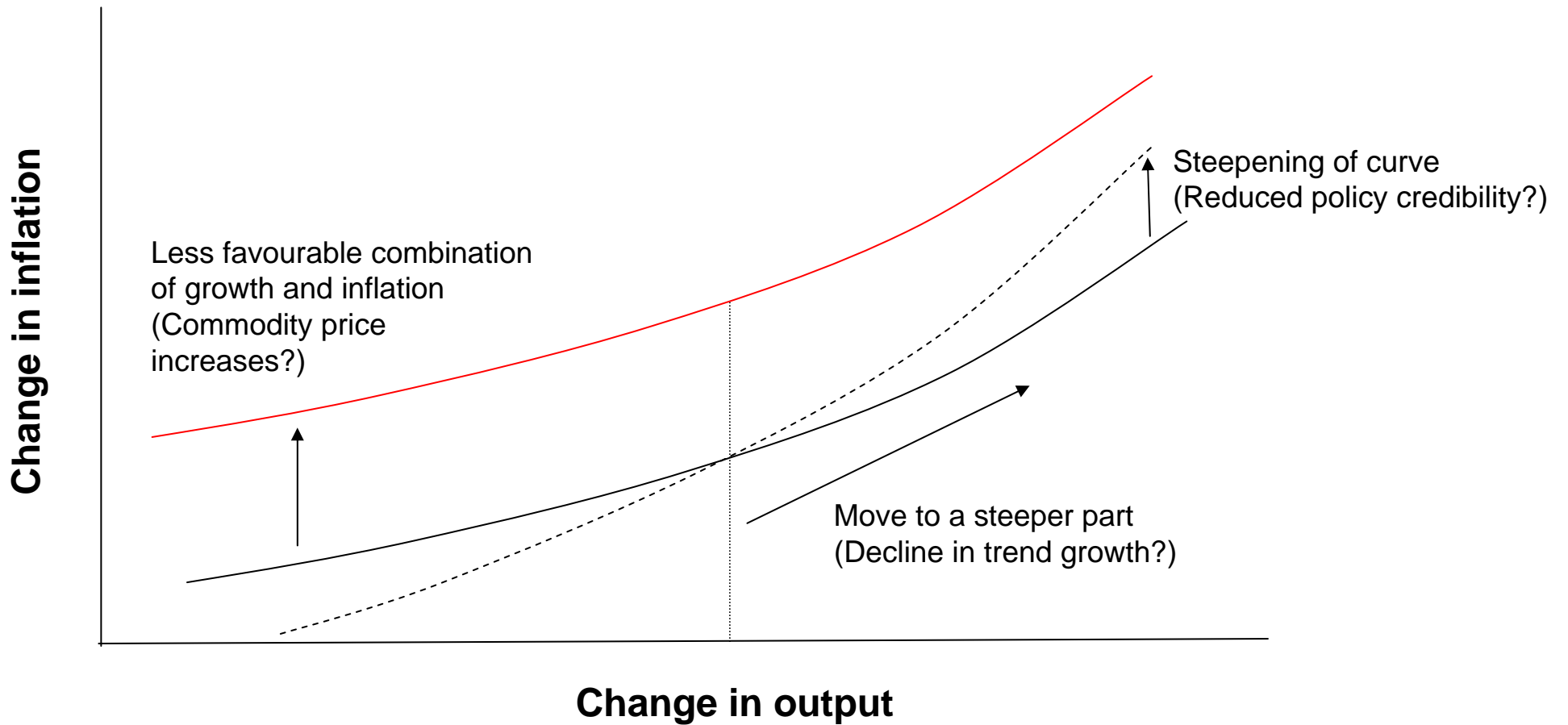


Regional growth (% y/ y rate)



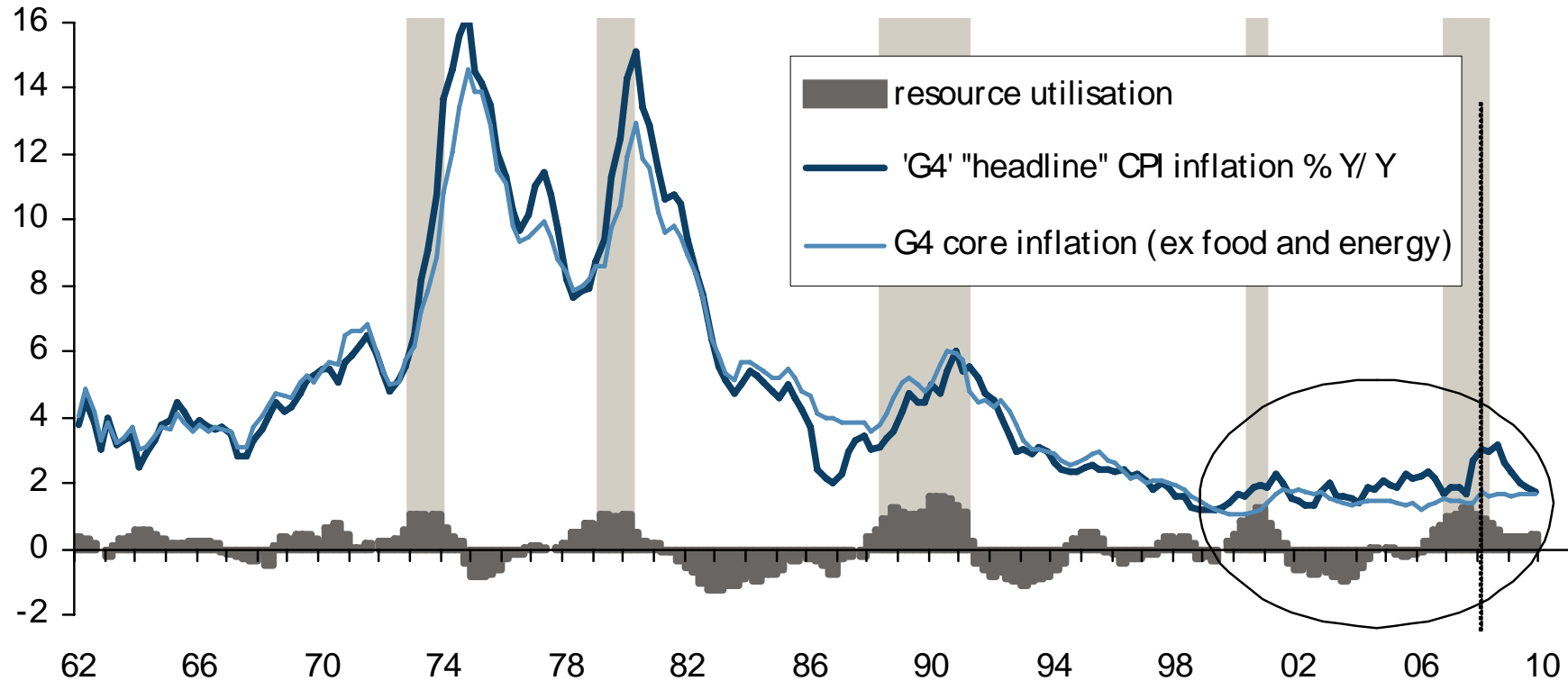
Source: Barclays Capital, using PPP weights

Why has the growth/inflation mix worsened?



“Resource utilisation” continues to be positive

Comparing inflation vs. resource utilisation in the "G4" (US, euro, UK, Japan)



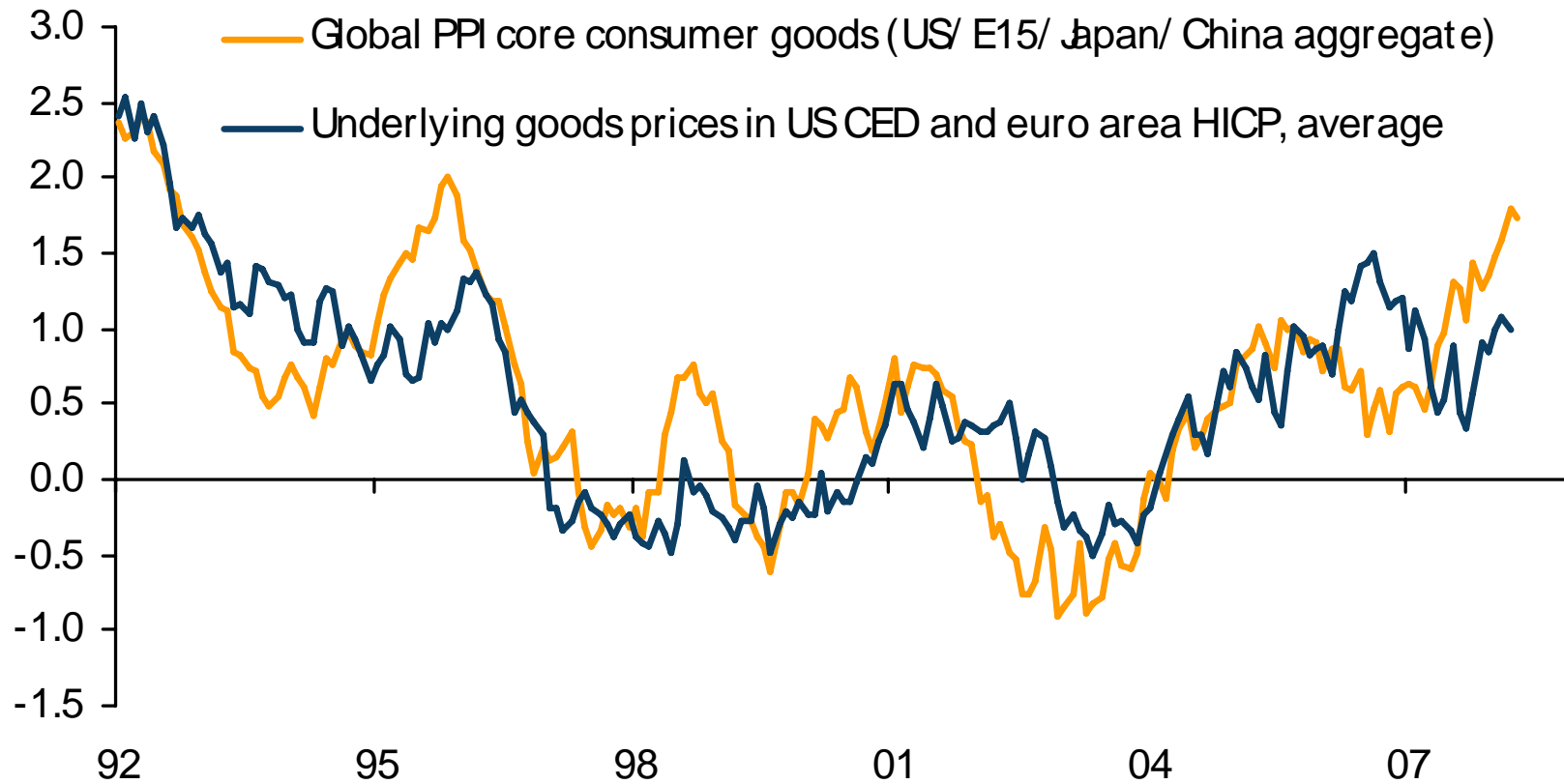
Resource utilisation is created as a weighted composite of normalised series representing firms' perceived labour market shortages plus capacity utilisation in the G4 (US, E12, UK, Japan); pre 1985 based on OECD output gaps

source: Barclays Capital

note: "G4" comprises US, E12, UK and Japan

Rising core producer price inflation

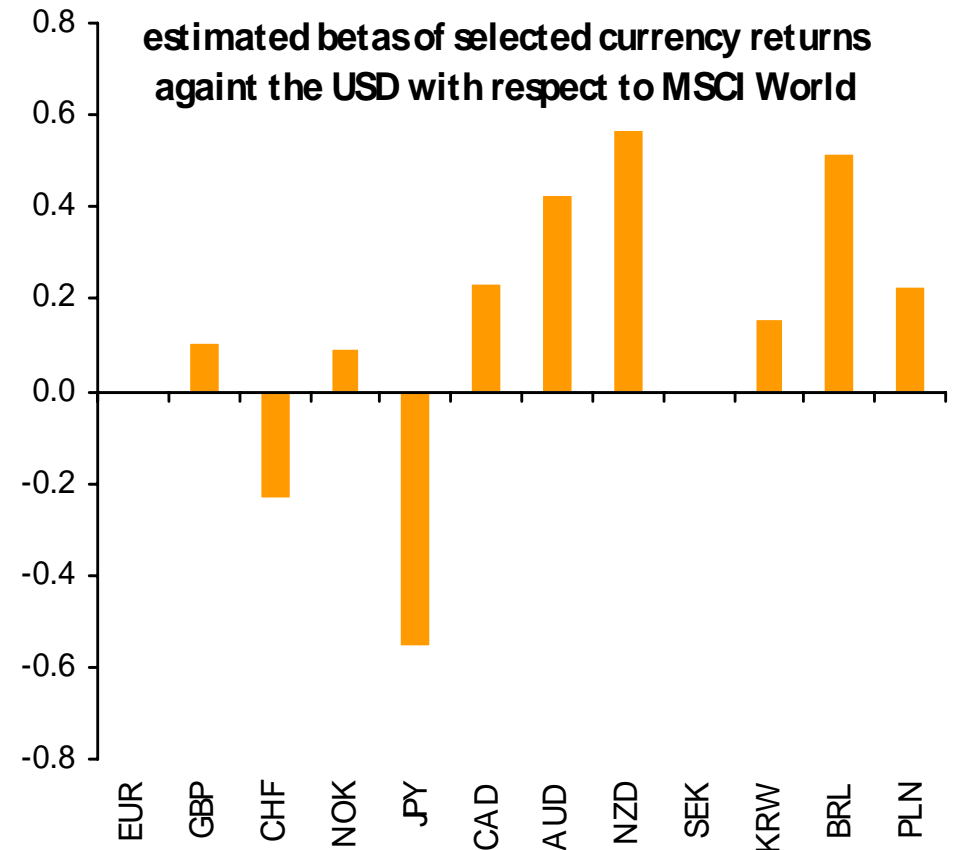
Underlying global goods prices (% y/ y)



Source: Datastream, Barclays Capital

Theme 3: Investor appetite and FX

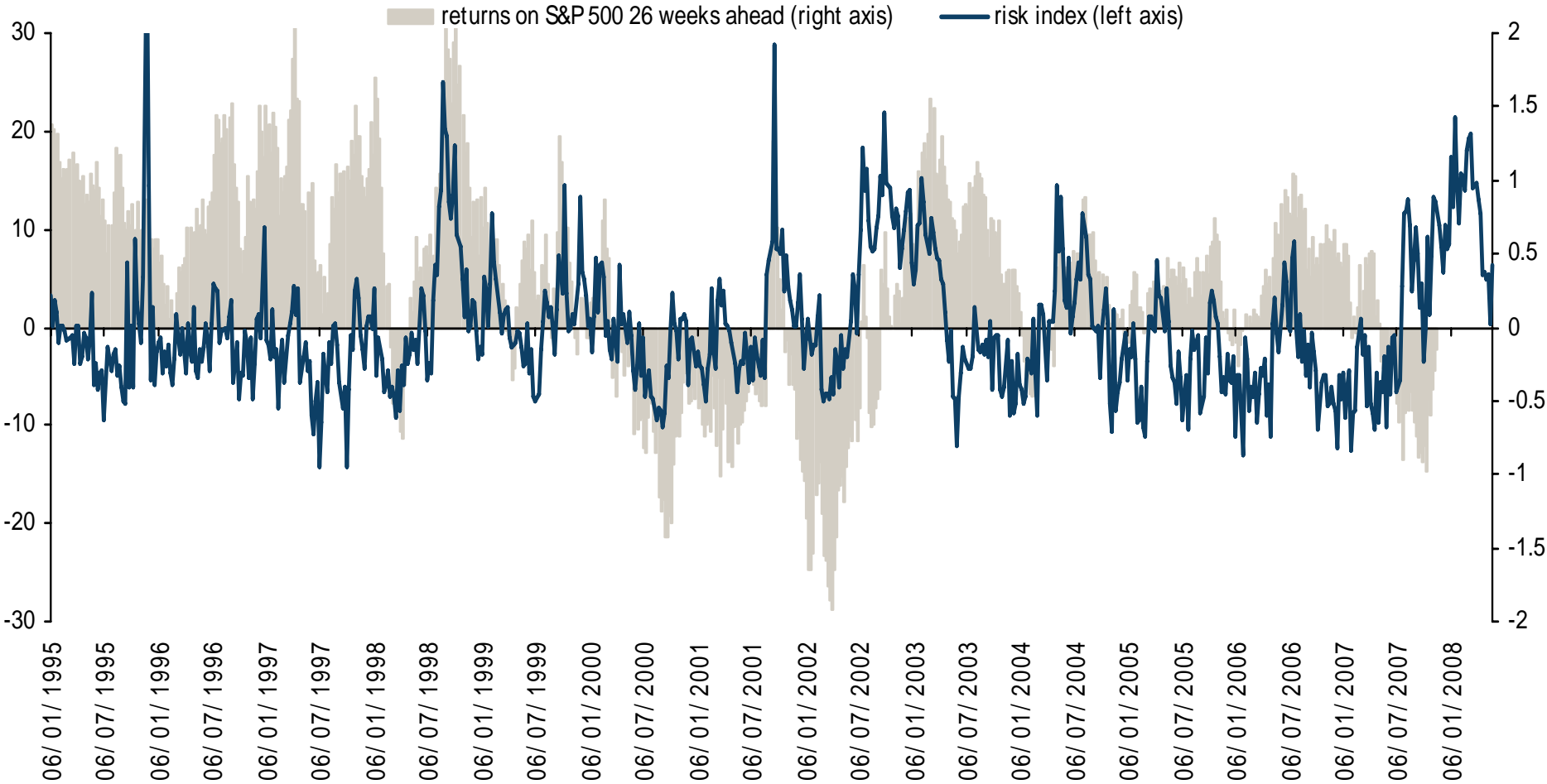
- Recently the FX markets have moved more closely with other assets – particularly equities
- Good reasons why this is the case:
 - ▶ Sub-prime/credit issues mean that the past macro position is less helpful
 - ▶ And forward-looking issues become more important
 - ▶ The repricing of risk affects assets across financial markets
- If risk continues to drive equities the close relationship between FX and equities (and other asset classes) is more likely to persist...
- ... than if idiosyncratic economic prospects start to dominate



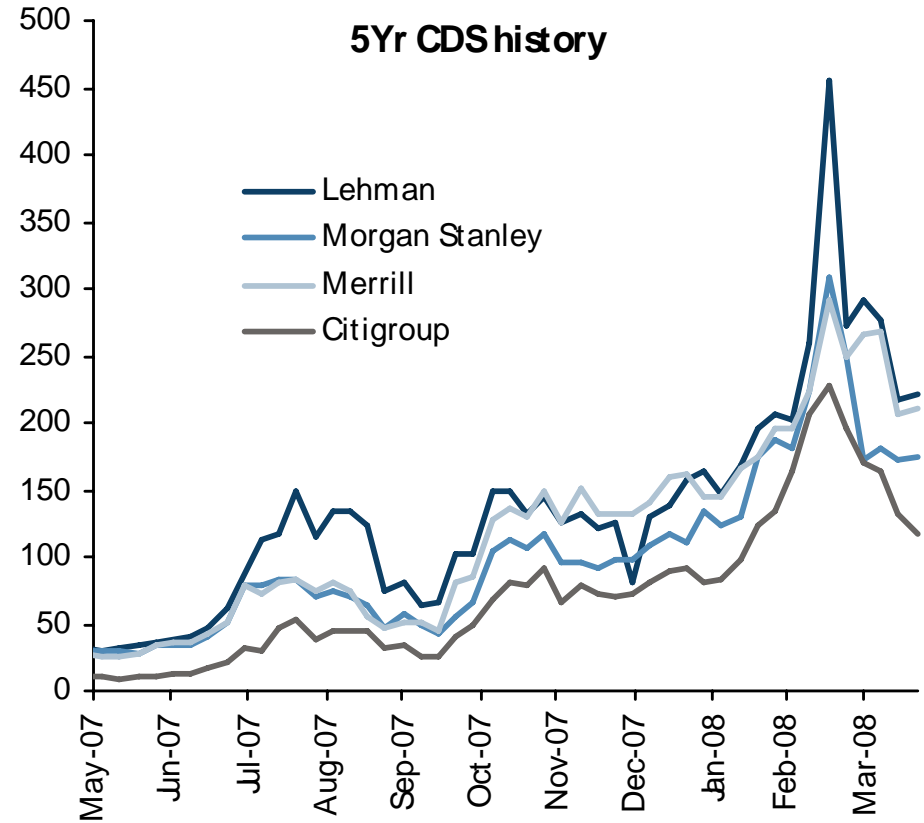
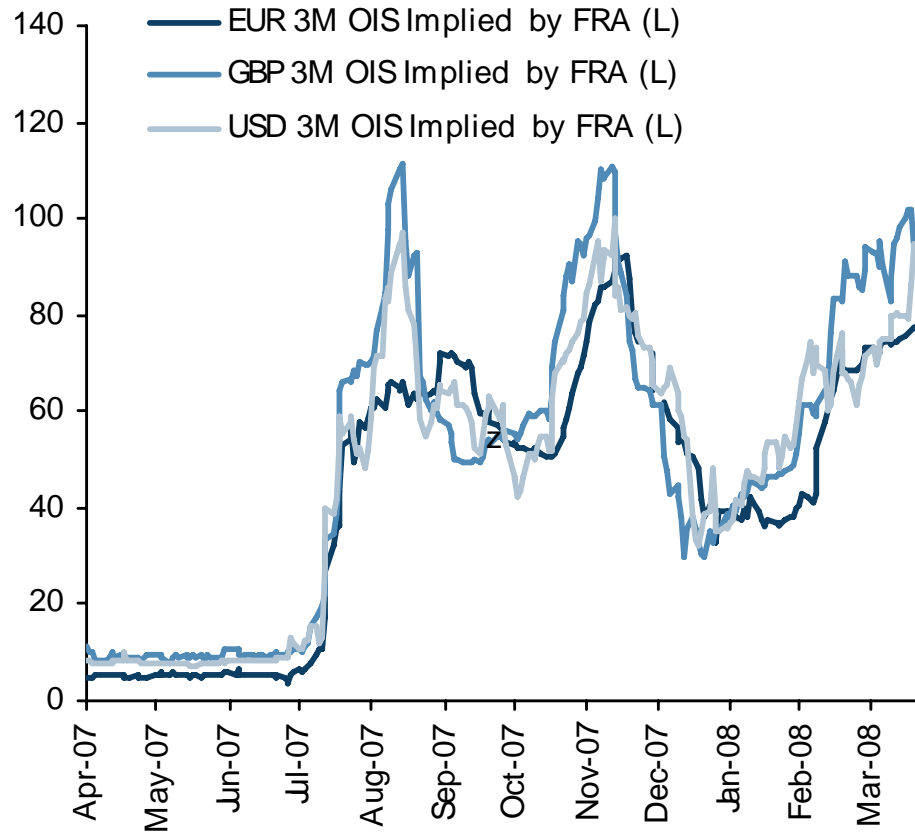
Markets are long commodities, neutral bonds and have largely squared up short equity positions

Asset	52-week-low	Minus 1SD	CFTC net long/open interest	Percentrank	Standardised Percentrank	Plus 1SD	52-week-high
NYMEX Gold	15.5	26.3	44.4	100.0%	1.00	41.9	44.4
CBOT 30-Day Fed Fund	-26.1	-8.3	23.0	100.0%	1.00	14.8	23.0
NYMEX Heating Oil	8.4	8.7	19.9	100.0%	1.00	14.6	19.9
Goldman Sachs Commodity Index (CME)	12.8	17.7	37.8	96.0%	0.92	32.4	39.2
CME Russell 2000 index	-37.9	-34.4	-15.1	96.0%	0.92	-19.2	-9.6
FINEX US Dollar Index	-64.8	-53.3	-3.0	90.1%	0.80	-7.9	9.9
MXN	-38.7	11.5	78.7	84.3%	0.69	78.9	86.3
CBOT Corn Future	13.7	16.3	25.1	84.3%	0.69	24.5	26.0
CBOT Dow Jones Industrial Average	-25.9	-5.1	11.9	78.4%	0.57	16.2	24.6
CAD	0.7	13.4	39.3	72.5%	0.45	43.8	52.7
AUD	5.2	28.4	53.1	70.5%	0.41	57.4	63.3
JPY	-53.4	-21.9	19.4	70.5%	0.41	26.4	33.5
NYMEX Copper	-12.4	-10.3	3.7	70.5%	0.41	4.6	9.7
CME Milk	1.1	4.8	17.3	66.6%	0.33	20.6	28.5
CME 3m Euroyen TIBOR	-26.7	-8.4	7.9	64.7%	0.29	11.5	16.3
NYMEX Natural Gas	-13.2	-10.4	-7.7	56.8%	0.14	-6.1	-2.2
CME 1m LIBOR	-29.9	-14.3	11.6	54.9%	0.10	16.8	24.8
CME 3m Eurodollar	1.9	7.5	10.1	49.0%	-0.02	14.3	17.4
CME S&P 500	-7.7	-6.3	-4.3	43.1%	-0.14	-1.8	-0.3
Nasdaq 100	-31.3	-20.0	-12.5	41.1%	-0.18	-0.1	7.4
CBOT Gold 100oz	-13.3	0.7	7.1	39.2%	-0.22	18.3	31.4
CBOT 2yr US Treasury Note	-14.7	-4.1	-1.2	25.4%	-0.49	8.1	16.3
CHF	-71.8	-28.1	-14.2	25.4%	-0.49	15.3	21.4
CBOT 10yr US Treasury Note	-4.6	1.6	2.0	19.6%	-0.61	15.8	20.8
NYMEX Platinum	37.0	42.6	42.7	11.7%	-0.77	57.0	64.9
NZD	11.3	31.5	15.5	5.8%	-0.88	65.1	73.0
EUR	-11.1	9.1	-1.5	5.8%	-0.88	37.9	46.0
GBP	-21.0	-3.8	-15.2	5.8%	-0.88	43.6	60.2
KCBT Wheat	12.1	24.5	21.7	3.9%	-0.92	32.2	33.7
NYMEX Light Sweet Crude Oil	1.8	2.9	1.9	3.9%	-0.92	6.3	8.4
CME Nikkei Stock Index	-44.0	-38.5	-43.9	1.9%	-0.96	-11.9	-1.9
CBOT Wheat	-0.3	2.5	-0.3	0.0%	-1.00	7.2	8.6
CME Standard & Poor's MidCap 400	-13.3	-7.8	-13.3	0.0%	-1.00	5.5	6.5
CEI Silver	-13.7	-16.6	-13.7	0.0%	-1.00	-8.9	3.0

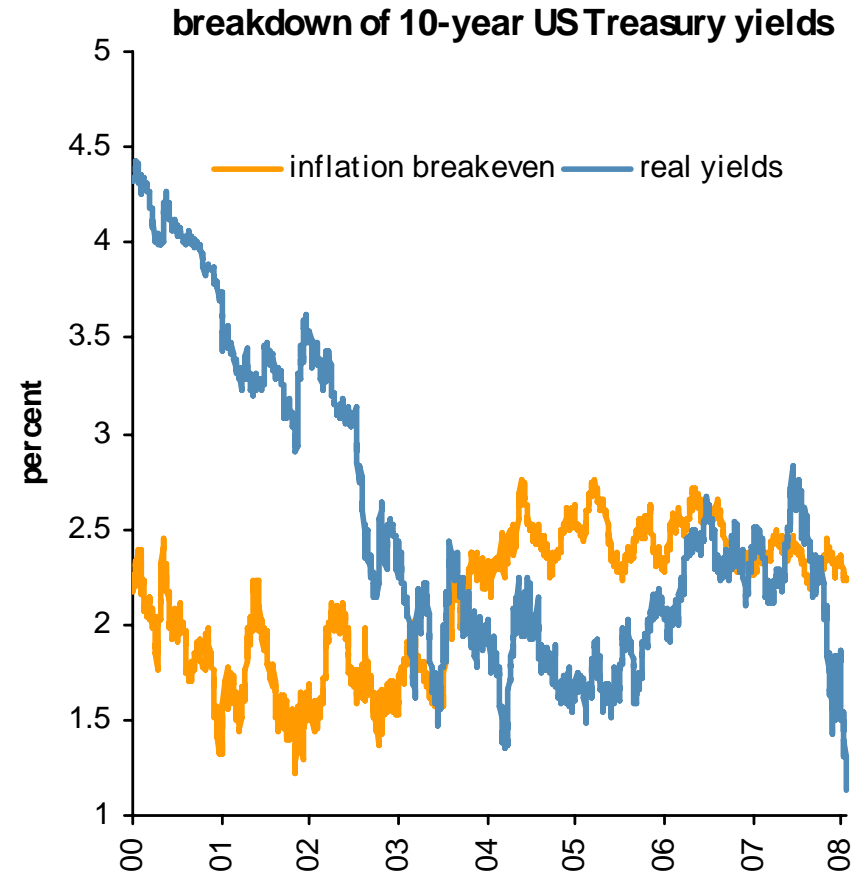
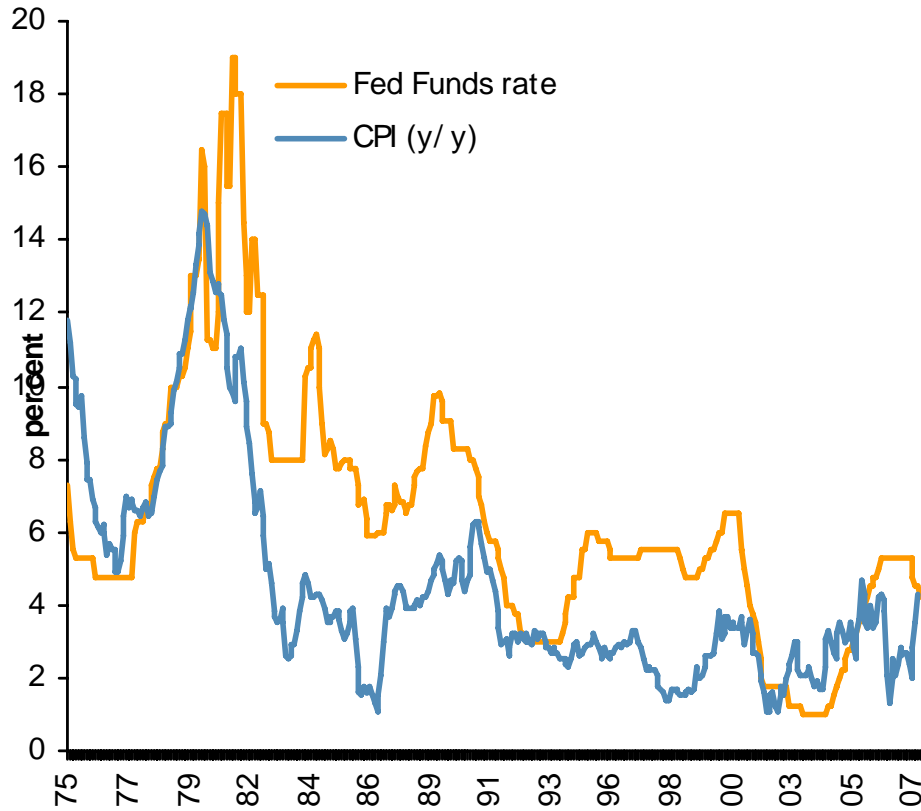
Risk aversion has fallen to normal levels



Financial market problems persist but disaster has probably been averted



Fed's ability to support the stock market is more limited than in the past easing cycles, as scope for compression of long-term bond yields is limited

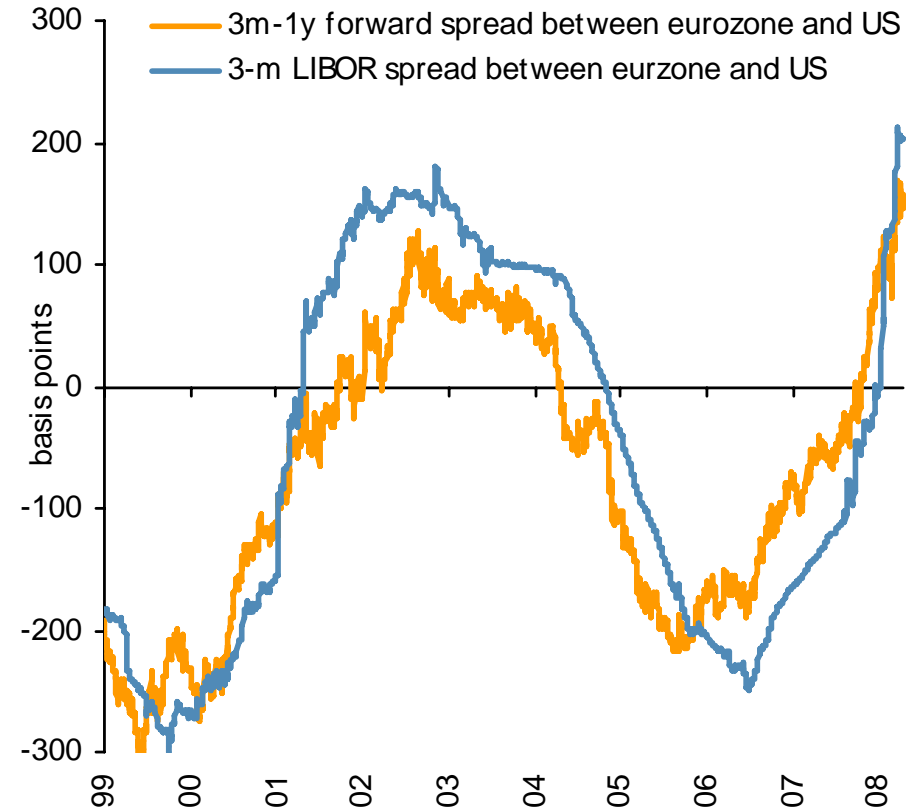
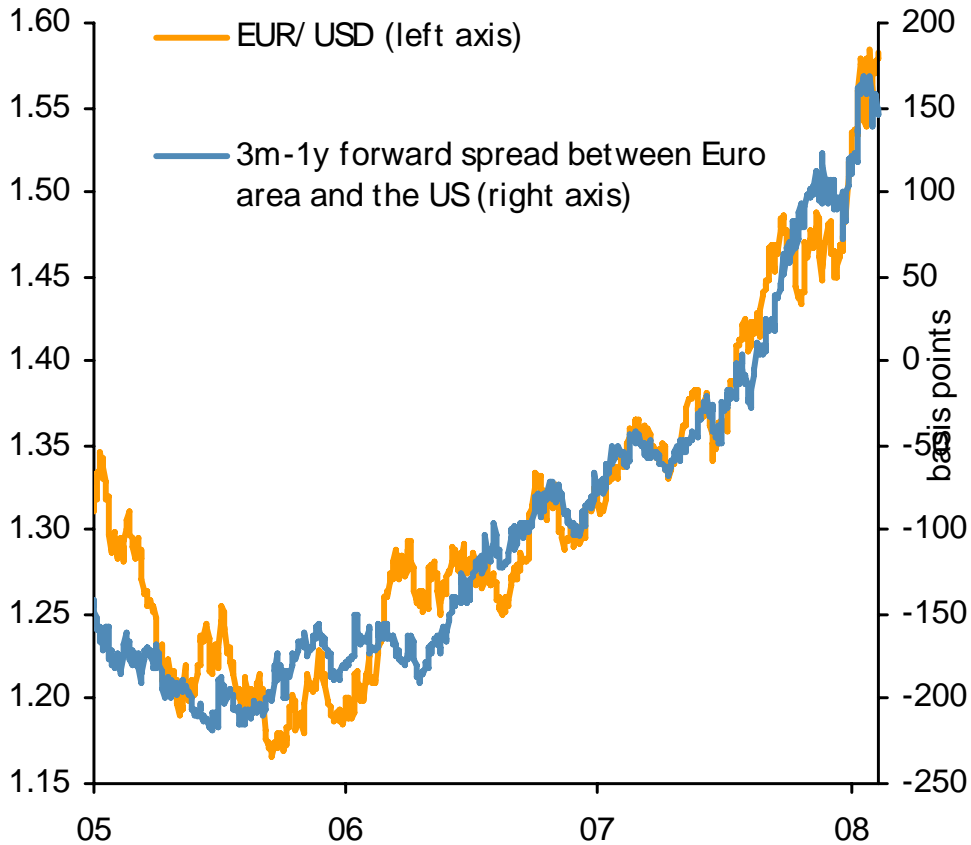


Implications for EUR/USD

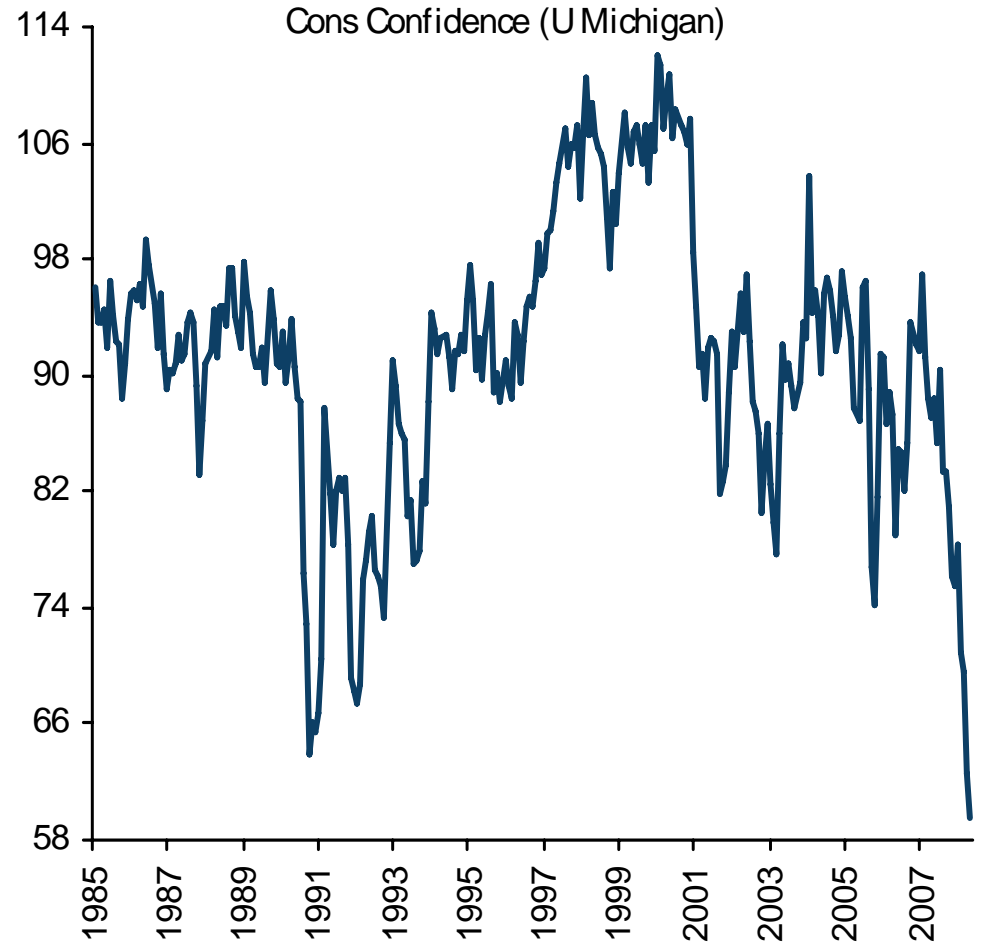
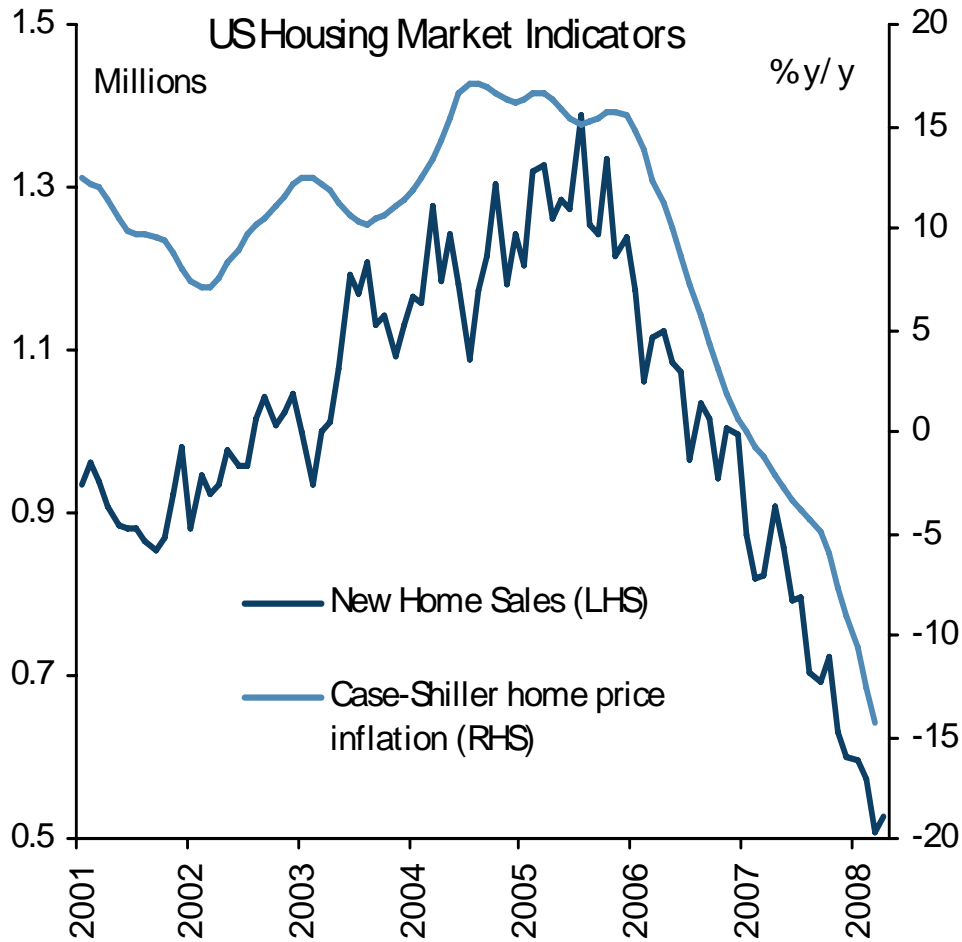
Summary of EUR/USD view

- Upside risk for EUR/USD over the short term, but we expect depreciation beyond three months (3-month forecast: 1.59, 12-month forecast: 1.50)
 - ▶ There are plenty of negatives for the USD but much is priced in.
 - ▶ In the short-term however, EUR/USD could appreciate because of relative interest rates, oil prices and positioning.
 - ▶ The increasing focus by the Fed on the effect of commodity prices and the USD on inflation has reduced the chances of a very large decline in the USD.
 - ▶ But the ECB remains likely to raise interest rates before the Fed

EUR/USD: Relative interest rate expectations for the ECB and Fed approaching a cyclical extreme, but ECB continues to sound hawkish relative to the Fed

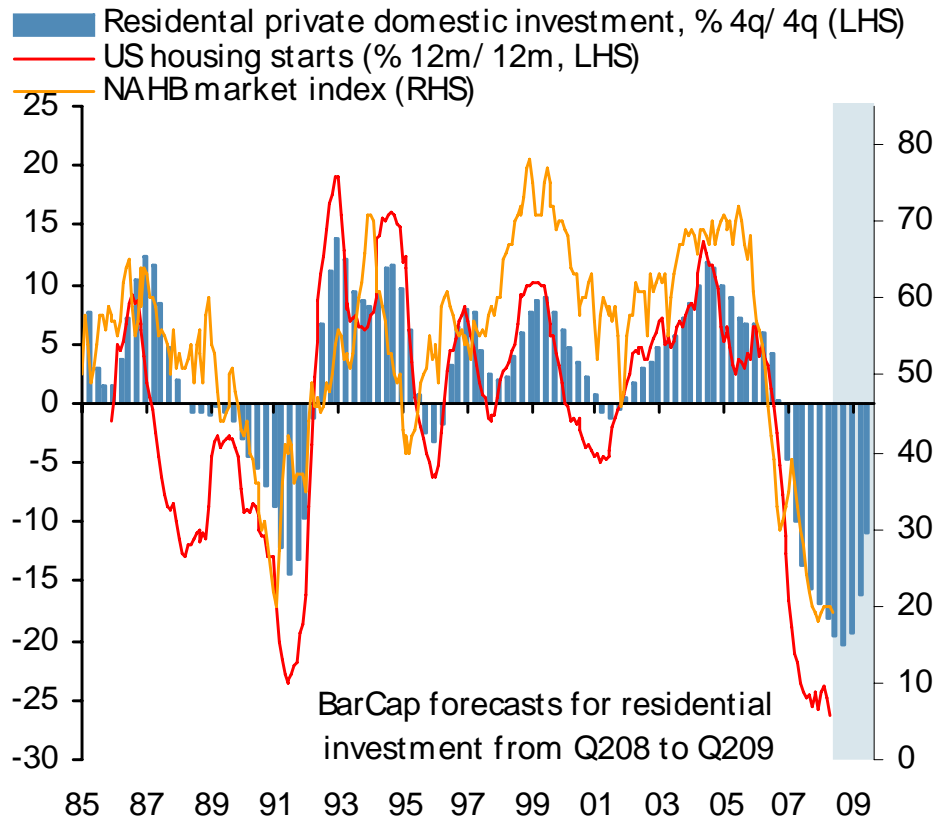


The US remains the weakest part of the global economy

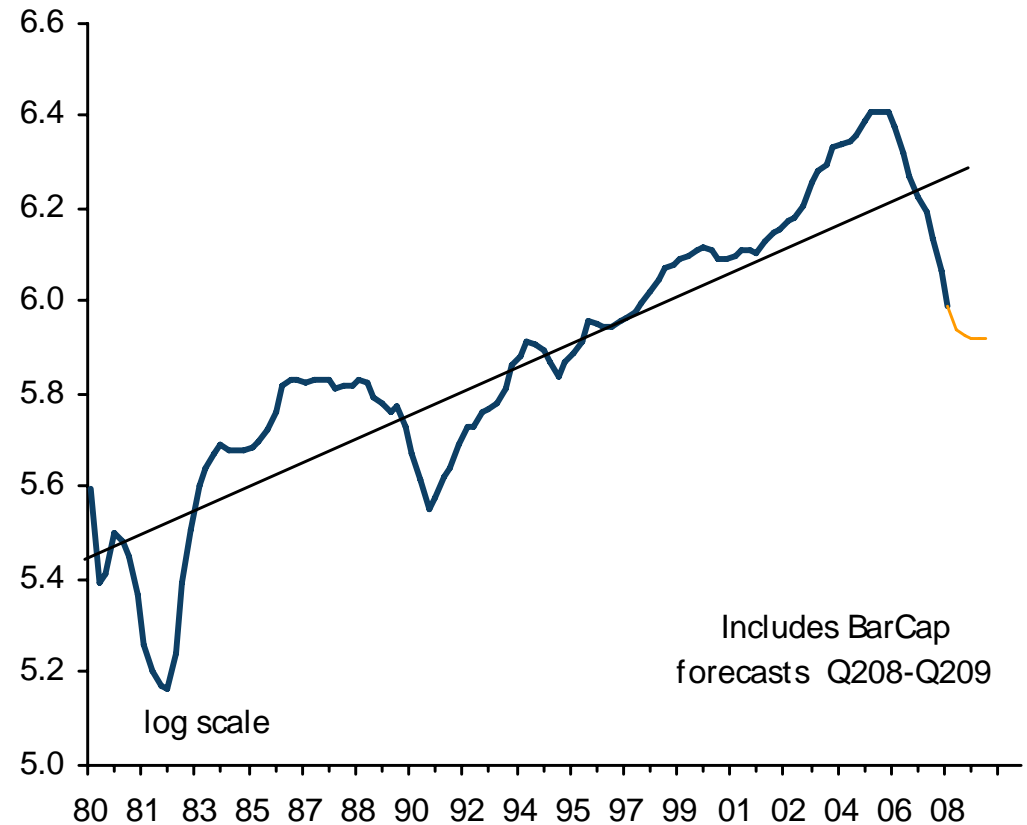


But we feel that things are likely to improve from here, eg US housing investment is close to a bottom

Residential investment vs NAHB market index



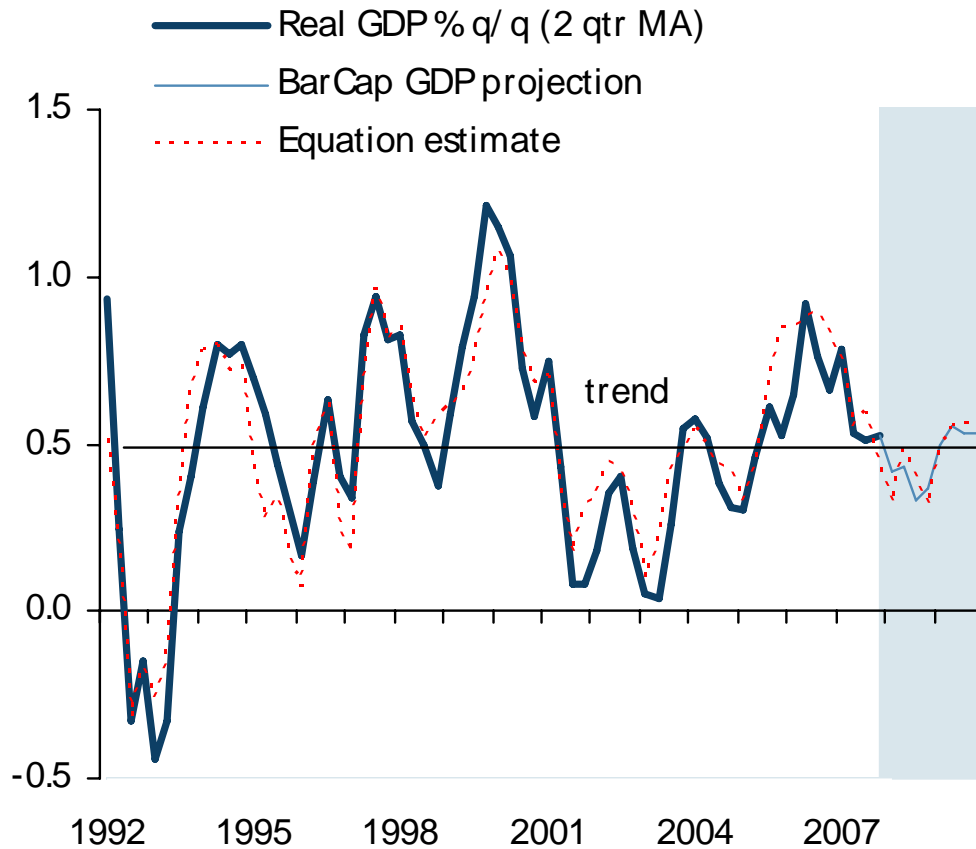
US real residential housing investment (log scale)



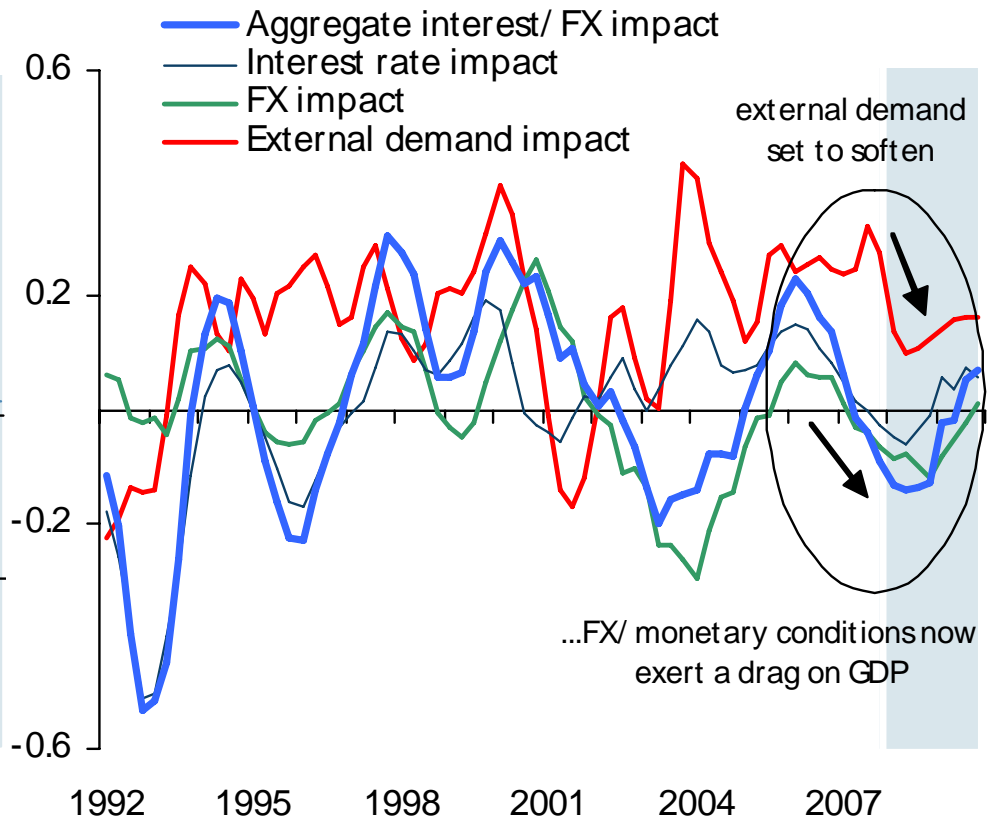
Source: Datastream, Bloomberg, Barclays Capital

Our euro area GDP equation signals sub-trend growth

BarCap euro area GDP equation

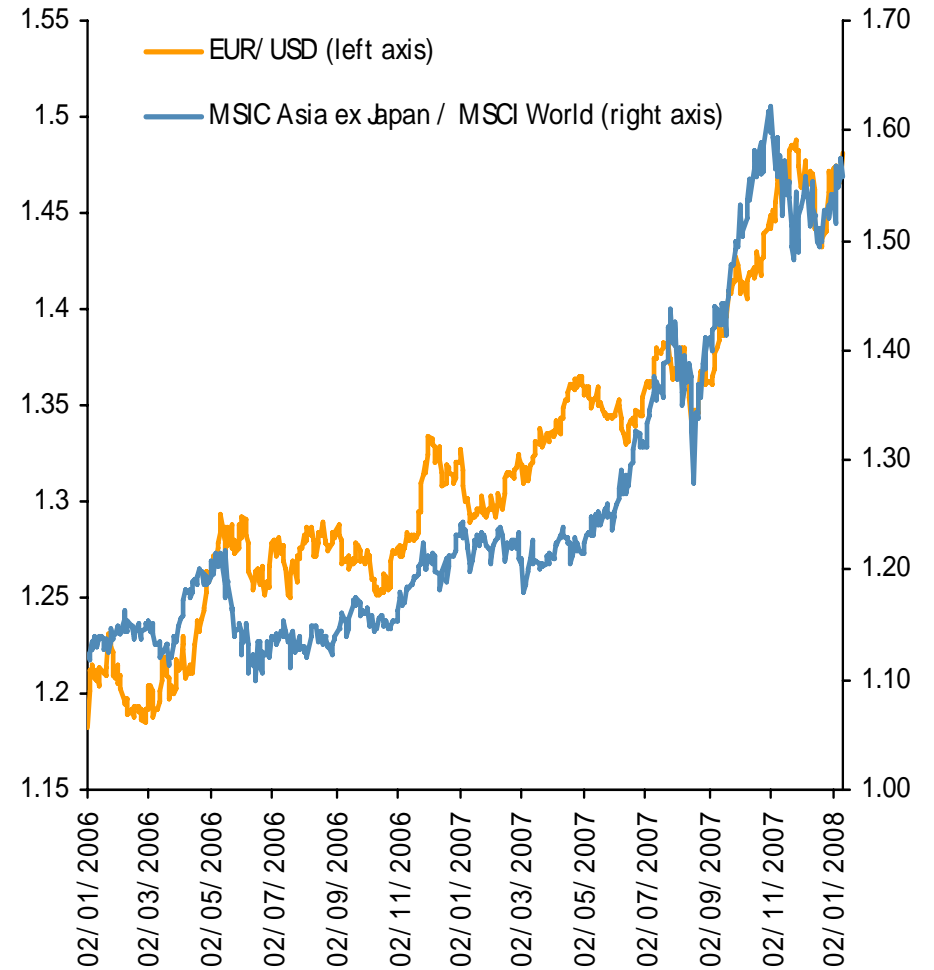
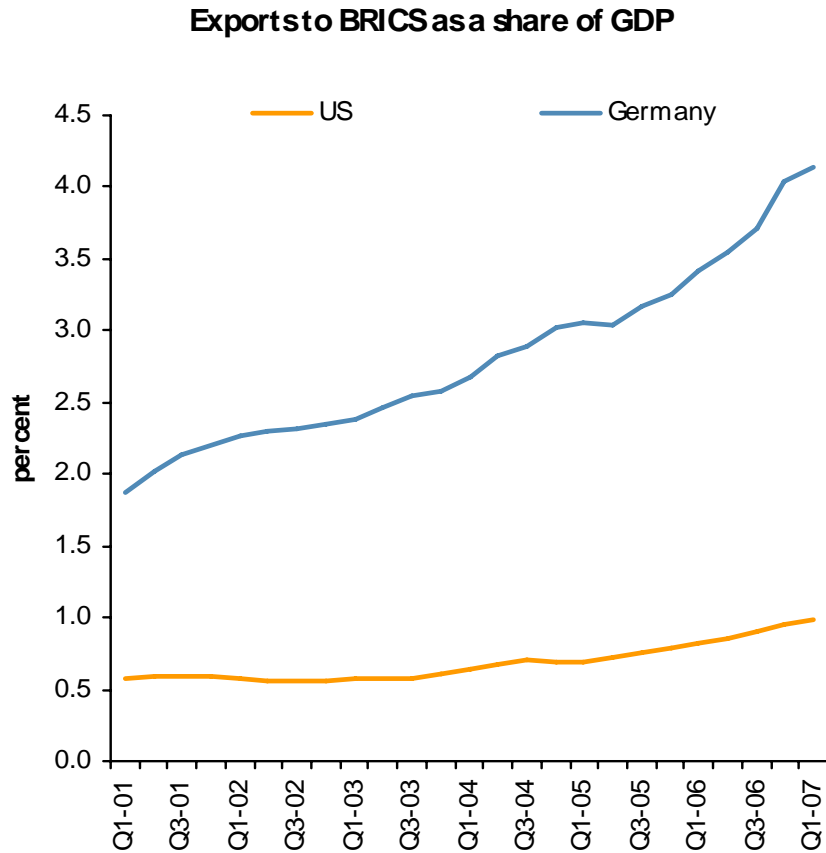


Impact of key components (pp impact on q/ q GDP)

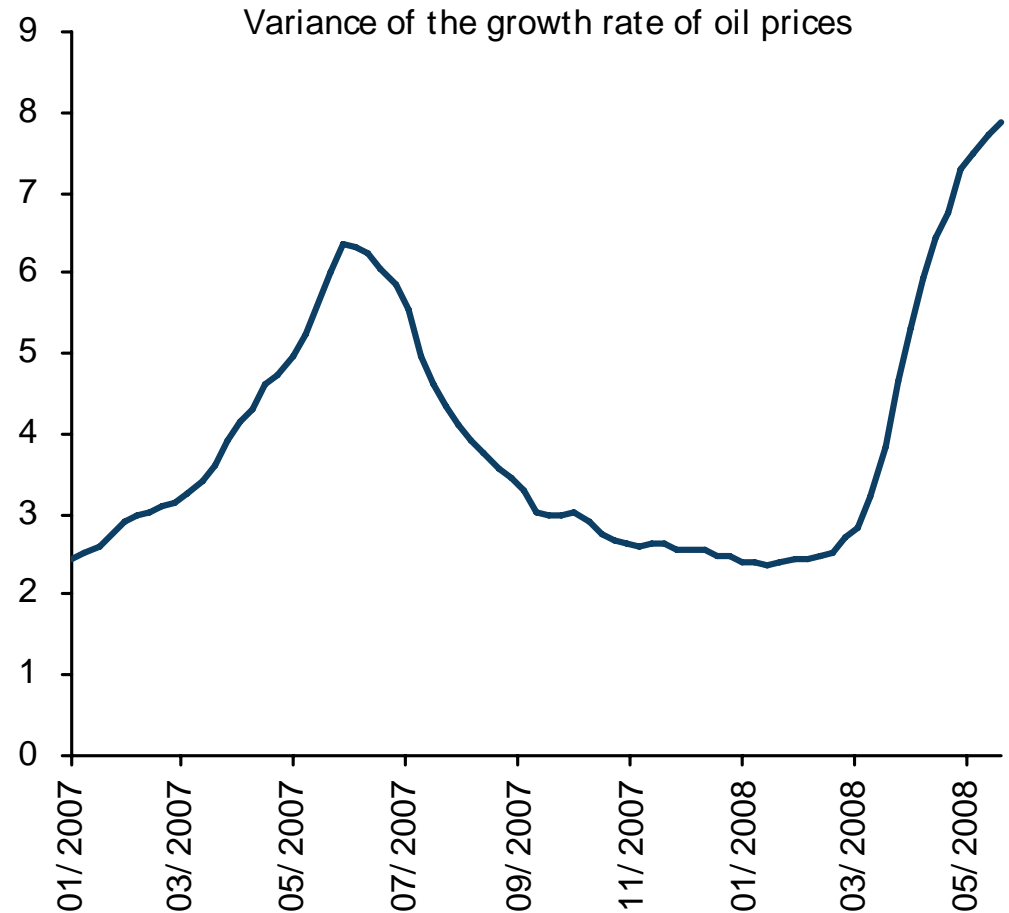
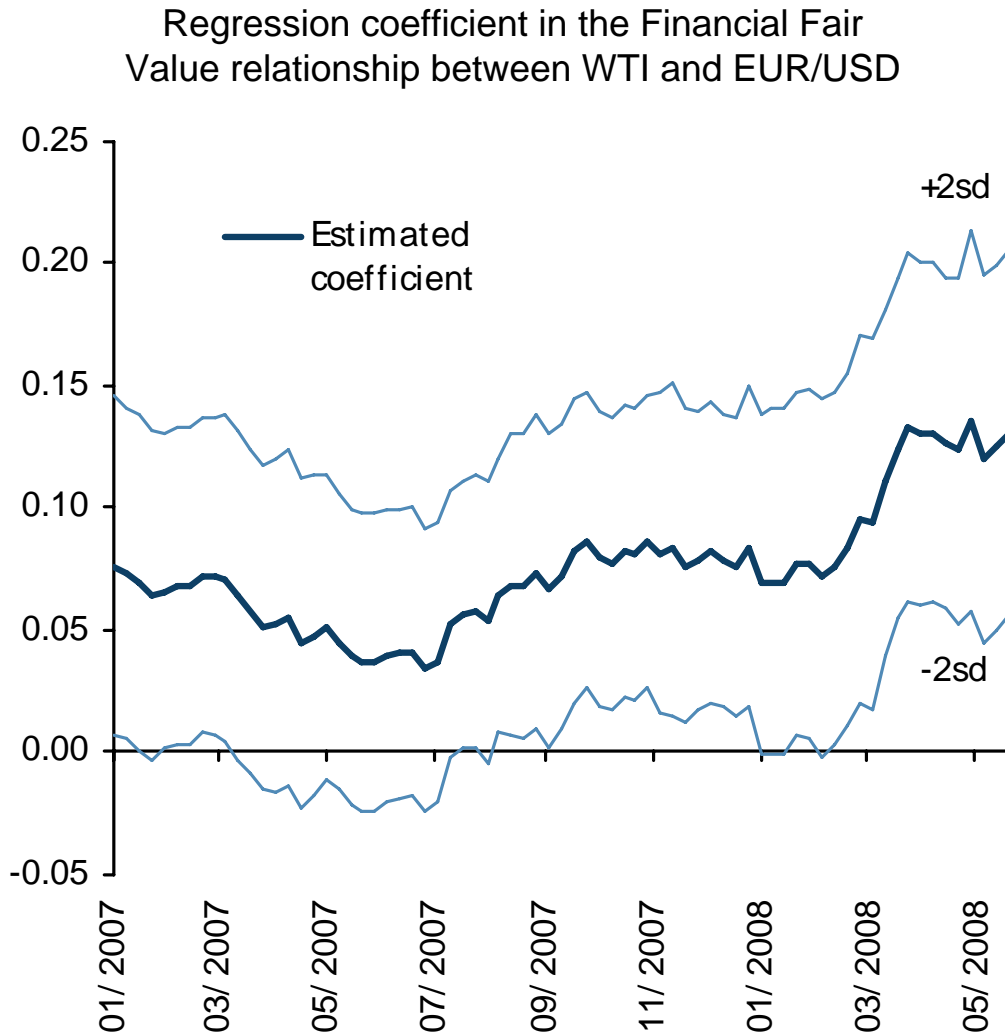


source: Barclays Capital

Euro's outlook is tied to ability of Asia to weather the US slowdown

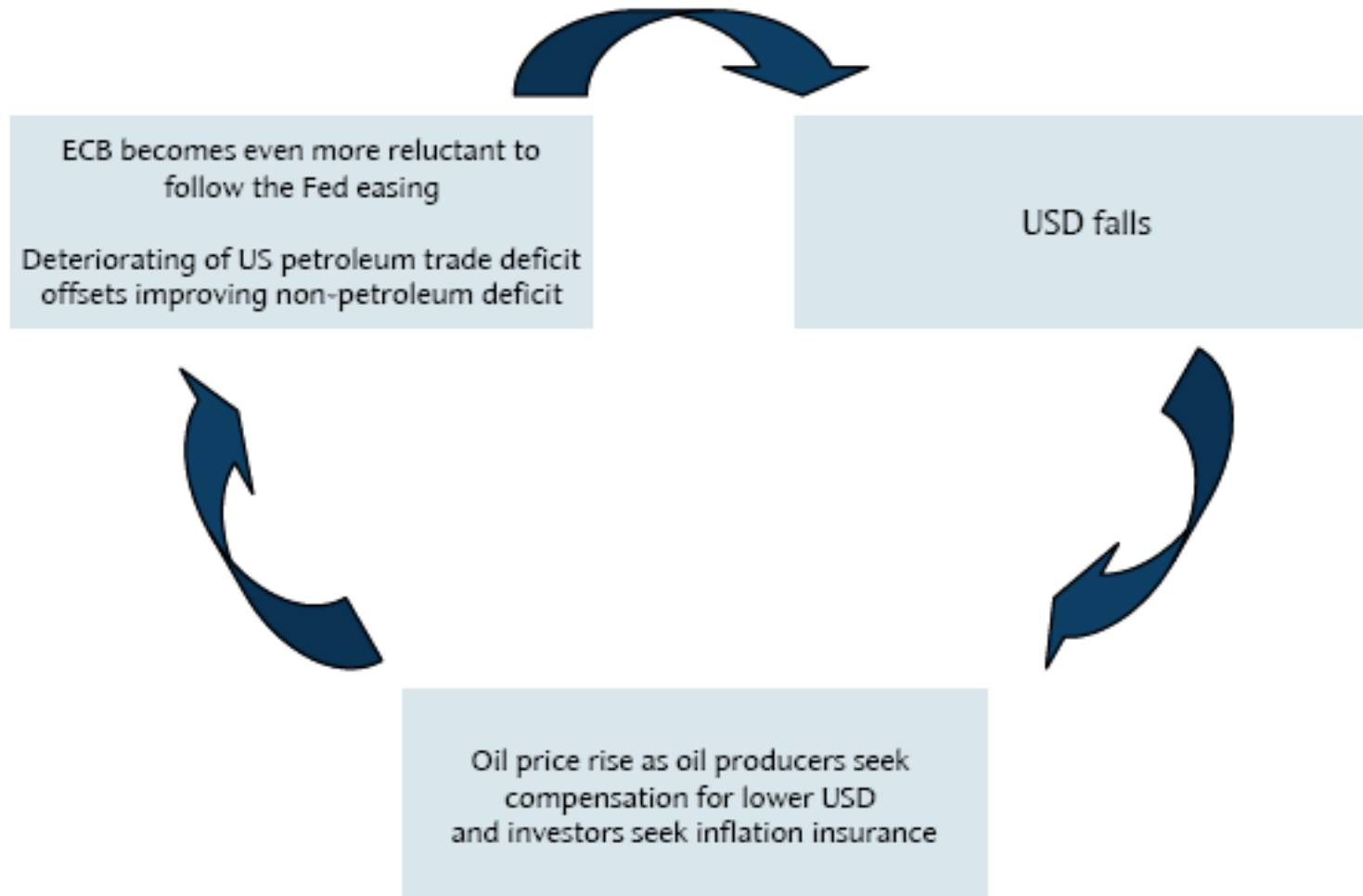


Oil has become increasingly important in explaining movements in EUR/USD – both because the relationship has strengthened and oil has become more volatile

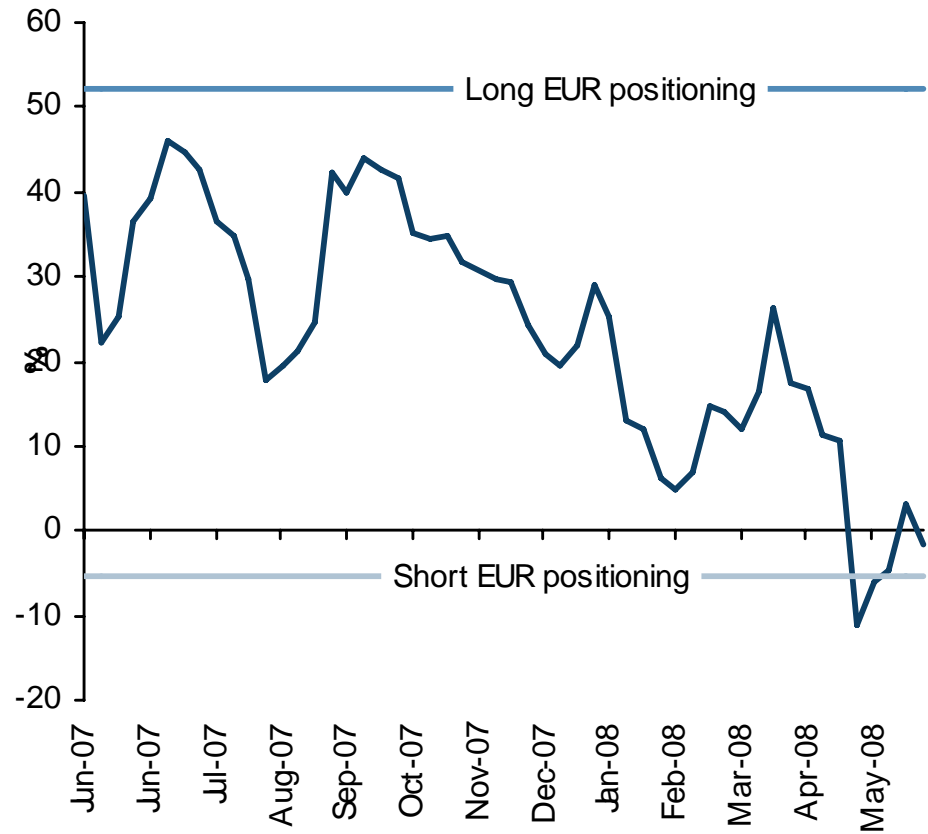
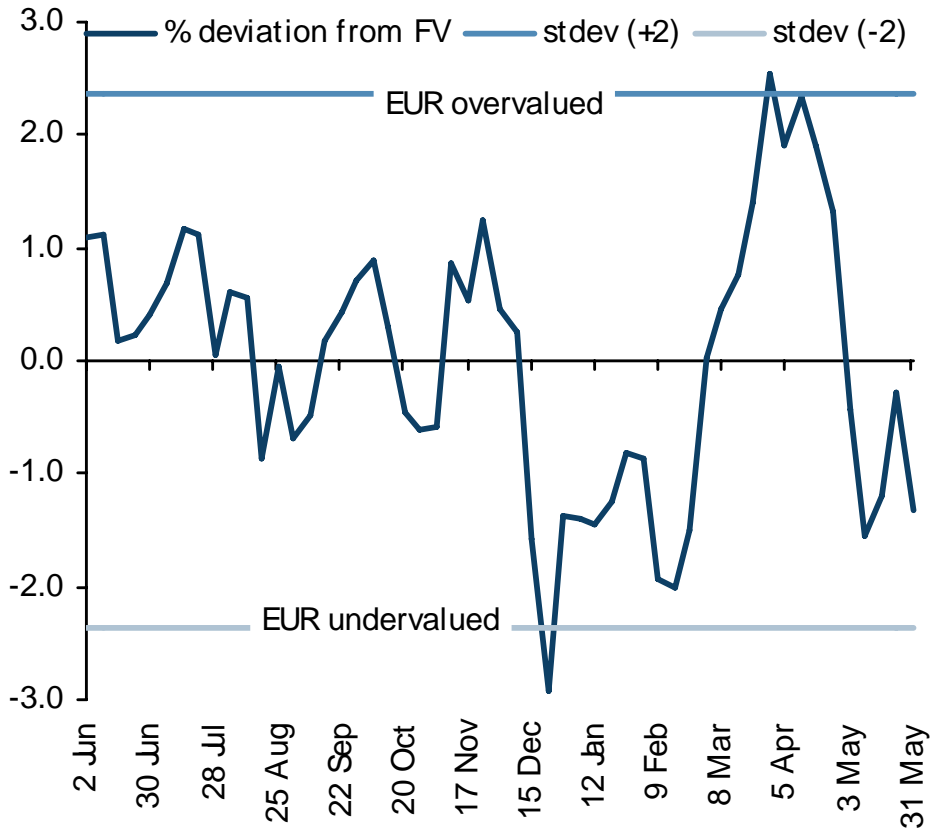


Note: this is the 52 week rolling variance of the log change of oil prices (multiplied by 10,000)

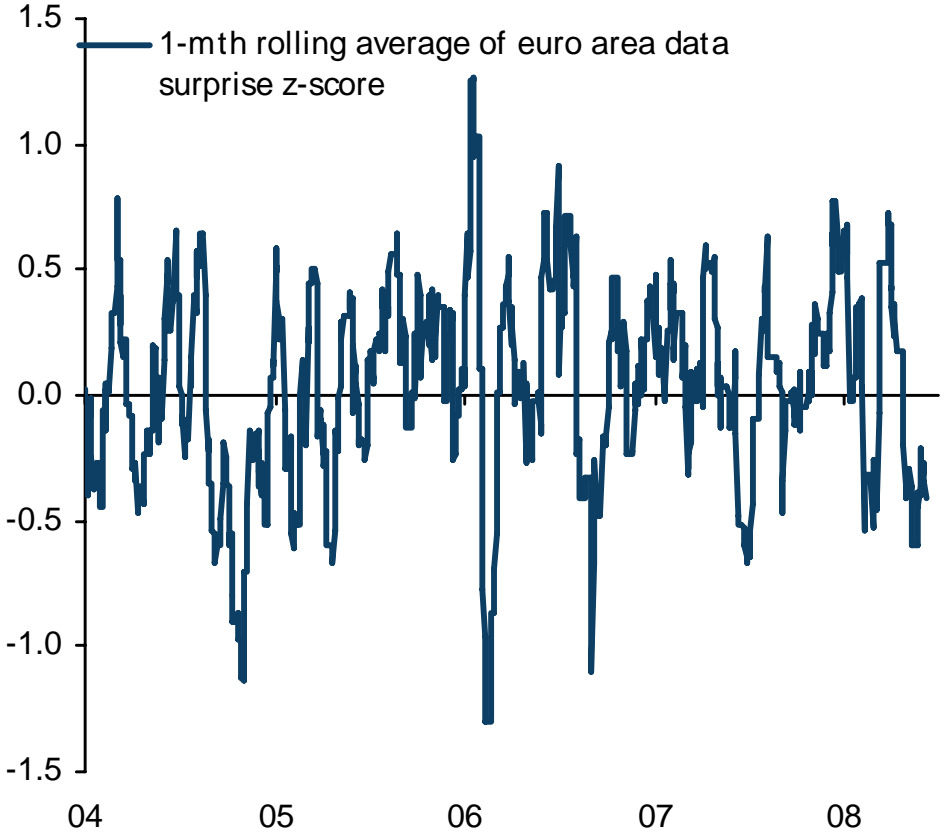
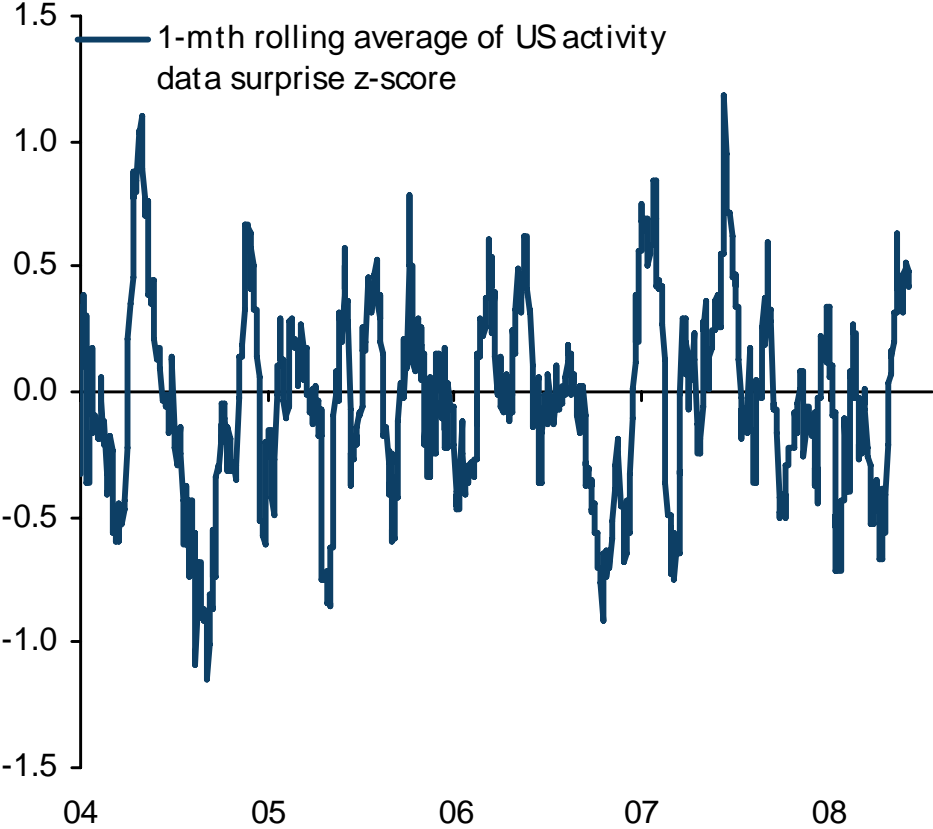
The relationship between the USD and oil prices – a vicious circle?



EUR/USD: Valuation and positioning indicate upside risk over short-term



Over the next month, data hurdle for US will go up but it will go down for Eurozone



Long-term measures of valuation matter as well: External balances

Two main components of our Barometer Model:

- Structural current account: current account position that would prevail if all variables are set to trend
- Target current account: medium-term target based on demographics and past current accounts

The real exchange rate equilibrates the structural and target current accounts

	Current TWI over (-)/ under (+) valuation (%)	Actual C/A (% GDP)	Structural C/A (% GDP)	Target C/A (% GDP)
USD	-6.5	-5.5	-3.8	-3.0
EUR	-6.6	0.0	-0.9	0.7
GBP	-6.9	-3.2	-2.6	-1.1
CAD	-0.4	2.0	-0.6	0.1
AUD	-18.3	-5.9	-6.9	-4.3
NZD	-21.9	-4.3	-9.4	-4.8
SEK	7.7	8.4	6.3	2.4
NOK	18.8	16.1	11.4	6.0
CHF	8.1	16.3	12.6	8.6
JPY	7.8	5.1	4.1	2.7

Estimates of PPP misalignment

	Spot	PPP estimate	% misalignment
AUDUSD	0.96	0.70	31%
USDCAD	0.99	1.22	-21%
EURUSD	1.58	1.23	25%
USDJPY	103	91	13%
NZDUSD	0.79	0.61	26%
USDNOK	5.02	6.52	-26%
USDSEK	5.91	6.68	-12%
USDCHF	1.02	1.20	-16%
GBPUSD	1.98	1.62	20%
EURNOK	7.91	8.01	-1%
EURSEK	9.31	8.21	13%
EURCHF	1.62	1.48	9%
EURGBP	0.80	0.76	5%

Barclays Capital G10 FX forecasts

	Forecasts				
	Spot	1 Month	3 Month	6 Month	1 Year
EUR	1.56	1.59	1.59	1.55	1.50
JPY	105.8	103	101	105	110
GBP	1.96	1.98	1.98	1.95	1.92
CHF	1.04	1.00	0.99	1.00	1.03
CAD	1.02	1.02	1.02	1.02	0.99
AUD	0.96	0.98	0.96	0.88	0.84
NZD	0.77	0.78	0.75	0.72	0.70
EUR/ JPY	164.8	163.8	160.6	162.8	165.0
EUR/ GBP	0.80	0.80	0.80	0.79	0.78
EUR/ CHF	1.62	1.59	1.57	1.55	1.55
EUR/ SEK	9.32	9.30	9.25	9.10	9.10
EUR/ NOK	7.96	7.90	7.80	7.70	7.60

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