QUARTERLY REVIEW

a quarterly market analysis from Travelex Global Business Payments

July 2011

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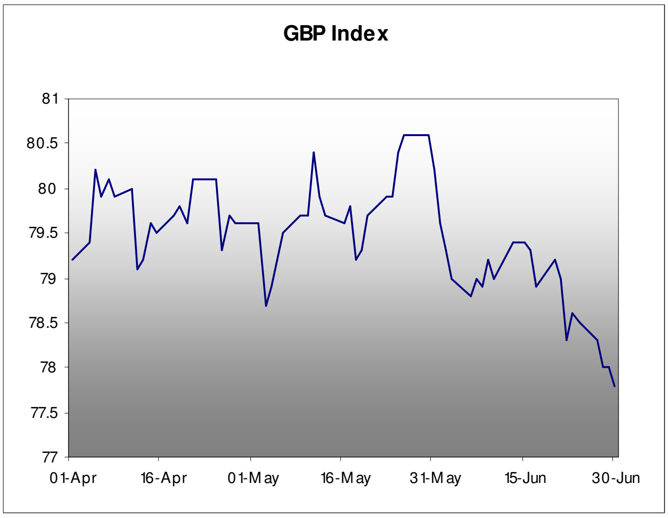
GBP Q2 Summary

Month:	-3.08%	Quarter:	-1.54%	YTD:	-2.57%



Having touched 18-month highs in April the pound sterling ended the second quarter of this year not far off its quarterly average against the US dollar. Against the euro, sterling continued its weakening trend; it had no chance against the Swiss franc. Like other major currencies it succumbed to record lows after being unable to beat back investor demand for the safe haven franc. Ongoing banking reforms and the public sector pension dispute in the UK have been largely overshadowed by the European debt crisis and the feud on Capitol Hill over raising the debt ceiling in the US. If these two issues can be (more or less) put to rest in the third quarter, focus could easily turn towards the UK and growing discontent there.

The Bank of England's Monetary Policy Committee maintained its three-way split over which path its policy should take, yet markets were calmed by the consistency of the split. On the one hand, MPC member Adam Posen maintained the need to increase quantitative easing measures by £50 billion, while three separate MPC members voted to raise interest rates in April and May. The most hawkish member on the committee, Andrew Sentance, continued to vote for a 50 basis point increase, before leaving the committee in June. Towards the end of the second quarter, however, the committee appeared to become more fragmented. In the Bank of England's Quarterly Bulletin, the Bank's Chief Economist suggested the need to exercise caution over rising inflation expectations. MPC member Paul Fisher maintained that he could side with fellow MPC member Adam Posen, to increase quantitative easing measures should the economy stall.

GBP Outlook

There are two factors that are disturbing the outlook for sterling in the third quarter. Firstly, local issues in the UK. Despite being overshadowed by the European debt crisis and the US vote over raising its debt ceiling, these issues could become more important for investors in the coming quarter and weigh on sterling's ability to make gains. Local problems could potentially weaken the country's growth outlook: a warning shot by rating agencies has already been fired. Moody's warned that it could lower its rating on UK sovereign debt if a more protracted slowdown were seen in economic growth and if the government failed to meet its fiscal consolidation plans. The second disturbing feature to sterling's outlook in the third quarter is confusion over where monetary policy is heading. The Bank of England's Monetary Policy Committee have been divided; although the markets have been calmed by the consistency of the divide. Recent comments and reports nonetheless suggest that the division could be widening.

Positive Factors

- The Consumer Price Index remains at two-and-a-half-year highs. According to the Bank of England, inflation could reach 5% over the summer months.
- Economic growth figures have been positively skewed.
- Sovereign interest in diversifying reserve portfolios will continue to help limit sterling's downside.
- The UK government continues to look as if it will be able to meet its fiscal consolidation plans.

Negative Factors

- Discord within the Coalition Government brought about by potential strikes over the public sector pension reform plans, could weaken the country's ability to meet its fiscal consolidation plan.
- The UK consumer continues to feel the onslaught of multiple headwinds, including reduced government spending, higher prices, low wage growth, a weak housing market and higher taxes.
- A weaker global growth outlook has jeopardized the outlook for exports and the strength of the UK industrial sector.

Conclusion

Following an initial decline, Cable should continue to make slow but steady progress over a falling US dollar later in the third quarter. Gains against the euro will continue to be difficult if the outlook for interest rates diverges, i.e. the

ECB raises interest rates, whereas the Bank of England leaves them unchanged. Weakness against the safe haven franc should also be anticipated for the third quarter as uncertainties in the global growth outlook abound for a variety of reasons. These include fear of a Chinese asset bubble popping, continuation of the European debt crisis, and budget negotiations in the US.

Rating agencies warned of a more protracted slowdown in growth and that the government might not be able to meet its fiscal consolidation plans. As weakness in UK economic data and discord over pension reform in the UK grew, these warnings started to become evident at the end of the second quarter. There is also continuing uncertainty over how banking reforms could negatively impact growth.

Growth and inflation figures in the UK were skewed for much of the second quarter. This has clouded the outlook and confused markets and policy makers over the way monetary policy could – or should – head. Down to maintenance closures in the oil and gas sector, industrial output saw its biggest monthly decline during the second quarter since 2009 . Retail sales figures experienced a rollercoaster ride, as good weather, a Royal Wedding, several holidays and a late Easter skewed data for a couple of months. The data was so skewed last quarter that markets in April priced in a rate increase for the month of May, which ultimately had to be reversed, weighing heavily on sterling by mid-May.

As the quarter came to a close, ONS Retail Sales Figures collapsed from +1.1% in April to -1.4% in May. A CBI Distributive Trades Report – which is also seen as a gauge for consumer activity – went from +21 to +18, then eventually to -2 during the last quarter. The last reading for June represented a one-year low, most likely reflecting the UK consumer's uncertainty.

The 'feel good' factor of the Royal Wedding and several national holidays helped to distort economic data from the second quarter of 2011, as most consumers and businesses received a boost in confidence. With that in mind, investors will place greater emphasis on economic data released between July and September.

The skewing of the data also affected the consistency of the voting split within the Bank of England's Monetary Policy Committee. While the Monetary Policy Committee were split three-ways in April and May, the June minutes revealed a more uncertain committee. The lack of clarity will serve to increase the divide within the MPC and could increase volatility in sterling's movements during the third quarter. On the one hand, MPC members Martin Weale and Chief Economist, Spencer Dale, still feel the need to raise interest rates by 25 basis points. At the other extreme, MPC member Adam Posen would like to increase the central bank's quantitative easing measures by £50 billion. Recent comments from Dale in the Quarterly Bulletin raise uncertainty over inflation expectations remaining anchored, as inflation continues to rise. The Bank has made it clear that it expects inflation to increase to 5.0% over the summer months.

On the other hand, wage pressure inflation has been restrained, but with oil prices hovering around $100 per barrel, it is only a matter of time before higher price expectations become entrenched. Potentially, this prompts higher wage demand and unleashes a more hazardous type of inflation. Indeed, the Bank of England's Quarterly Inflation report revised its projected outlook for inflation from 1.6% to 1.9% in two years time – the policy relevant period. Other committee members say that the headwinds facing the consumer and the decline in the global growth outlook will increase already high spare capacity within the economy, absorbing any transitory price pressures.

In settling these differing outlooks on inflation, investors will be forced to look towards growth data. In doing so, they will monitor the health of the UK consumer, along with the industrial sector and UK exports.

The clouded data has thus far told investors that the consumer is starting to feel some heavy headwinds, whilst storefronts are gearing up for weaker demand. However, all is not lost for the consumer. A GfK Consumer Sentiment Survey, which is seen as a leading indicator, confounded expectations when it rose to an 18-year high. Nevertheless, internal growth thanks to a weakened consumer should be cautiously approached because the headwinds are so strong.

The outlook for the UK industrial sector and exports is dependent on external factors, making the situation even more disturbing. Sterling's decline against the franc and euro over the course of the first half of this year, however, should benefit exports and provide a bit of price competitiveness just at the right time.

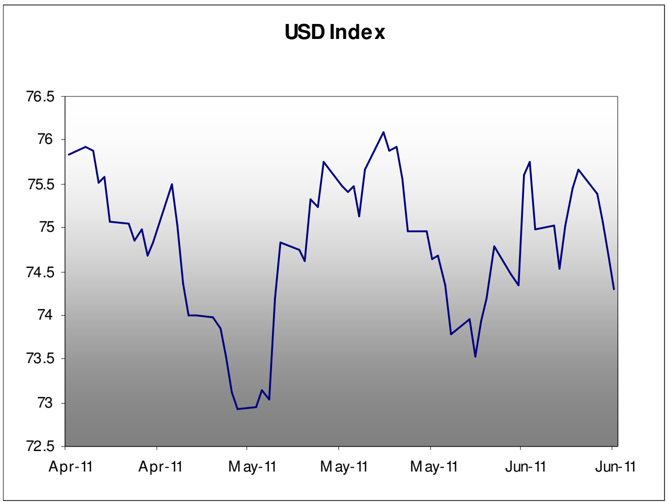
If the outlook for growth and inflation remains more or less neutral for sterling in the third quarter, markets will be mindful of events that could tip the balance. Any negative impact on growth from striking unions or internal government debates over planned reforms is the very last thing the country currently needs.

The Bank of England's Governor King and Chancellor Osborne have said that they will implement the two main suggestions proposed by the Independent Commissions on Banking. The first suggestion – to ring fence retail banking from other sections of banks – will increase borrowing costs by ending cross subsidies between different divisions. Secondly, banks will be required to increase their capital requirements above the Basel 3 limits, which are international guidelines. On the face of it, the reforms look good and should be adhered to, but the cost banks will have to endure upfront is probably going to make credit lines even tougher to come by, which will not have a positive impact on local growth. The reforms might help to create a solid banking sector in the future, but the timing might be better in terms of the negative impact it could have on the forecasts of fragile growth in the UK.

Implementing austerity measures at the same time as public pension, health care and banking reforms could be overkill for a UK economy that is still very fragile. Sterling may therefore be weakened by the onset of the third quarter. Governor King has already implied that interest rates will only be raised when banks are in better shape. This will take more time, providing another negative for the local currency. However, strong positives are in place: the government has set a course and a pull back in sterling will help exporters. Ultimately, higher inflation levels, transitory though they maybe, will also feed into expectations at some point, prompting speculation over rate increases. The last bit of good news for sterling: its downside will continue to be protected by diversification flows from Asian and emerging economies, as they look to decline dollar holdings.

USD Q2 Summary

Month:	-0.45%	Quarter:	-2.09%	YTD:	-6.36%



The US dollar index – the value of the dollar compared to a basket of currencies – touched a three-year low during the second quarter of this year. Three factors helped to bring the dollar lower before it stabilized, eventually recovering some losses at the end of the quarter. Firstly, there was a general malaise surrounding the dollar during this quarter. Comments from the World Bank, saying the dollar will lose its dominance as a reserve currency, plus those from a Chinese official who said that he would not be 'too long dollar assets', did not help. Secondly, gridlock over raising the debt ceiling prompted rating agencies to offer warnings over the outlook for US sovereign debt ratings. A vote in the House of Representatives against raising the debt ceiling was also provocative, even if it was only for show. Nervous stories over large US banks preparing to cut their purchases of T-bills, along with Treasury data showing Chinese purchases of US debt, both slowed unsettled dollar buying. Lastly, economic data began to weaken, confirming that interest rates will remain low for an extended period. This helped speculative traders use the dollar as funding currency for carry trades. The dollar's fortunes began to turn when the US Government announced its number one fugitive, Osama bin Laden, had been killed. Dollar gains heightened at the end of the quarter, as safe haven flows into the currency picked up.

The Federal Open Market Committee began to sound like the Bank of England and look like the European Central Bank this quarter. On inflation, the Head of the Federal Reserve said that the spike in prices has been 'transitory' – something the Bank of England has always maintained. The format of the press conference following the policy announcement was reminiscent of the European Central Bank's. Regardless of these similarities, which might suggest a lack of originality, the US Central Bank said that the economy sustained two main shocks in the second quarter. The Arab Spring helped to push up prices at the pump, eating into the purchasing power of consumers. Secondly, supply constraints coming from Japan following the natural disaster on March 11, also weakened the US industrial sector. The negative shocks to growth are also seen as transitory, but that did not stop the Federal Open Market Committee from significantly reducing its growth outlook for this year. Additionally, at its June meeting, the Central Bank maintained a rather negative outlook on the US jobs market. Interest rates were left on hold throughout the entire quarter, but the Central Bank did indicate that its second round of quantitative easing measures, which began in the third quarter of last year, would be completed by the end of June. In an effort to comfort edgy bond markets, the Federal Reserve said it would continue to roll over profits on maturing assets into Treasuries.

USD Outlook

It's 'all or nothing' for the US dollar this quarter. The chances of an 'all' outcome will initially be better than for a 'nothing' outcome. A 'nothing' outcome would result from a default on Treasury bill payments that would lead to a downgrade by rating agencies of US sovereign debt and conclude in a complete collapse of the US currency. This is such a frightening prospect that most politicians, not only in the US but also around the globe, will to want to avoid it. As a result, the US dollar could see a temporary pause in its downtrend over the first part of the third quarter. Dollar gains should continue as evidence of bi-partisan cooperation in budgetary reforms and negotiations take place. But whatever negotiations are made, it is likely they will be short term since Presidential elections are scheduled to take place next year and politicians will want to battle out longer-term budget reforms on the campaign trail. With the prospect of a default – albeit it only 'temporarily' – avoided, economic data will come into focus once again later in the quarter. As the quarter comes to a close, and as economic data continues to reflect a 'soft patch' in growth and weakness in the labour markets, the more likely a dollar downtrend will resume.

Positive Factors

- A move to limit the rise in the price of oil should help lift the US dollar, despite traditionally having a negative correlation with it.
- Some form of budget negotiation is likely to be hammered out at the last minute between Democrats and

Republicans to prompt a rise in the debt ceiling and thus avoid default.

- The dollar will at times continue to be seen as a safe haven currency, particularly when the outlook for Europe begins to sour.

Negative Factors

- The housing market remains in a double-dip recession, reminding investors what happens once government support is removed.
- Reserve diversification out of the dollar will continue to weigh on the currency.
- A weak labour market will hold down consumer spending and limit the central bank's ability to normalize interest rates.
- Strength from the industrial sector will wane as global growth slows.
- If a vote over raising debt ceiling is not passed, the threat of a rating downgrade on US sovereign debt does exist.

Conclusion

The US dollar will strengthen at the first part of the quarter and then weaken as the quarter progresses. Momentum behind the dollar's moves in the past has been driven either by safe haven flows or by a shift in global interest rate outlooks. The same will hold true this quarter.

Dollar gains will materialize as investors become increasingly nervous over the European debt crisis and as negotiations for budgetary reforms are likely to continue in the US right up to the deadline of August 2. As a result, short dollar positions are likely to be bought back as safe haven flows into the dollar pick up. The idea that governments will try to control energy prices by releasing strategic reserves (as 27 countries announced they will at the end of the second quarter) will initially, if unsustainably, support the dollar.

The negative impact from the Japanese supply constraints, along with higher oil prices, should pass through the economy. More upbeat economic data will initially support equity markets, which would be bad for the dollar if the sentiment were positive. Speculators will then attempt to use the dollar as a funding currency for carry trades, which will send it lower.

Momentum behind the dollar's turnaround could grow as the quarter advances. The impact of the Federal Reserve's quantitative easing, which ended in June, will start to feed negatively into economic figures, potentially turning a positive equity market around. The housing market, once it was taken off government life support, tripped and then collapsed. It has been argued that higher equity markets are largely a result of the Federal Reserve's quantitative easing program. Without the added stimulus, equity markets would not be so high.

A sharp decline in equity markets might typically prompt safe haven dollar buying again. However, campaigning for the Presidential race will start to pick up and investors will continue to note that while the EU is still in a mess, governments there will at least be attempting reform measures, like in the UK. Facing political instability amid elections in the US, plus uncertainty over budgetary restraint, could hinder what would traditionally be an opportunity for the dollar to see positive safe haven inflows.

With equity markets falling, consumer demand will continue to remain depressed. Not only will the weak housing market continue to negatively impact consumers via weak home equity, but a lacklustre jobs market is also expected to continue being a burden. Figures to date in the jobs market have been shamelessly weak with the exception of perhaps one month last quarter.

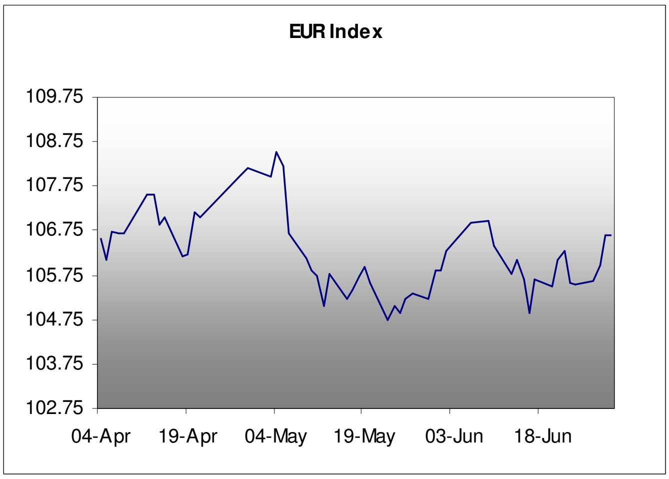
If the consumer is unable to play the normal role in an economic recovery, the business and industrial sector has to help pick up the slack. Until manufacturing appeared to peak that had been happening. Further gains will depend upon demand for exports, which is a questionable external factor at this point. Clearly the weakness in the US dollar to date will help, but exports have not fully driven the US economy in the recent past.

Because the US Central Bank must not only look for inflation, but also growth and unemployment, a more permanent outlook for low interest rates will continue to weaken the US dollar. There has already been speculation that the central bank will need to embark upon a third round of quantitative easing, which would certainly bear negatively on the US dollar.

In summary, the dollar will gain on safe haven flows at the beginning of the quarter, but the currency's safe haven status will be called into question later in the quarter. A dollar decline will be exacerbated by its continued status as a funding currency for carry trades, since the Federal Reserve's ability to raise interest rates will remain hindered. Lawrence Summers, former Economic Advisor to the President, has been quoted as saying that the US is just about half way through its lost decade – a reference to the troubles seen in Japan after its asset price bubble burst at the end of the 20th century.

EUR Q2 Summary

Month:	+0.75%	Quarter:	+0.28%	YTD:	+3.81%



On an indexed basis, the euro rose to levels not seen since the beginning of 2010. Those gains, primarily against the US dollar, did not last, and an escalating debt crisis in Greece helped to knock the single currency off this quarter's highs. By the end of the quarter, the euro had dropped to record lows against the Swiss franc, despite maintaining a widened and higher trading band against sterling. Economic data throughout the quarter continued to point towards an economic recovery, while inflation figures prompted policy action by the central bank for the first time since 2009. The euro garnered much of its strength through speculative trade based on the European Central Bank's higher interest rate outlook. Upside gains for the euro were, however, cut short by a deteriorating fiscal position in peripheral countries such as Greece, Ireland and Portugal. Tensions mounted to such an extent that democratically elected governments were overthrown whilst in the process of working out ways to solve the problems of the heavily indebted countries. Historic parliamentary election results in Finland were fuelled by a widespread reluctance to continue bailing out fiscally-weak EU countries. Portugal held elections after a failed vote of no confidence, before formally making a request for assistance from the EU/IMF bailout fund. Core countries including Italy, Germany and Spain saw ruling party losses in local elections. At the same time that ruling political parties were debased, rating agencies played their role in adding fuel to the fire. Greece's sovereign debt rating dropped to the lowest level worldwide, which suggests that there is a 50% chance that the country will default in the next five years. In preparation, the EU nearly doubled the size of what will eventually become its permanent bailout fund. At the end of the quarter, Greece passed austerity measures which enabled it to avoid default at least until 2014. The icing on the political cake, however, was the resignation of the Managing Director of the IMF – also a potential candidate for the French presidency – following charges of an alleged sexual assault in New York.

The European Central Bank raised interest rates by 25 basis points for the first time since 2009. The Central Bank made it clear in April that it would not be the first of a series of increases. Nevertheless, with inflation well above the Central Bank's 2% target, policy makers were widely expected to start the third quarter with a second rate increase, taking interest rates to 1.5%. European Central Bank staff projections at the June meeting showed upward revisions for the euro zone's growth and inflation outlooks. Current monetary policy is still considered to be accommodative and policy makers remain in a state of vigilance, in order to control second round effects of inflation. Furthermore, the Central Bank has indicated it will maintain its non-standard measures of supporting liquidity in financial markets. Lastly, Jean-Claude Trichet's replacement was officially appointed this quarter. As of the start of November, the head of the European Central Bank will be Italy's Mario Draghi.

EUR Outlook

As markets question the timing of the next European Central Bank rate increase, the euro could lose some initial support against sterling early in the third quarter. High inflation figures in the euro zone will keep speculation alive over tighter monetary policy, but a potentially weaker growth forecast, compounded by the economic damage created by an ongoing debt crisis, could allow policy makers to pause their tightening measures. Due to negative factors surrounding the local UK market, however, euro downside against sterling will be limited. Against the Swiss franc, no end is in sight. Full investor confidence in the euro zone will only be restored once credit default swap prices fall and bond yields between Germany and the peripheral countries begin to narrow and the need for a safe haven currency such as the franc diminishes. Against the US dollar, the euro is likely to slip early in the quarter, gathering strength later.

Positive Factors

- The new leader of the European Central Bank will want to establish his ability to fight inflation early on in his tenure. In doing so, the outlook for higher interest rates should support the euro, though possibly not until the fourth quarter.
- Sovereign wealth funds, particularly from Asia, continue to have interest in diversifying away from US dollar holdings and into the euro.
- The two-speed euro zone economy saw its better half slip in the second quarter; although there is evidence of a sustainable economic recovery.

Negative Factors

- Ruling political parties are being displaced as much by an unemployed youth in the peripheral countries as they are by a discontented populace in the core economies. Leadership in this crisis is weak.

- Stress tests on major banks are expected to be released early in the third quarter. They do not contain a scenario where an EU country defaults on debt. Their credibility, therefore, could be seen as lacking.
- The European debt crisis will continue, even if the outlook for a potential default on government debt has been kicked longer down the proverbial road.

Conclusion

Many commentators have speculated this quarter about the best and worst case scenarios for the euro. Indeed, the worst-case scenario is fairly easy to envisage; a Greek default, systemic risk is unleashed, contagion spreads and financial markets experience a fresh crisis, the likes of which could lead to popular uprisings and the end of the single currency. Many have agreed that the worse-case scenario is catastrophic enough to avoid at any price.

For many, the best-case scenario is that a second EU/IMF bailout of Greece is sufficient to end systemic risk, contain contagion fears, and allow growth in the euro zone to exceed forecasts. Furthermore, it will help prices of credit default swaps reverse, narrowing gaps between the yields of the German bonds and the bonds of the peripheral countries. Confidence is then fully restored. Social and welfare reforms are made to fiscal polices and the euro soars on the back of a higher interest rate outlook and reserve diversification flows.

In truth, the most likely outcome is somewhere between the two. Weak leadership, undermined by high unemployment, prohibits the best-case outlook. Additionally, taxpayers in core economies (Germany and France) are extremely reluctant to bail out less efficient countries such as Greece.

Certainly, dealing with the tide of unemployment will be difficult, due to the heavy austerity measures forced upon Greece, Portugal and Ireland by the IMF and EU; which are inherently counterproductive. Less government spending, coupled with tax increases, damages the economic growth outlook, eventually leading to weak tax receipts and a limited ability to pay off debt. Furthermore, to increase a country's competitiveness and accelerate growth, wages as well as prices need to be kept low. This will also make paying off debt difficult to handle without a small help from inflation.

One thing that has been made perfectly clear in the media, however, is that the current situation in Greece is completely unsustainable. Throwing large sums of money at Greece only serves to pull core economies down with a sinking ship. As the saying goes, however, time heals all wounds, and time is exactly what politicians are expecting will rescue the EU from its current situation.

At the end of the second quarter, French banks and insurers – the largest holders of Greek debt outside of Greece – agreed to a voluntary rollover of maturing paper into 30-year contracts. That would not only buy time for the Greek government time, but also allow time for the EU to gather some leadership momentum. Assuming that investors are comfortable with the prospects of kicking the payback can further down the road, the desensitization process seen last quarter will continue. Consequently, further concerns over Portugal and/or Ireland may, in the short term, carry less negative weight for the euro.

However, the longer term outlook for the euro remains very questionable. The Stability and Growth Pact was clearly a giant failure and fiscal polices across the EU must be brought in line with one another if the union is to hold together in the future. Scholars, financiers, as well as the European Central Bank's Jean-Claude Trichet, have gone so far as to suggest that an EU parliament that controls euro-wide fiscal policy needs to be considered as a way forward, along with a need to create a EU Treasury with the ability to raise capital. Getting individual countries to give up sovereignty is, naturally, going to be difficult and will undoubtedly be a future topic of conversation.

Leaving the debt crisis momentarily behind, the second event risk that could sway the direction of the euro early in the third quarter is the release of stress test results on several European banks. The original release date was postponed because the banking authority asked banks to resubmit figures based on the questionable accuracy of the original data.

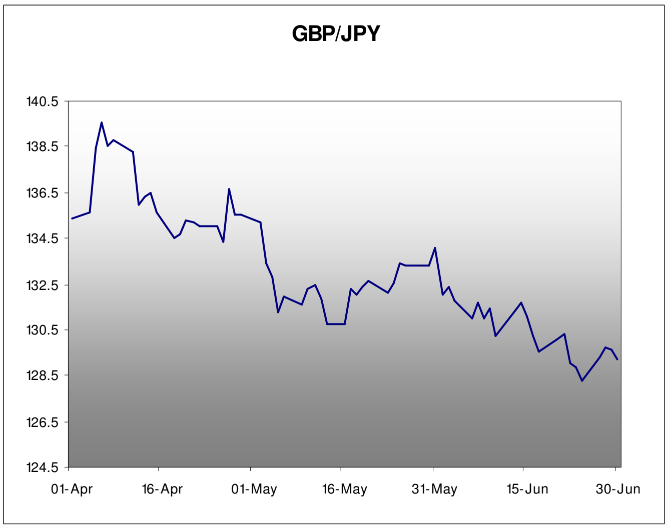
The stress tests, which set out to restore confidence in Europe's financial centre, have unfortunately ended up doing the opposite. Last year, the tests were completely discredited, and while tougher conditions were imposed this year, investors are likely to remain exceedingly sceptical, particularly since the tests do not include what would happen to the banks if a sovereign defaulted on its debt payments.

Looking ahead, the final consideration is macroeconomic data and its influence on the European Central Bank's Monetary Policy Outlook. Currently inflation rates remain above the central bank's target and the European Central Bank has a reputation for being exceedingly committed to its mandate of price stability. The incoming Governor, Mario Draghi, will certainly want to establish his hawkish tendency early on in his tenure. The current spike in prices is seen as transitory in the UK and the US, while the European Central Bank feels that it threatens both the un-anchoring of inflation expectations, as well as second round effects. As the quarter wears on, however, a pull back in euro zone prices could allow investors the opportunity to price out a rate increase at the end of the year, as planned austerity measures begin to weaken the economic growth outlook. Weaker oil prices should also play a role in altering the interest rate outlook, provided they can be maintained below USD100 per barrel.

In summary, the euro will see a lift as a Greek default is avoided early in the quarter and as confidence is at least marginally restored. An expected 25-basis-point rate increase at the central bank in July will initially also lend the single currency upside support. As banking stress test results on some of Europe's largest banks are published, positive momentum for the euro will wane. That negative momentum will pick up mid-quarter, but the euro's downside will be minimized by continued diversification from Asian sovereign funds. At the end of the third quarter, or even at the start of the fourth, euro losses will, at least temporarily, become gains as the new leadership at the European Central Bank looks to establish its ability to fight inflation.

JPY Q2 Summary

Month:	-3.8%	Quarter:	-3.17%	YTD:	+2.08%



Following direct intervention by the G7 central banks to weaken it at the end of the first quarter, the Japanese yen made a quick recovery during April. Against sterling, the recovery continued, allowing the yen to finish near four-month highs at the end of the quarter. Against the euro and US dollar, the yen's gains reached a plateau in June, leaving it trading in relatively tight ranges. Currency markets showed an uncanny ability to look past skewed economic data as well as the political uncertainty that continues to plague the country. The outlook for Japan's sovereign debt rating was even put on negative watch. This is primarily down to the enormous burden rebuilding will put on a fiscal position that is already stretched. At the same time, however, the Japanese government felt confident enough about the economy's ability to recover from the events that took place in March, that it increased its growth outlook for the first time in four months. On the political front, Prime Minister Kan has said he accepts his declining approval ratings and will step down after dealing with the crisis.

The Bank of Japan stayed busy this past quarter, stimulating the Japanese economy through a variety of exceptional measures. Interest rates remained at the ultra-accommodative level of 0.0-0.1%, while at the same time the Central Bank created a loan scheme for earthquake victims, to the tune of one trillion yen. In June, the Central Bank expanded its asset-based loan scheme by 500 billion yen, increasing its growth loan scheme by three trillion yen. In the minutes from the policy meeting, the committee members began to sound more upbeat about the outlook for the economy, as the quarter came to a close, although there was frustration voiced over failing power supply and the negative impact it will have on Japan's ability to restore its supply chain. Additionally, there were concerns that households are not spending. Policy tightening throughout Asia was seen as offering an external downside risk to Japan's export market.

JPY Outlook

The problems for Japan have not changed and the outlook for the yen is for a modest strengthening, capped by periods of uncertainty that will limit its upside potential. Ongoing political instability and high debt levels above and beyond the EU and US are likely to help cap the yen's ability to appreciate. However, with expanding Asian economies on Japan's doorstep and huge government stimulus measures taken in the wake of the events in March, should help jump start the economy and lift Japan out of the doldrums, ultimately drawing investors into the country and lifting the yen.

Positive Factors

- Along with the Central Bank, the government has poured money into the economy, not only to stimulate it out of a deflationary spiral, but also to encourage recovery and reconstruction.
- The macroeconomic data has started to show signs of recovery, although the initial data is likely to be uneven.
- The proximity to growing Asian economies supports the country's outlook.

Negative Factors

- The government's sovereign debt has received a rating downgrade, based on political uncertainties and the country's inability to consolidate its long-term fiscal position.
- The Prime Minister's ratings plummeted, with markets widely expecting the leader to resign his position before mid-August.
- Low interest rates will continue to allow the yen to be used as a funding currency for carry trades in times of improved risk appetite.

Conclusion

The uncertainties surrounding the yen's outlook for the first part of the third quarter could limit its ability to trade outside of the broader ranges established during the second quarter against the US dollar, sterling and euro. As the third quarter advances, the chances for a yen recovery increase as macroeconomic data begins to smooth out and as stimulus begins to feed into figures.

Surprises are already starting to show up in Japan. Retail sales fell 1.3%, instead of a more spectacular decline of 4.8% seen in the previous month of April. While still in negative territory, the figures suggest consumer demand has reached its nadir and is turning around. Private consumption accounts for approximately 60 percent of the economy.

Business confidence has also shown signs of returning. Indeed, Nissan has said that it thinks bringing production back to pre-earthquake levels ahead of its October target is possible. A Reuters Tankan survey, measuring business sentiment and has a 95% correlation with the Bank of Japan's survey, rose for two consecutive months after collapsing to record lows in April. The survey also gave evidence of the restoration of supply chains.

Industrial output for May saw its biggest increase in 60 years. The data is clearly skewed, but nevertheless indicates how quickly companies have been able to restore supply chains. While the data was encouraging, the industrial sector remains cautious as it still faces the threat of having to cope with power outages over the summer months.

Just as there are signs of recovery within the Japanese economy, there have also been signs of sudden weakness. Key core machinery orders (seen as a gauge for capital expenditure, exclusive of foreign firms) dropped suddenly by 3.3% in April, having seen gains in March despite the earthquake. The sudden drop is an example of how economic data will be skewed. It will take several months of figures to show a clearer view of how the Japanese economy survived the March crisis.

In terms of inflation, price pressures are finally starting to reappear. Following five consecutive months of gains, wholesale prices increased by 2.2% annually. Core consumer prices on an annual basis rose for the first time in two years. The gains were skewed slightly because of the base effect of ending school tuition programs, but nonetheless show Japan's economy moving further away from the deflationary forces of the past.

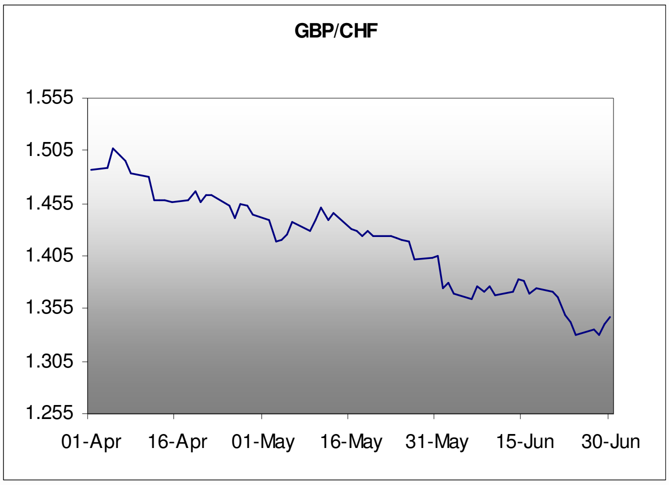
This bodes well for the Bank of Japan's monetary policy outlook. While no one expects the Central Bank to raise rates any time soon, there is evidence that, over time, the bank may need to consider putting an end to extraordinary stimulus measures, ultimately putting it on the path towards higher interest rates.

Even though economic data will be skewed, and the outlook for monetary policy unclear in the earlier part of the third quarter, there are other factors that will limit upside potential for the yen. Political uncertainty hangs in the air, along with structural problems and massive public debt.

In summary, the road ahead for the Japanese economy is a bumpy one, especially when power shortages could disrupt progress this summer. However, early assurances that a recovery has begun are encouraging. By the end of the third quarter, a clearer outlook for growth should be on the horizon, whilst talk of ending stimulus measures progresses. At the same time, a new political landscape should have formed and work on long-term issues that threaten the country's sovereign debt rating will be well under way. By the end of the third quarter, feelings of optimism should help maintain yen gains going into the last quarter of the year.

CHF Q2 Summary

Month:	-4.22%	Quarter:	-9.25%	YTD:	-7.05%



As demand for safe havens accelerated unabated, the Swiss franc raced to record highs against the US dollar, euro and pound sterling during the second quarter. It also saw a more dramatic turn of events with the escalation of the European debt crisis. Frayed nerves over the US debt ceiling debate and the ongoing geopolitical tensions in the Middle East and North Africa compounded flows into the safe haven. Investors were increasingly convinced that Greece would default on its sovereign debt and be forced to leave the European Union, triggering wholesale panic in financial markets. Consequently, the currency's safe haven status was further elevated. And as if the currency needed any more help, merger and acquisition flows into the franc also helped lift the currency even more during the quarter.

The Swiss National Bank left interest rates unchanged at its policy meeting in June, apparently ignoring what many feel is a property bubble building in Switzerland. Resilient consumer demand could also put upside pressures on prices. The Central Bank instead focused on the deflationary forces at play in the economy because of the strength of the local currency. Indeed, CPI data recorded earlier in the year at 1.0% has pulled back to an extremely benign 0.4%y/y. Furthermore, producer and import price figures turned negative, having seen five consecutive months of gains. The Central Bank and Government maintain that the strength of the currency is damaging exports and weakening the country's manufacturing sector. Growth and inflation forecasts have officially been lowered. Spectacular economic data has, to date, supported the currency's role as a safe haven.

CHF Outlook

The outlook for the Swiss franc is continued gains until the conclusion of uncertainties. While current geopolitical tensions appear more contained in the oil-producing region, there is always the possibility of a flare up. US budgetary reform was addressed in the above USD outlook, but in summary it is likely a temporary fix will be allowing a vote to pass over raising the debt ceiling and averting a crisis in the US. With two of three uncertainties more or less 'under control', markets will focus attention on the European debt crisis. Investor confidence will not be truly restored until the price for insuring against a default (by way of credit default swaps) declines, and when government bond yields between core and peripheral countries narrows. Once these signs of restored confidence become evident, the deterioration of local macroeconomic data could exacerbate a reversal once it's begun. However, that is contingent upon any other unforeseen global calamity necessitating a safe haven.

Positive Factors

- The safe haven status of the franc is intact and supported by rather upbeat economic data.
- Unemployment figures continue to fall.
- Property prices are rising and a resilient consumer could put upward pressures on prices.

Negative Factors

- The strength of the Swiss franc holds down import costs.
- Growth figures, while strong, have begun to show signs of weakening due to the strength of the franc.
- The Swiss franc is overvalued.

Conclusion

The issue is not the Swiss franc maintaining its safe haven status; rather it is how long the global economy will need a safe haven to operate, and the effect, if any, that weaker Swiss economic data will have on the local currency. Perhaps the last question that could be asked is at what point should investors brace themselves for a new form of intervention by the Swiss government or central bank in order to limit further gains?

Stepping back into markets will be a tender subject for the Swiss National Bank, after it lost so much money intervening directly in currency markets attempting to weaken the franc in the fight against deflationary forces. On the other hand, Central Banks have become increasingly clever in finding alternative measures to encourage change in investor attitudes. Officially, there is no word on any sort of policy, even though one could conceivably be created – and perhaps watched out for – should the franc see gains this quarter on the scale that were reached in the last.

Outside of government intervention, the franc will fall when there is no longer a need for a safe haven currency and/or when economic data no longer supports the currency's role as a safe haven. The latter may come sooner than the former. However, two of the three uncertainties that led to the franc's gains in the second quarter may find conclusions in the coming months, limiting its upside potential.

Data supports the view that the economic recovery in Switzerland remains robust, but could potentially face longer term sustainability problems. The manufacturing outlook in Switzerland remains robust. A PMI manufacturing survey actually saw the pace of expansion rise for the month of May, while other PMI surveys around the globe showed signs of fatigue. Not only is manufacturing doing well despite the strains of a strong currency, but a leading economic growth survey remained high. The KOF leading economic survey came in at 2.3 in May, matching an upwardly revised released in the prior month.

Exports in May rose 22.6% on the year, but the month figures suggested that the franc could be starting to have a negative impact on growth. Lower export prices suggest that companies are taking in lower profits so that they can remain competitive. This is not sustainable over a longer period of time and is one of the main reasons that the government and national bank fear the strength of the franc.

An additional reason to fear such a strong currency is the deflationary impact it could – and is – having on prices. Even with the price of oil above USD100 per barrel Swiss CPI has stayed below 1% on an annual basis for over a year, with the exception of one reading and pipeline pressures looking weak. Looking at producer and import prices, data has turned negative.

A resilient consumer is helping to fuel growth in Switzerland outside of exports. Soft price pressures clearly help, as does a falling rate of unemployment, which has appeared to be on a downward slope since mid- 2009. Evidence of a strong consumer is reflected in retail sales data, which rose 7.5%. The data was positively skewed by a late Easter, but even so, the increase was substantial compared to last year. Further evidence of a resilient consumer was given by the release of a UBS consumption indicator, which showed demand was up to levels not seen since last year.

With such strength in the economy many, including the IMF, feel that the Swiss National Bank should go ahead and raise interest rates to pop swelling property prices and control consumer demand, which could lead to higher prices. But the Bank does not want to provoke a further raise in the franc by lifting interest rates. Low interest rates allow the franc to be sold as a funding currency for carry trades when demand for a safe haven does not exist. Equally, raising rates could send the franc even higher, which the government clearly wants to avoid.

In summary, until uncertainties (Arab Spring, European debt crisis, US debt ceiling) can be convincingly cleared from the marketplace, the franc's role as a safe haven will continue and its downside will remain limited. However, Governments and Central Banks around the world have become increasingly creative in the 'extraordinary measures' taken to achieve their aims. A policy set in place to limit franc gains could accomplish these goals.

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