

FX Update

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THIS WEEK'S RISKS, BIASES AND EVENTS

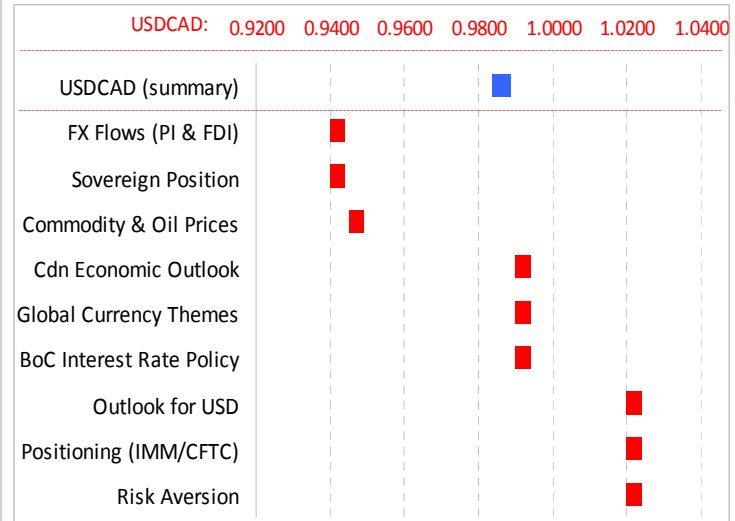
- CAD's near-term outlook is weighed down by EUR depreciation and we are biased to be long USDCAD over the next week, looking for a test towards 1.04. EURCAD failed to confirm a bottoming pattern, leaving the outlook for EURCAD negative. Psychologically a close below 1.30 will be important; with a test to last January's closing low of 1.28 likely.
- EURUSD downside risks dominate. An upcoming ECB meeting, a disappointing meeting between Merkel and Sarkozy, building negative sentiment and a downward trend are all likely to weigh on EUR this week. We look for a near-term test of 1.25 and are biased to be short.
- GBPUSD downside risk dominates. An upcoming BoE meeting, a broadly stronger USD, negative sentiment and pressure for the currency to push through support at 1.54 are all weighing on the currency. For this week, we are biased to be short, targeting the October low of 1.5272.
- USDJPY has been in a tight, 76.33 to 78.98, range since official intervention on October 31. There is no obvious near-term catalyst for a break of this range, leaving our near-term outlook fairly benign.

NEAR & MEDIUM-TERM USDCAD OUTLOOK DIFFERS

In the near-term, USDCAD is likely to drift higher, testing back up above 1.04 (CAD weakness); but the fundamental backdrop is in place for it to break sustainably back through parity later in 2012. The near-term outlook hinges on EUR. Over the past month EUR has taken another leg lower and dragged the USD broadly higher. However, correlations between EUR and CAD have fallen, now at just 0.3, and risk metrics are generally at their summer lows, suggesting that USDCAD is not on its way to repeat the 2008 experience where it rallied aggressively from 1.03 to 1.30 over a one month period. Instead the risk is more likely some moderate USDCAD upside (CAD weakness).

Looking out, 2012 presents a different backdrop. The decoupling of EUR and CAD risk is already beginning and this is likely to be a major 2012 theme (ie: CAD can strengthen against the USD even as EUR weakens). The drivers that should support CAD this year include: Canada's triple A status and developed bond market, which should keep global flows into Canada (and CAD). In addition, we expect an engineered soft landing in China, which suggests that commodity prices can be supported at current levels. Canadian economic fundamentals are not as strong as they have been historically, but on a relative basis shine. Recent US data suggest that the economic outlook is stabilizing, which would also be positive for CAD, and interest rate spreads have been relatively stable since the summer, but as we move closer to 2013, we would expect that spreads begin to move against USDCAD (in favour of CAD) as the BoC proves more likely to tighten policy ahead of the Fed.

USDCAD DRIVERS LEADING TO Q4 2012 TARGET of 0.9800



USDCAD PRICE PATTERN AND TECHNICALS



Source: Scotia FX Strategy & Bloomberg

SUMMARY - RECENT DEVELOPMENTS AND NEAR TERM OUTLOOK

EURUSD IS POISED TO TEST THE PSYCHOLOGICALLY IMPORTANT 1.25

EUR has lost 11% since its late October high of 1.4247 and continues to trend lower. Investors have rapidly lost faith in a potential near-term solution and a re-pricing of EUR has ensued. We expect further near-term downside as sentiment continues to weaken (CFTC net shorts are at record levels), economic fundamentals are deteriorating and the overhang of rating agency downgrades loom. With no clear political appetite to solve the crisis (essentially move towards closer fiscal ties), EUR is bearing the brunt of it. However, a weaker EUR helps support exports, providing at least some easing on the economic front. At current levels (1.27), EUR is 11% overvalued on a PPP basis and the RSI, at just 32, remains well above oversold levels - see chart. The currency continues to trade well above the average rate since inception of 1.20. Looking out to the near-term, the psychologically important 1.25 is the next important test, with a test of the 2010 lows of 1.1877 an increasing possibility. This Thursday the ECB announces its interest rate decision, widely expected to remain on hold at 1.0% with the key risk surrounding President Draghi's press conference.

EURUSD DOWNWARD TREND IS HARD (& EXPENSIVE) TO FIGHT



Source: Scotia FX Strategy & Bloomberg

GBP TO SHINE THROUGH AS CURRENT CHALLENGES DISSIPATE

Although the outlook for Sterling remains challenged by both domestic and external headwinds, we expect it to outperform as we continue into 2012 given the difficulties facing other developed economies. The UK retains some of the lowest sovereign debt yields among developed economies, which should allow for a facilitated deleveraging process amid continued austerity. Additionally, the country's AAA sovereign credit rating makes it a relatively preferred destination for investors seeking safer assets, and expectations of continued asset purchases from the BoE should keep yields low for the foreseeable future. As indicators of volatility continue to decline, we expect market participants to favor GBP's comparatively stronger fundamentals. Technically, indicators remain mildly bearish, though to a much lesser extent than has been seen in prior months, considering the lows in the MACD and RSI (see right hand chart) seen in late September 2011. Accordingly, the near-term path for GBP could see weakness in sympathy with EUR. Given our near term outlook for sterling, we hold a GBPUSD target of 1.63 for Q4 2012 and 1.68 for Q4 2013.

GBPUSD DOWNTREND HAS TEMPERED SOMEWHAT INTO 2012



Source: Scotia FX Strategy & Bloomberg

GOLD'S TECHNICAL & FUNDAMENTAL OUTLOOK BEGINS TO IMPROVE

Gold trended lower in December, but it is currently testing an upward break of its 200-day moving average. As EUR has fallen and the USD has strengthened, gold has struggled; however correlations change over time and after reaching a high of 0.98 in January, the rolling 30-day correlation between gold and EUR is rolling over. This provides an early clue that gold is moving back towards a period where it can move in an opposite direction to EUR (gold positive), trading as a currency. Technically, the MACD (see chart) has provided a buy signal, and the 9-day MA is threatening a bullish cross of the 21-day MA. A break of \$1,635 (the 200-day MA) would be encouraging for bulls.

GOLD AND VOLATILITY MEASURES



Source: Scotia FX Strategy & Bloomberg

VOLATILITY MEASURES ARE SURPRISINGLY COMPLACENT

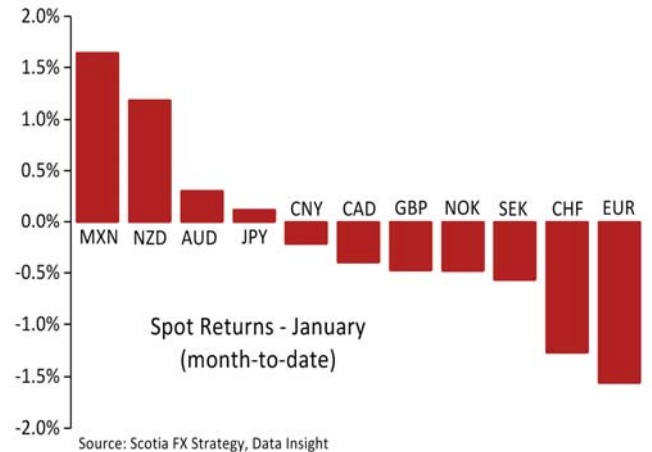
Both currency and equity volatility have trended lower, suggesting that the market is re-pricing global risks and decoupling those from Europe. This is positive for risk sensitive assets like CAD, and suggest that we are not poised to re-live the 2008 experience.

SUMMARY - THE WEEK AHEAD, SENTIMENT & YEAR-END FORECASTS

THE KEY RISKS TO OUR MEDIUM-TERM VIEWS ARE:

- 1) A more dramatic fallout in Europe that causes a renewed spike in risk aversion and significant market reaction; pushing USDCAD dramatically higher, and causing EUR to collapse.
- 2) A hard landing in China, which weighs on the outlook for global growth, commodities and commodity currencies; but would also have repercussions into global growth forecasts, driving USD strength.
- 3) An unexpected downturn in the US economy that dampens the Canadian economic fundamentals, and weighs on global growth.

ONE MONTH FX RETURNS AGAINST THE USD

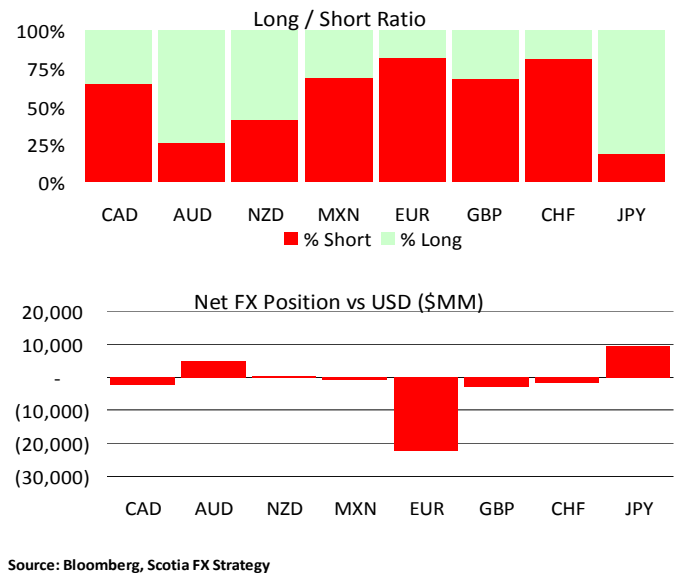


SENTIMENT SUMMARY

Sentiment indicators are mixed as we start 2012:

- 1) **OPTIONS** - Risk reversals: The breakdown in correlations that we have seen since December suggests that investors are no longer aggressively hedging themselves for USD strength vs EUR, typically a warning of upcoming EUR strength. Potential alternative explanations for this shift could be because their positions have been built, or because they have slowed their use of EUR as a hedging vehicle for other assets given the recent breakdown in correlations.
- 2) **RISK METRICS** - Additionally, the fall in risk seen both in the VIX and in general currency volatility metrics indicates a return to a more normalized trading environment in which fundamentals are expected to garner more attention (see charts on p. 2).
- 3) **TRADER POSITIONING (CFTC)** - The net short EUR position has fallen to a record at \$22.7bn, with traders still building short positions w/w. Most other currencies are held short or flat vs the USD, with the exception of AUD and JPY, held long \$4.8bn and \$9.2bn, respectively. JPY traders appear unfazed by the threat of BoJ/MoF intervention.

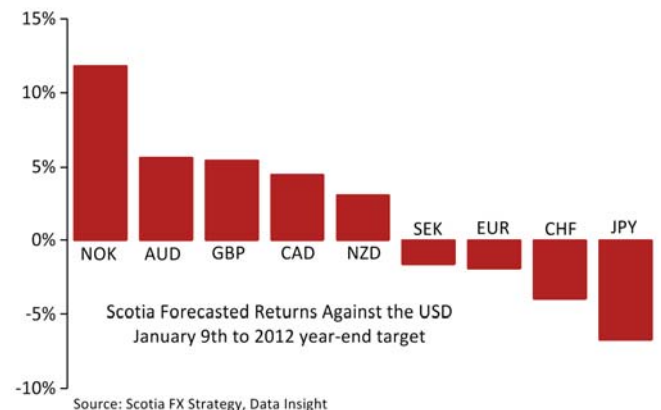
CURRENCY POSITIONING - CFTC



SCOTIA FORECAST VS BLOOMBERG CONSENSUS

	Q112	Q212	Q312	Q412	Q113
USDCAD					
Scotia	1.02	1.01	0.99	0.98	0.98
Consensus	1.05	1.04	1.03	1.00	N/A
EURUSD					
Scotia	1.29	1.28	1.27	1.25	1.25
Consensus	1.27	1.28	1.29	1.30	N/A
GBPUSD					
Scotia	1.56	1.59	1.62	1.63	1.65
Consensus	1.53	1.53	1.55	1.56	N/A
USDJPY					
Scotia	78.00	80.00	80.00	82.00	83.00
Consensus	77.00	78.00	79.00	80.00	N/A

SCOTIA FORECASTED RETURNS TO YEAR-END

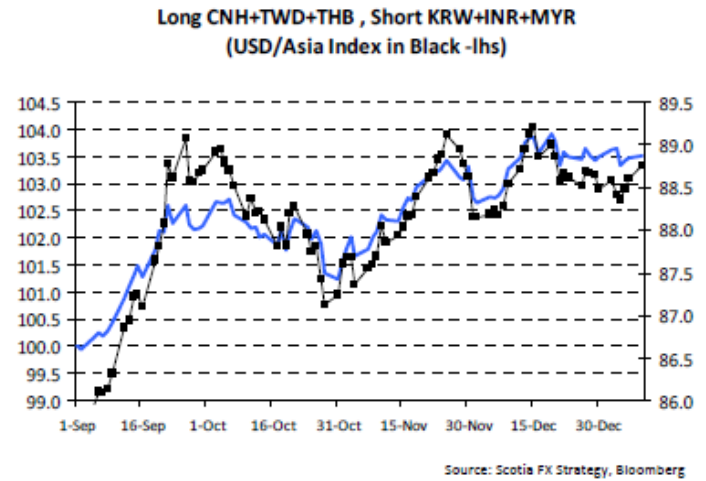


SUMMARY - ASIAN & LATAM STRATEGY

ASIA FX - Sacha Tihanyi

Defensive positioning in Asia remains our recommendation

Defensive Trade - We find that our defensive Asian FX positioning trade is still remaining well supported, with a gain of 3.5% since the beginning of September (see chart). The trade has stagnated since the middle of December, despite the liquidation in EURUSD over the past few sessions. We remind readers that the trade is an equally-weighted long CNH+TWD+THB, funded via KRW+INR+MYR. However, quite positively, the value of the trade basket has remained stable in the face of less firmness in our broader USD index versus the Asian FX space. Considering the risks that abound in the first quarter of this year, namely the credit rating downgrades that threaten Europe's sovereigns and financial institutions, we remain of the opinion that Asian exposure is best expressed through such a defensive position.



LATAM FX - Eduardo Suarez

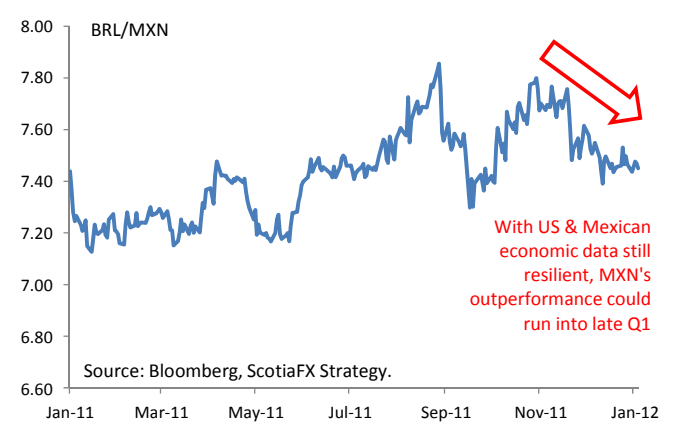
Trades for in 12Q1: "Swapitos"

- Although we are tactically bullish LATAM FX to start the year, global event risk remains high. Consistent with our relatively cautious view on the external environment, we find the arbitrage provided by cetes & MXN forwards as one of the more compelling trades out there.
- Our preference is to trade Mexico through "swapitos", but positions in cetes and other domestic fixed income instruments (i.e. M-bonos) are another alternative that offers a yield pick-up over MXN forwards.

Short BRL/MXN (early Q1), long BRL/MXN (late Q1)

- We are relatively bullish MXN, given what look like attractive valuations, continued resilience in US & Mexican economic data, and what looks like a strong pipeline of FDI. The peso's high beta, in a still uncertain global environment, makes BRL/MXN's 90-day correlation with the S&P500 is 13% compelling.

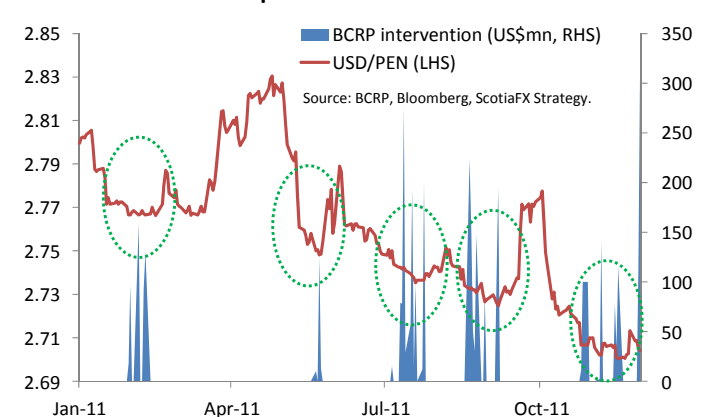
Graph 1: We believe the recent trend is BRL/MXN has some room left to run



Short USD/PEN

- Even during the risk-selloff we witnessed in the fall of 2011, USD/PEN only spiked 2.4% higher, while the rest of the major LATAM FX lost 14% to 28% vs the greenback. We believe PEN should continue to outperform its LATAM FX peers in "risk-off" environments, while providing attractive total returns as a carry currency.
- With a strong pipeline of FDI projects and what we view as a relatively low risk of an unwind in domestic fixed income markets by foreigners we believe flows are supportive for the sol.
- BCRP intervention behavior suggests that rather than trying to defend certain levels in USD/PEN, the central bank wants to curb rapid appreciation. As a result of this behavior, USD/PEN has one of the lowest vols of any major FX, accompanied by a high carry. Our bias is to trade short USD/PEN as a carry trade, targeting annualized total returns of 4%- 8%.

Graph 2: BCRP intervention suggests the central bank targets low vol. rather than specific valuations



Please join us in our **FX Strategy Conference call**, available for the next 30 days

Dial: 905-694-9451

Passcode: 289 803 925#

The 15-minute call is hosted by Eric Theoret and discusses:

- Overview of Scotia's FX Forecast
- FX trends and themes in 2011
- USDCAD outlook from here
- How USDCAD has reacted to spikes in risk aversion in the past

The presentation is attached but can also be found at:

<http://www.scotiafx.com/conference/index.htm>

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