AXIS BANK

THE EURO AND OTHER MYTHS...

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The recent surge in the Euro has been attributed to very strong "RISK ON" factors like a bazooka type resolution to the EU debt crisis and the acceptance of a very practical approach to the EFSF and ESM funding platforms. The reality may be not be that straightforward. The Euro is "surging" not because the Investment environment has suddenly become pro-risk, but because of strong Euro transactional buy flows from EU Banks who are liquidating USD assets globally and bring them back home to compensate for the loss of EU deposits and the severe strain on banking capital.

Figure 1. Global FII Flows and the EUR/USD: FII flows a mere trickle as opposed to a surging Euro

Figure 2: EU M1 collapse.....

Figure 3. ..... A surge in US Money supply & ....

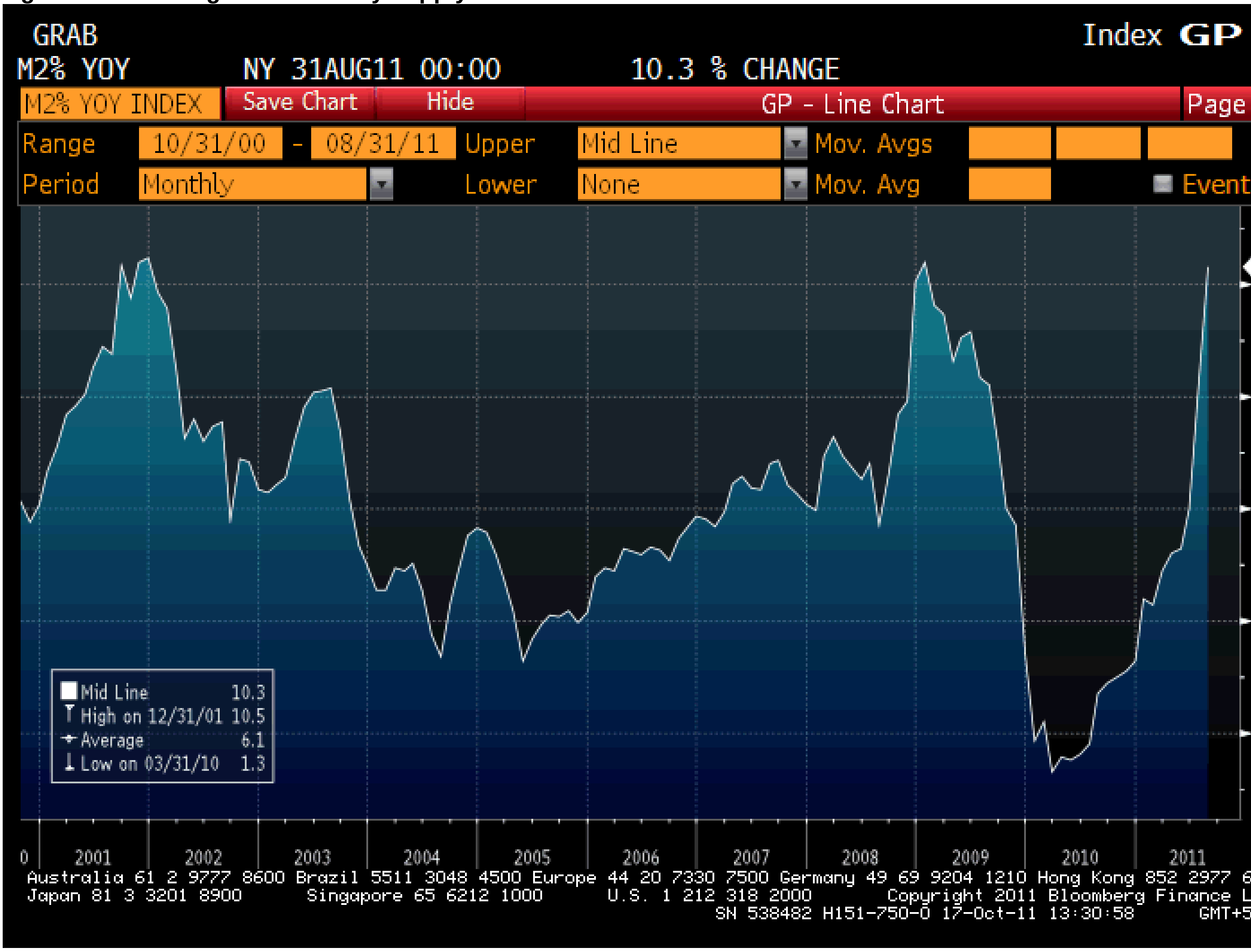

Figure 4 -.... A bump in Swiss Money supply--------- EU zone Bank deposits are fleeing to safe havens in the US and Switzerland

Figure 5: French 10 yr Yield - 10 yr German Bund yield- 93 bps spread last seen in 1996

Robot Algo trading have been trained to recognize a surging Euro as a "signal" to buy into risk assets forgetting that a FX pair is primarily meant to be transactional in nature where buyers will buy the currency to satisfy a pressing requirement and this time all algos have been fooled by a purely transactional purchase of the Euro against the greenback to populate stock exchanges with buy orders. This surge in risk assets has in turn dragged the Euro only higher in the mistaken belief that the investment climate is more favourable. This mistaken market direction will most certainly end in grief if the EU is unable to convince the market that there is a credible plan to ring fence vulnerable Banks and sovereigns like Spain, Italy, Belgium and France.

Figure 6: The attack from the periphery to the core- 5 Yr CDS of Belgium, Spain, France and Italy

Key takeaways:

1. This rally is not a “first leg " of the rally to be driven higher if EU/G7 conjure up a Cannes encore. It will, at the most +ve scenario, make risk assets unchanged if all market expectations are met.

2. Even the slightest of disappointments with the EFSF/ESM package will lead to a selloff of all risk assets

3. A sovereign downgrade of Belgium and France and a downgrade of Banks in China should be watched out for.

4. Indian corporates have unhedged ECB's and FCCB's. Hedging is advisable with a "buy on dips" strategy taking each dip as an opportunity to cover USD payables.

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