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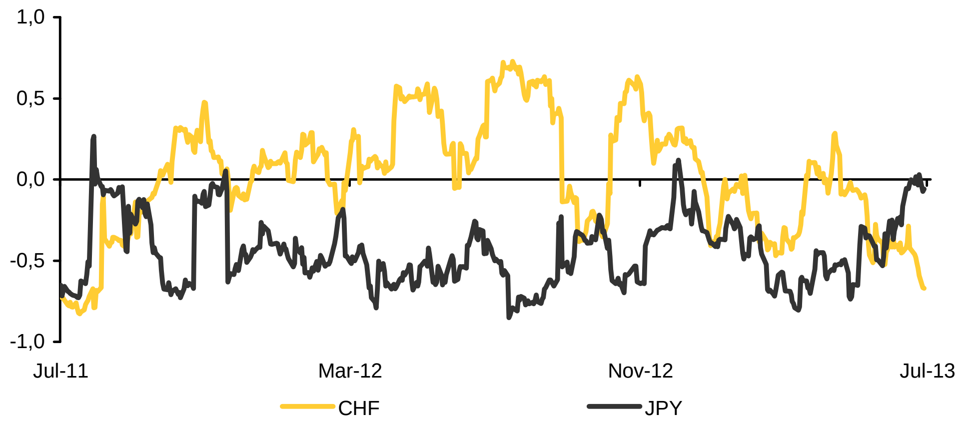
FX Alpha

9 July 2013

I'll buy that for a dollar!

I'll buy that for a dollar! Clearly divergent policy cycles amongst the majors will lead to USD appreciation. The question is how to position for the USD move. We think USD-JPY should outperform USD-CHF, whilst the likes of AUD, NZD and GBP remain vulnerable to further downside.

CHART 1: **Battle of the safe havens…**
21 day correlation of trade weighted CHF / JPY vs S&P index



Sources: Bloomberg L.P., Commerzbank Research

G10 Highlights. Returning tension within the euro zone once more signal the dilemma the ECB has to deal with. In the meanwhile macro data in the U.S increase the likelihood of a QExit before year end. We are sellers in EUR-SEK above 8.80.

FX Metrics. We use correlation forecasts to construct optimized carry trades. Based on this we outline a trade idea on carry trades.

EM Highlights. Hungarian MPC cautious for now. Monetary policy decisions in Brazil and Mexico: the interesting part is the statement.

Tactical trade recommendations. Re-enter short GBP-USD positions.

Technical Analysis. US dollar over-stretched near term. Allow for consolidations/corrections.

Event calendar. The upcoming days, the data calendar is rather light. Focus will be on the FOMC minutes on Wednesday.

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I'll buy that for a dollar!

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Clearly divergent policy cycles amongst the majors will lead to USD appreciation. The question is how to position for the USD move. We think USD-JPY should outperform USD-CHF, whilst the likes of AUD, NZD and GBP remain vulnerable to further downside.

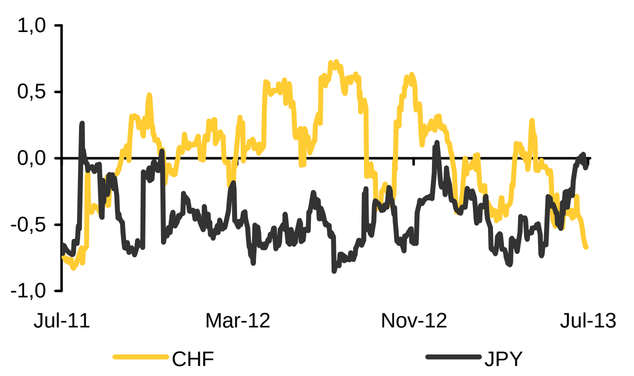
The leap towards explicit forward guidance policies by the BoE and ECB last week clearly highlights the divergence in monetary policy amongst the majors with respect to the Fed. A clear majority of market participants now expect a significant USD rally in the coming months and years. The only question is what to buy the USD against?

USD outperformance against safe haven currencies is perhaps the most obvious position to initiate. The trade should benefit from rate spreads moving in favour of the USD and also from the dollar's transformation into a more growth oriented currency. So should one buy USD-JPY or USD-CHF?

Thus far the move higher in USD-JPY has been a largely idiosyncratic JPY move as can be seen via the increase in Japanese inflation expectations. Given that inflation expectations are not likely to move significantly above the 2% inflation target, at least in the short term, one has to conclude that in the short term the JPY move is largely done. From here the move higher in USD-JPY will be largely driven via the increase in rate spreads, which have recently turned decisively in favour of the USD. Against CHF the situation is somewhat more complex. CHF is now the only 'real' safe haven within the G10 complex and displays a negative correlation against most risk metrics, especially the S&P. This contrasts with JPY, where we see evidence of correlation breakdowns against traditional risk indices. The obvious implication is that JPY is slowly losing its safe haven status and given the tricky budgetary arithmetic that the Japanese are running, this should not surprise. On balance one should expect that USD-JPY should outperform USD-CHF, as CHF will retain a safe haven bid with peripheral euro zone yields remaining elevated.

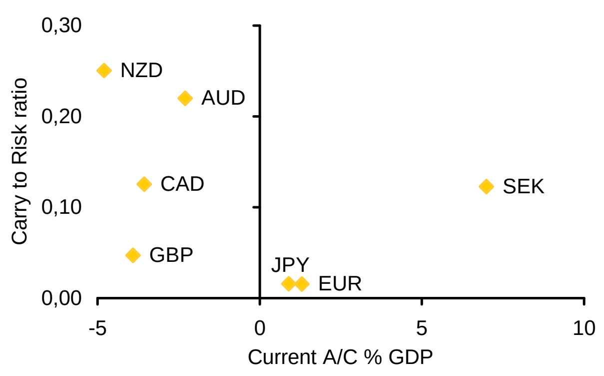
This leaves the question of how to position against higher yielding commodity currencies. Year to date this underperformance has been notable even before the increase in FX volatilities since April, which points to idiosyncratic factors being in the driving seat. Indeed carry to risk ratios for AUD and NZD illustrate a notable downward bias over the last 6 months. The move towards a stronger USD, in an environment of still relatively low aggregate volatility implies that those higher yielding currencies with structural weaknesses are at risk of further falls. On this metric the commodity currencies and GBP look particularly vulnerable. With the UK set to adopt a more formal forward guidance policy, short positioning in GBP-USD will also prove to be a profitable trade in the coming quarters and the fact that the BoE will look beyond positive economic surprises in the UK points towards a more asymmetric reaction function for sterling exchange rates in the coming months.

CHART 2: **Battle of the safe havens…**
21 day correlation of trade weighted CHF / JPY vs S&P index



Sources: Bloomberg L.P., Commerzbank Research

CHART 3: : **NZD and GBP look vulnerable**
3 Month carry to risk ratio, current account as a % of GDP



Sources: Bloomberg L.P., Commerzbank Research

G10 Highlights

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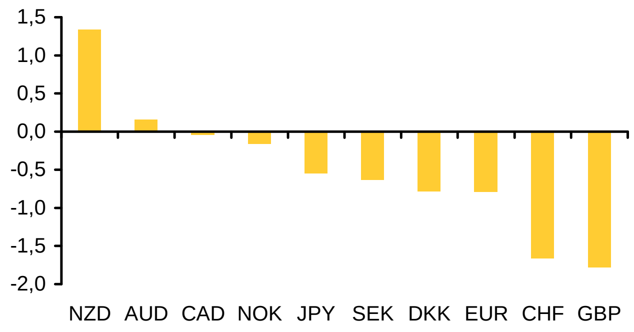
Returning tension within the euro zone once more signal the dilemma the ECB has to deal with. In the meanwhile macro data in the U.S increase the likelihood of a QExit before year end. We are sellers in EUR-SEK above 8.80.

EUR: For quite some time the European debt crisis was more or less off the table at least in FX market participants mind. But as the underlying problems are not solved it should not be a surprise that tensions are growing of late. Portugal hardly avoided a collapse of its government and Greece is once more struggling to reach the agreed level of reforms to receive the next tranche of its rescue package. Against this background the ECB provided quite some forward guidance last week by stating that the key interest rates will remain at current or lower levels for an extended period of time. No wonder that the euro got hit by this. It becomes more and more obvious that the ECB is already a prisoner of its own device. On the one hand it wants to step back making sure that sufficient reform pressure on European government remains. On the other hand Mario Draghi and his combatants are eager to avoid the crisis to pop up again. For the euro this constellation is clearly a burden. At the end the "extended period of time" in Europe will turn out to be much longer than the one in the US. While on the other side of the Atlantic the Fed just waits for the economy to pick up sufficient momentum, the ECB is dependent on the various governments' will to undertake rather painful reforms. The latest decision regarding Athen's next tranche (disbursement despite failing on most of the promised reforms) shows this dilemma once more. It increases the incentives for peripheral countries to rather rely on the European funds than taking painful decision at home. In the end the euro will have to pay the bill for this lack of incentives.

USD: Clear guidance from FOMC put macro data in the driving seat for the USD. And the economic performance in the US seems pretty good at least compared to what we can observe in the euro zone. Non farm payrolls increased another 195K in June in line with the 6 month average. Sooner or later the Fed is set to reduce its asset purchases. We therefore stick to our forecast of lower rates in EUR-USD.

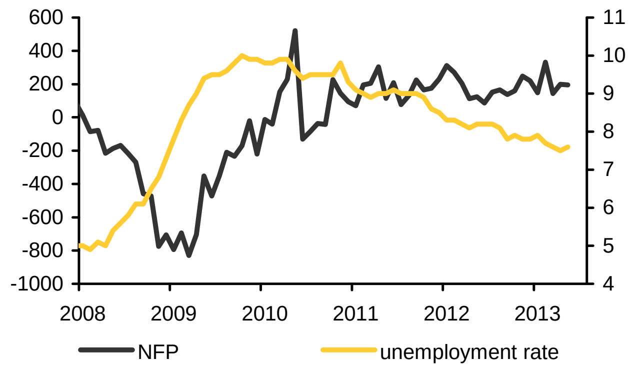
SEK: The Swedish krona got hit again at the beginning of the week on the back of disappointing industrial production data. It had already suffered heavily on Friday due to the strong US NFP report, which sent USD-SEK flying higher, dragging EUR-SEK with it. In this environment, times are likely to remain tough for the SEK in the short-term, unless economic data surprises notably soll to the upside. Besides the unemployment rate on Wednesday, the main focus is June CPI data on Thursday. Any hint to a pick up in the inflation rate, which has been lingering in the red since November, is likely to enable SEK to pare back some of the recent losses. We stick to our view that, especially against the EUR, current levels are not fundamentally justified. However, it may take some more time for the market to realise it. We are sellers in EUR-SEK above 8.80.

CHART 4: **Strong USD but NZD the outperformer**
% gain / loss vs. USD since July 2 2013



Source: Commerzbank Research

CHART 5: **US labor market on track**
Change in Non Farm Payrolls and unemployment rate



Source:Commerzbank Research

FX Metrics

G10 carry trade indices

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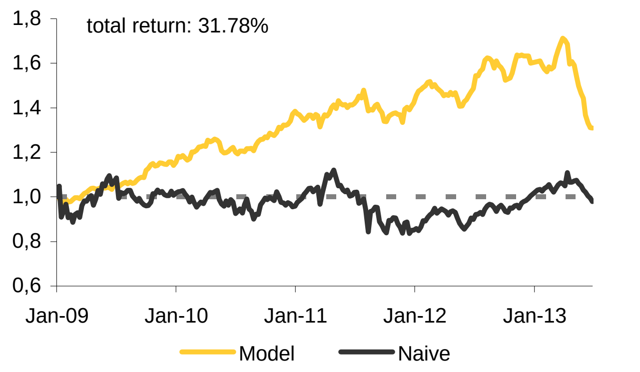
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different investments. We therefore suggest a portfolio strategy that optimizes the diversification effect and significantly reduces the downside risk entailed in carry trades using "mean-variance" optimization.

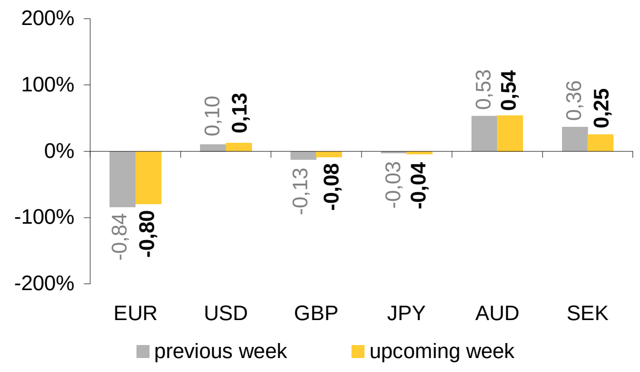
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

CHART 6: **Historic performance of optimized Carry Trade Portfolio**
Cumulative return[1] since 6 January 2009, weekly rebalancing, target variance: 6%; Naïve strategy: B&H strategy, 3 high yielders long, 3 low yielders short; Currency basket: EUR (base), USD, GBP, JPY, AUD, SEK, CHF (excluded after Sept 2011)



Source: Commerzbank Research

CHART 7: **Portfolio weights for week 9 July to 16 July**
Currency basket: EUR (base), USD, GBP, JPY, AUD, SEK; weights in %



Source: Commerzbank Research

Methodology

Our optimized strategy considers the correlation of the exchange rates in the portfolio weighing decision, i.e. the good old "mean-variance" optimisation according to Harry M. Markowitz. For the carry trade portfolio this means investing in carries in such a manner that an optimum relation between carry and the risk assumed is achieved. Needless to say, the more accurate the estimate of the correlation matrix the larger the advantage of the portfolio optimisation. For our portfolio we therefore use a trend model to forecast the relevant correlations on a weekly basis. In particular, the forecast is based on a linear trend over the weekly correlations of the last month. This trend is then extrapolated to the coming week to yield a forecast. Subsequently, the trend is rolled over on a weekly basis. This trend-based forecast therefore uses more timely input which ultimately increases forecast accuracy.

[1] Returns are based on Tuesdays' London opening

EM Highlights

Hungarian MPC cautious for now. Monetary policy decisions in Brazil and Mexico: the interesting part is the statement.

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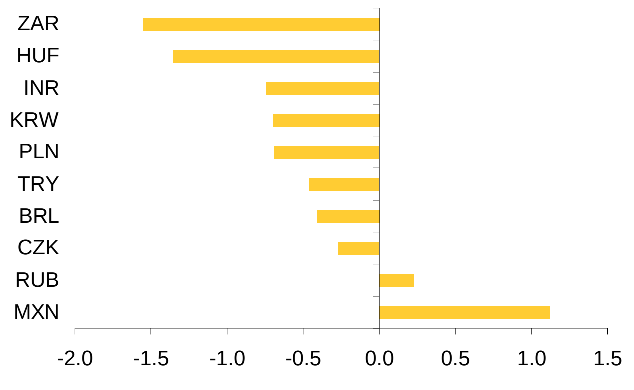
HUF: MPC minutes due tomorrow should shed more light on the currently cautious stance of the MNB. While it is likely to again highlight that the economic situation provides further room for monetary easing, volatility on global financial markets remains a risk factor that could limit the scope of further rate cuts. As we believe that EM weakness on the back of QE tapering speculation will subside though as it will become clear that the Fed will not start to normalize monetary policy, i.e. hike key rates any time soon, we continue to look for key rate cuts down to 3.50% by the end of the year. The June inflation rate due on Thursday, which we expect to remain flat at 1.8% in line with the benign inflation trend in the region, too supports our expectation of a continued expansionary stance of the MNB. Against this background, the upside in EUR-HUF continues to be the weak side in our view.

BRL: In the past weeks speculations about tapering by the US Fed were the main driver for the real. This week the focus will shift back to Brazil were the central bank decides on its rates on Wednesday. We expect as most market observers a rate hike by 50 bps. While the rate decision itself should deliver no surprise the statement will be of interest. Against the background of stubbornly high inflation figures the market increasingly expects more tightening by the central bank in the coming months. We remain skeptical though, as the latest data show that the economy is recovering only slowly. The central bank will bear this in mind when making its monetary policy decisions. Therefore if the central bank disappoints the market on Wednesday and sounds less hawkish this should put downside pressure on the real.

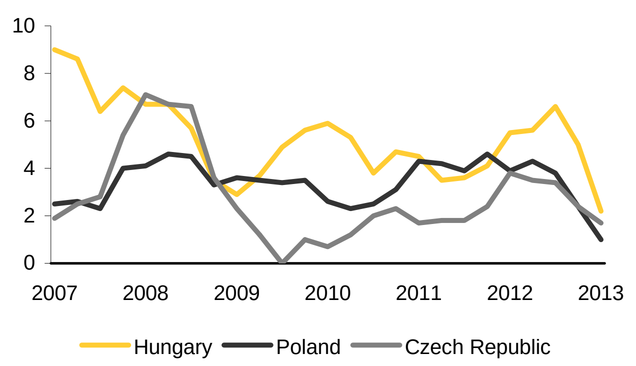
MXN: The Mexican central bank will also decide on its rates this week. As the concensus we expect the central bank to keep rates unchanged. Inflation has climbed above the 2-4% target range of the central bank in the last months. Therefore we see no room for a further rate cut currently. Market expectations is divided regarding the future course of monetary policy, while the majority expects a rate hike this year there are also some expecting further rate cuts. Against this background the statement will be of interest since it might give hints regarding monetary policy actions in the coming months. Should the central bank give hints that the next rate move will be a hike instead of a cut this should be supportive for the peso.

CHART 8: **Broad based EM weakness, MXN outperforms**
% gain against USD since 2nd Jul



Sources: Bloomberg, Commerzbank Research

CHART 9: **Benign inflation in Eastern Europe**
CPI, in % yoy



Sources: MNB, NBP, CNB

Tactical trade recommendation

Re-enter short GBP-USD positions.

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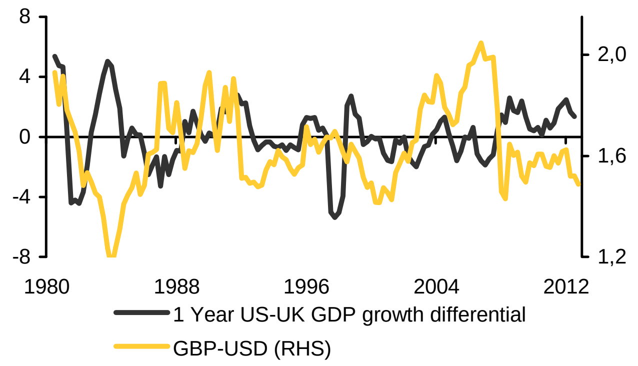
Over the course of this year our view has been that short GBP-USD positions offered significant scope for outperformance given the relative growth trajectories of the US and UK economies. Following the events of the past few weeks we can also add another rationale towards short GBP-USD positioning; divergent monetary frameworks.

The explicit move towards a forward guidance framework by the BoE essentially means that sterling exchange rates will suffer from an asymmetric reaction function to UK economic data in the coming weeks. Therefore, investors can take short positions safe in the knowledge that rate expectations are not likely to move in favour of the pound anytime soon. Contrast this with developments in the US treasury market and one can see that GBP-USD has more scope to the downside.

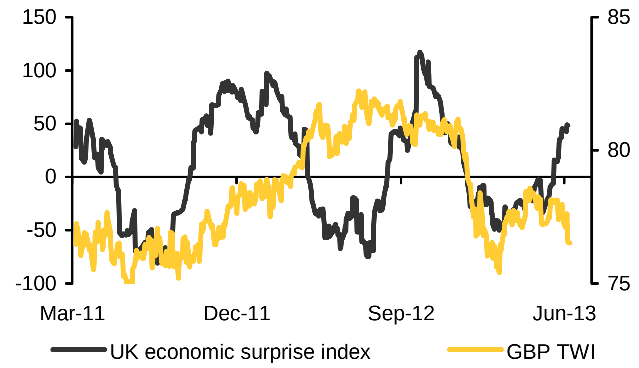
We recommend investors to enter short GBP-USD positons via selling risk reversals over a 3 month tenor by selling 1.51 GBP calls and buying 1.46 GBP puts for a total cost of approximately 0.01% of notional.

CHART 10: **Cable grinds lower with growth differentials**
GBP-USD spot, US – UK GDP growth differential in %



Sources: Bloomberg LP, Commerzbank Research

CHART 11: **Get used to asymmetric reactions**
GBP TWI, UK Economic Surprise Index



Sources: Bloomberg LP, CFTC, Commerzbank Research

TAB. 1: **Discretionary Option Trade Recommendations (base currency EUR)**

Trade date	Strategy	Expiry	Size	Premium	Value	P&L	Open / Closed
04.02.2013	Short EURp-CHFc 1.2050	04.12.2013	1m	+1.10%	-0.34%	0.76%	Open
26.02.2013	Sell AUDc-USDp 1.06 Buy AUDp-USDc 1.00	22.08.2013	2m x 1m	0.28%	7.30%	7.00%	Open
12.03.2013	Sell CAD-MXN risk reversal 13.00 / 11.90	12.09.2013	2m x 1m	0.28%	-0.38%	-0.66%	Open
22.04.2013	Sell EUR-USD risk reversal 1.33 /1.28	22.07.2013	1m x 1m	0.20%	0.43%	0.23%	Open
28.05.2013	Buy USD-CHF risk reversal 0.94 / 1.00	28.08.2013	1m x 1m	0.23%	-0.04%	-0.27%	Open
19.05.2013	EUR-GBP put spread 0.84 / 0.81	19.08.2013	1m x 1m	0.98%	0.20%	-0.78%	Open
06.05.2013	Buy MXN-JPY risk reversal 8.00 / 8.40	06.08.2013	2m x 1m	0.005%	-0.23%	-0.235%	Open
08.07.2013	Sell GBP-USD risk reversal 1.51 / 1.46	08.10.2013	1m x 1m	0.01%	-0.23%	-0.24%	Open

Source: Bloomberg L.P., Commerzbank Research

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Technical Analysis

US dollar over-stretched near term. Allow for consolidations/corrections.

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Given the massive acceleration we have seen on the US 10Y yield chart from a low of 1.6090 to a high so far of 2.759, it has exceeded most peoples expectations. Now technically this move looks over-stretched, the rally has reached the 2007-2013 down trend, the daily RSI has diverged and we have a TD perfected set up on the weekly chart. All 3 factors suggest that we will see a retracement (a move to approximately 2.40-2.33 is anticipated).

We suspect in conjunction with this that a correction lower on the US 10Y yields is likely to spill over into a US dollar correction also and in particular we suspect that both GBP-USD and AUD-USD will struggle to maintain losses beyond 1.4832 (2013 low) and the psychological support at 0.9000 at this juncture. We are therefore alert to the idea of a corrective rebound near term in these markets and the US dollar generally.

We look only for corrective moves at this stage. Rallies on GBP-USD, for example, are not expected to reach 1.5304 (50% retracement and the 3rd July high) and while capped here will remain directly offered. The market is likely to struggle to maintain a break of 1.52 (38.2% retracement of the move down) and below 1.4832 on a closing basis will see the next downside target of 1.4229/59 engage.

CHART 12: **GBP-USD Weekly Chart**
Sell off has reached long tern Fibonacci retracement at 1.4850

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
10 July	07:00	GER	Consumer prices	mom	JUN F	0,1	0,1
				yoy	JUN F	1,8	1,8
	08:00	RON	Consumer prices	mom	JUN	0,2	0,2
				yoy	JUN	5,5	5,3
	09:00	NOK	Consumer prices	mom	JUN	-0,3	0,1
				yoy	JUN	2,1	2,0
	12:00	USA	MBA Mortgage Applications	%	JUL 5	-	-11,70
	13:00	RUB	CPI weekly year to date	%	JUL 8	-	3,8
11 July	02:30	AUD	Employment change	K	JUN	0,0	1,1
			Unemployment rate	%	JUN	5,6	5,5
	08:00	TRY	Current account balance	USD bn	MAY	-6,9	-8,2
	08:00	HUF	Consumer prices	mom	JUN	0,1	-0,1
				yoy	JUN	1,8	1,8
	08:30	SEK	Consumer prices	mom	JUN	-0,2	0,2
				yoy	JUN	-0,2	-0,2
	12:00	ZAR	Industrial production	mom	MAY	0,2	8,4
				yoy	MAY	2,9	7,0
	12:00	RUB	FX and gold reserves	USD bn	JUL 5	-	514,5
	12:59	JPY	BoJ Target Rate	%	JUL 11	-	0,10
	13:30	USA	Initial jobless claims	K	JUL 6	340	343
	13:30	USA	Import Prices	mom	JUN	0,0	-0,6
				yoy	JUN	0,4	-1,9
12 July	05:30	JPY	Industrial production	mom	MAY F	-	2,0
				yoy	MAY F	-	-1,0
	08:00	HUF	Industrial production	mom	MAY F	-	-1,3
				yoy	MAY F	-	-2,1
	10:00	EUR	Industrial production	mom	MAY	-0,3	0,4
				yoy	MAY	-1,4	-0,6
	-	RON	Current account balance	EUR mn	MAY	-	55
	13:00	PLN	Current account balance	yoy	MAY	-157	468
		USA	Producer price index	mom	JUN	0,5	0,5
				yoy	JUN	2,1	1,7
			core rate	mom	JUN	0,1	0,1
				yoy	JUN	1,6	1,7
	14:55	USA	Michigan consumer confidence		JUL P	84,8	84,1
15 July	00:01	GBP	Rightmove House Prices	mom	JUL	-	1,2
				yoy	JUL	-	2,7
	08:00	CZK	Producer price index	mom	JUN	-0,1	-0,3
				yoy	JUN	0,6	0,3
	08:15	CHF	Producer and import prices	mom	JUN	-	-0,3
				yoy	JUN	-	-0,2

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