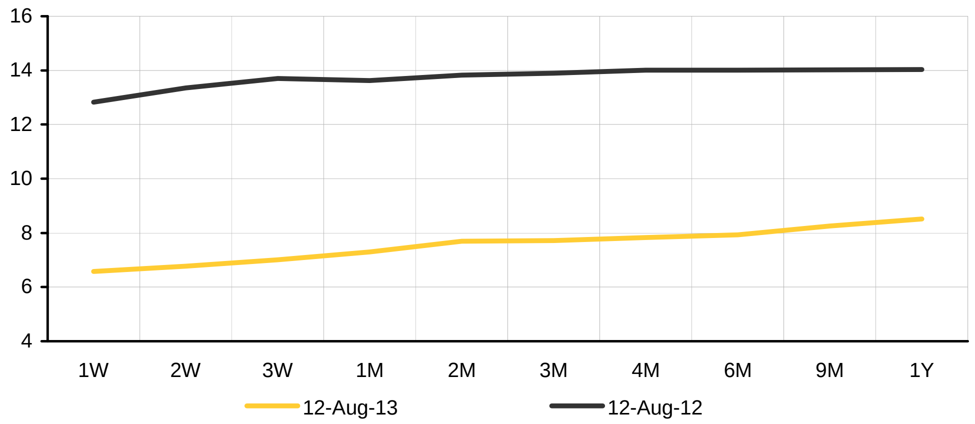
FX Alpha

13 August 2013

Complacency reigns

Complacency reigns. Despite market moving event risk in the coming weeks and months, volatilities remain at depressed levels. It is unlikely to last.

CHART 1: **EUR-USD vol curve abnormally flat**
EUR-USD at the money volatilities in %



Source: Commerzbank Research

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Despite market moving event risk in the coming weeks and months, volatilities remain at depressed levels. It is unlikely to last.

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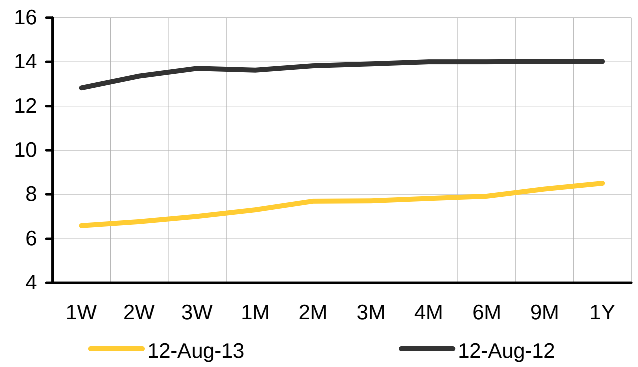
Coming into September the FX markets seem to be in a relatively sanguine mood. Consensus expectations are for Fed tapering to take place in the latter part of 2013 rather than at the September meeting. At the same time, the German election in September offers some event risk for EUR crosses, whilst the development of yields in Greece suggests the possibility of another Greek restructuring which has the potential to include official sector lenders for the first time. On the policy side the clear divergence in monetary policy between the Fed and the ECB could not be more clear, with the ECB doing all they can to keep rates low, whilst the Fed are gradually moving towards a normalization of policy, as the Fed's Fisher hinted last week. All told it seems as though market volatilities should be set to increase.

However the market seems unimpressed. Take the EUR-USD vol curve at the moment. It displays a remarkably flat profile at what are close to historically low volatilities. If this does not smell of complacency on the part of investors I really don't know what does. To put this into context, EUR-USD volatilities have only traded below current levels 9% of the time since January 2000. The current low levels are no doubt due to the (as yet untested) OMT effect. Thus it has to be argued that at present levels not only do volatilities offer reasonably decent value, but given event risk in the coming weeks and months investors would be foolish not to take advantage of them.

At this stage investors who have tried to short EUR-USD over most of the year have by now given up trying, given how badly their fingers have been burned. In a relative context the EUR benefitted from having the tightest combination of fiscal and monetary policy amongst the majors, however this is set to change. The US budget deficit shows clear signs of improvement whilst US interest rates continue to grind higher. With the ECB engaging in forward guidance it is only a matter of time before lower levels prevail. In essence we are not far from a turning point.

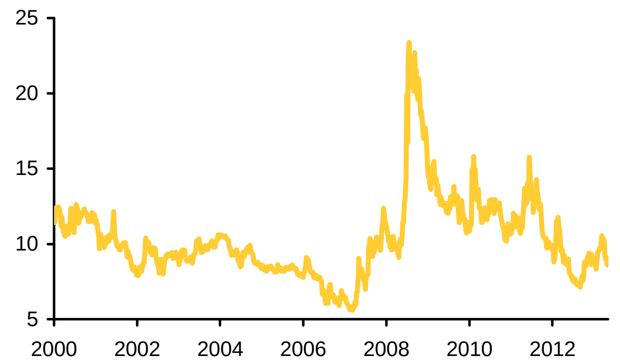
Price action and positioning are also instructive. The move towards 1.34 was not in any way sustained last week with little follow through from investors. IMM positioning now shows that speculators hold a net long EUR position, albeit in small size. So far this year net long EUR positioning has been a rather good contrarian indicator when it comes to subsequent moves in EUR-USD and our feeling is that this time will be no different. It is hard to envisage a significant down move in EUR-USD having little impact upon volatilities more generally speaking and therefore the uptrend in aggregate G10 volatilities that has been in place since January of this year should be set to resume.

CHART 2: **EUR-USD vol curve abnormally flat**
EUR-USD at the money volatilities in %



Sources: Commerzbank Research, Bloomberg LP

CHART 3: **G10 vols set to resume uptrend**
G10 aggregate 3 month at the money volatilities in %



Sources: Commerzbank Research, Bloomberg LP

G10 Highlights

US activity data scrutinized in the search for signals about the timing of QE3 tapering. Cable likely to remain under pressure. Chances for a further rate cut in Sweden getting slimmer.

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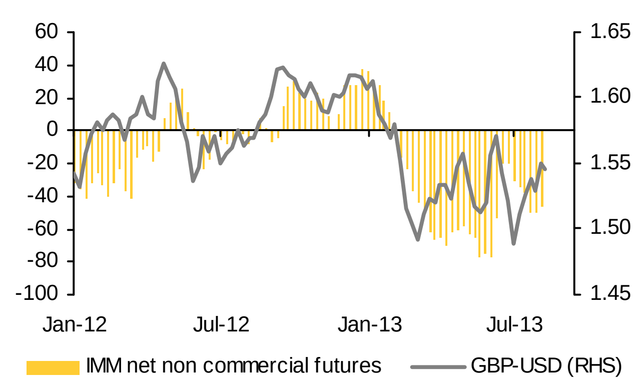
USD: The upcoming days will see the release of several US activity data, like retail sales and industrial production. The market hopes to get hints about the timing of QE3 tapering from it. However, employment is the Fed's target. Growth it not a Fed target. This means that activity data only has an indirect effect on its policy. Nevertheless, since the QE3 tapering issue is the main story in the financial markets, any US data will serve as a signal for the timing of the tapering – be it justified or not. Overall, we expect rather friendly US data. However, GDP data out of the euro zone will also show the the euro zone is working its way out of recession. This means that EUR-USD is set to consolidate on high levels but that the overall trend will down. The upside remains capped at 1.3400-20.

GBP: The most important data release this week will be UK unemployment data for June, with expectations for an unchanged print of 7.8%. Indeed following last week's Inflation Report, unemployment releases will likely become the most watched UK economic indicator, given its primacy within the new forward guidance framework adopted by the BoE. Our view from here on is that sterling exchange rates will trade with greater sensitivity to data releases now that market participants have clarity with regard to what the BoE intends to do, rather than the asymmetric response function we have gotten used to over the last few months. Regarding the unemployment rate our economics team are of the view that it will take 3 years before we see the BoE's 7% target meaning that rate hikes are a long way off. That means downside in GBP-USD remains the more likely trading range. Markets seem to agree as last week's high of 1.5540 has been thoroughly rejected.

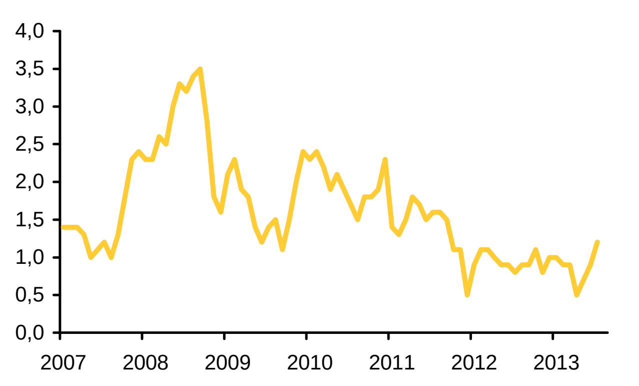
SEK: Another rate cut in Sweden becomes less and less likely. Just to remind you: in early July Riksbank raised the rate path slightly thus signalling that a rate cut is slightly less likely. Moreover it expects inflation to reach the target of 2% in 2015. However, this year Riksbank still expects a low inflation rate, as a result it forecasts core inflation to remain around 1% in 2013. Against this background today's inflation data fits into the Riksbank's big picture: July inflation data came in above market expectations, with +0.1% yoy for the overall rate and 1.2% yoy for the core rate. The data can't entirely offset the strong effect on the SEK of the rather disappointing economic data of the past few days (Q2 GDP, PMI etc.) but is another signal that markets slowly have to wave goodbye to the idea of rates falling further in Sweden. We stick to our view that the SEK will regain ground against the EUR over the next months due to its more solid fundamental basis, which will become clearer and clearer with economic data improving further.

CHART 4: **Large short GBP position still evident…**
GBP-USD spot, IMM net non commercial futures



Sources: CFTC, Commerzbank Research

CHART 5: **Rising inflation reduces chances of another rate cut in Sweden**
Swedish CPIF (core rate), yoy, in percent



Source: Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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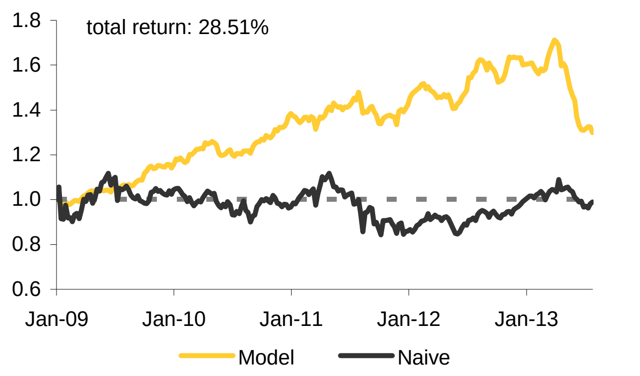
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different 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.

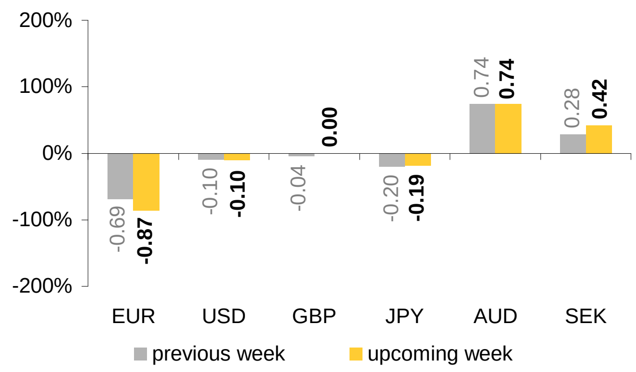
Below we illustrate an example of a mean-variance optimized carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 13 Aug to 20 Aug**
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

Polish CPI set to rise moderately. CEE Q2 GDP due. Rates likely to have bottomed out in Israel.

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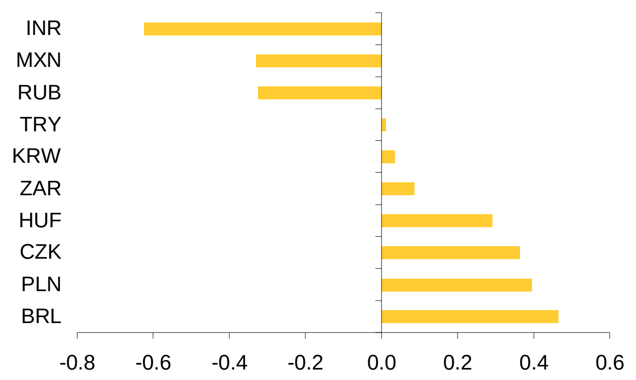
PLN: Polish July CPI data is due tomorrow and is expected to show a moderate increase in price growth. According to consensus, the inflation rate will rise to 0.5% from 0.3% yoy which is still far below the NBP's target of 2.5%. Nonetheless, the NBP has made clear that no further rate cuts are in the pipeline as it expects price growth to gradually pick up alongside the economy. Should the inflation rate however turn out lower than expected this might cause rate cut speculation to flare up again and provide some headwind for the PLN.

CEE: Q2 GDP data will be released tomorrow which will show that the Eastern European economies are in the process of recovery. The Czech print should bring the most positive surprise as growth is expected to pick up from -1.1% to 0.5% qoq according to consensus which would be the first positive growth figure since H1 2011. Should the figure turn out to be even higher, fx intervention speculation are likely to take a hit which in turn should weigh on EUR-CZK where the next support is located at 25.75. Hungarian GDP growth is set to grow at a comfortable rate of 0.3% qoq which is however somewhat lower than in Q1 which saw a pickup of 0.7% qoq. The figure would have to surprise massively on the upside in order for the MNB to scrap its rate cut plans and thus provide some sustainable support for the HUF. Polish GDP too is expected to grow by 0.3% qoq which would confirm the market's and NBP's expectation of a solid recovery. Only a surprisingly weak outcome would have a notable market impact in our view as this might provide a reason for speculators to bet on the NBP possibly rethinking its neutral monetary stance after all. Unless the external backdrop worsens, the 4.22 resistance level in EUR-PLN should however hold.

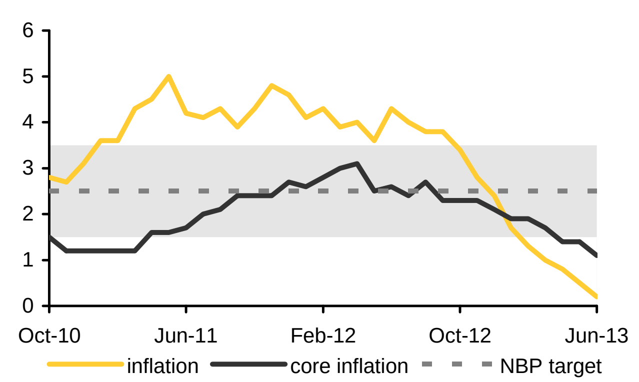
ILS: The coming week will be busy one for the shekel in terms of data releases. CPI data for July will be released on Thursday and are expected to print at +0.3% mom and +2.2% yoy. Once again housing and rent costs are on the up and the latest BoI minutes showed that this is a concern for the MPC, hence rates remained on hold despite the slowdown in some cyclical economic indicators. In our view we are increasingly of the opinion that rates have bottomed out. The markets seem to be of the same opinion as the shekel continues to come under appreciation pressure with the BoI forced into nearly daily FX interventions. As always these interventions merely slow the pace of the move rather than the trend, the bottom line is that we're going to have to get used to stronger shekel exchange rates in the near to medium term.

CHART 8: **Mixed picture on EM front**
% Gain / Loss Vs. USD since 6th August 2013



Sources: Bloomberg, Commerzbank Research

CHART 9: **Polish CPI to turn around?**
CPI change in % yoy



Sources: NBP, Commerzbank Research

Tactical trade recommendation

Establish short EUR-USD positions.

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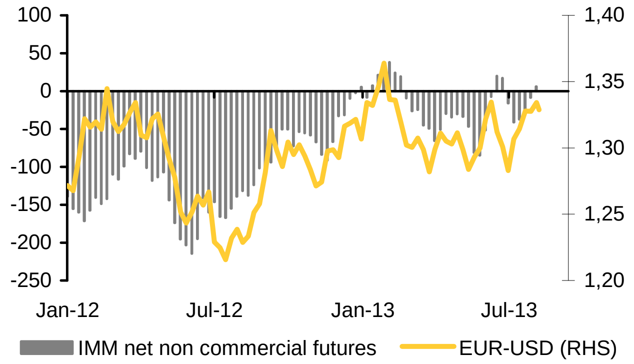
So far this year attempting to short EUR-USD has been an exercise in futility and frustration. Despite clearly divergent monetary policies and divergent growth trajectories, the EUR has been remarkably well supported. However coming into September and the autumn period there is reason to believe that the USD will begin to meaningfully appreciate. For a start the 'will they / won't they' tapering discussion should become more clear, such that rate spreads move meaningfully in favour of the USD.

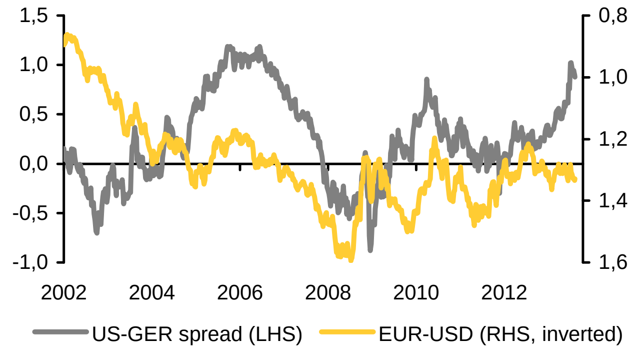
Within the euro zone the ECB's explicit move towards a forward guidance framework places the EUR on the back foot whilst event risk in the form of the German election and potential official sector involvement in sovereign restructurings should serve to increase volatility to the detriment of the single currency. IMM positioning is notable in that there is now a small net long EUR position, which over the course of this year has served as a remarkable contra indicator for subsequent moves in EUR-USD. All told the reasons for a down move in EUR-USD are gaining momentum; it's just a question of patience at this point. We recommend investors to establish short EUR-USD positions around current levels with a view to taking profit towards the mid 1.20's. We maintain a stop at 1.3570.

CHART 10: **Contra indication from positioning?**
EUR-USD spot, IMM net non commercial futures



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **Atlantic trade yet to gain traction**
EUR-USD spot, US-GER 10y spread in bp



Sources: Commerzbank Research, Bloomberg LP

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%	-0.18%	0.92%	Open
26.02.2013	Sell AUDc-USDp 1.06 Buy AUDp-USDc 1.00	22.08.2013	2m x 1m	0.28%	6.50%	6.22%	Open
12.03.2013	Sell CAD-MXN risk reversal 13.00 / 11.90	12.09.2013	2m x 1m	0.28%	0.03%	-0.25%	Open
28.05.2013	Buy USD-CHF risk reversal 0.94 / 1.00	28.08.2013	1m x 1m	0.23%	-1.26%	-1.49%	Open
19.05.2013	EUR-GBP put spread 0.84 / 0.81	19.08.2013	1m x 1m	0.98%	0.01%	-0.97%	Open
08.07.2013	Sell GBP-USD risk reversal 1.51 / 1.46	08.10.2013	1m x 1m	0.01%	-3.20%	-3.21%	Open

Sources: Bloomberg L.P., Commerzbank Research

Technical Analysis

EUR-TRY looks toppish below the 2011-13 resistance line at 2.5857

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EUR-TRY's advance has struggled in the 2.5800 region over the past couple of months or so.

The loss of upside momentum over the past few weeks, coupled with the negative divergence which has accompanied the July high at 2.5859, leads us to believe that EUR-TRY is to soon fall through its four month support line at 2.5518 and should then head back to the 2.5000 zone.

We would thus tighten our trailing take profit stops to just below the 2.5467 late July low and think about initiating outright shorts in the 2.5650/2.5800 region with a stop loss being placed above the 2.5961 2011 peak and the psychological 2.6000 level.

Potential downside targets are the 2.4769 July low, the 2.4654 mid-June low and also the 2013 support line at 2.4051. The latter may well be reached before year end.

CHART 12: **EUR-TRY Daily Chart**
Slowdown in recent upside momentum and negative divergence both point to a reversal lower

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
13 August	13:30	USA	Import Prices	mom	JUL	0,8	-0,2
				yoy	JUL	1,5	0,2
	13:30	USA	Retail sales	mom	JUL	0,3	0,4
			less vehicles	mom	JUL	0,4	0,0
14 August	08:00	HUF	Industrial production	mom	JUN F	-	1,2
				yoy	JUN F	-	1,7
	08:00	CZK	GDP	yoy	2Q P	-1,4	-2,2
	08:00	HUF	GDP	yoy	2Q P	0,6	-0,9
	08:00	RON	GDP	yoy	2Q A	1,4	2,2
	08:15	CHF	Producer and import prices	mom	JUL	0,2	0,1
				yoy	JUL	0,5	0,2
	08:30	SEK	Industrial production	mom	JUN	1,0	-2,6
				yoy	JUN	-6,4	-7,3
	09:00	PLN	GDP	yoy	2Q P	0,7	0,5
	09:30	GBP	Unemployment rate	%	JUN	7,8	7,8
	10:00	CHF	ZEW business expectations		AUG	-	4,8
	10:00	EUR	GDP	qoq	2Q A	0,2	-0,3
				yoy	2Q A	-0,8	-1,1
	12:00	USA	MBA Mortgage Applications	%	AUG 9	-	0,20
	13:00	PLN	Consumer prices	mom	JUL	-0,2	0,0
				yoy	JUL	0,5	0,2
	13:00	RUB	CPI weekly year to date	%	AUG 12	-	4,5
	13:30	USA	Producer price index	mom	JUL	0,3	0,8
				yoy	JUL	2,4	2,5
			core rate	mom	JUL	0,2	0,2
				yoy	JUL	1,3	1,7
15 August	08:00	TRY	Current account balance	USD bn	JUN	-5,1	-7,5
	08:00	CZK	Producer price index	mom	JUL	0,1	0,1
				yoy	JUL	1,0	0,7
	09:30	GBP	Retail sales	mom	JUL	0,7	0,2
				yoy	JUL	2,4	2,2
	12:00	RUB	FX and gold reserves	USD bn	AUG 9	-	507,9
		USA	Initial jobless claims	K	AUG 10	335	333
	13:30	USA	Empire State Index		AUG	10,00	9,46
	13:30	USA	Consumer prices	mom	JUL	0,2	0,5
				yoy	JUL	2,0	1,8
			core rate	mom	JUL	0,2	0,2
				yoy	JUL	1,7	1,6
	14:00	USA	Tic data	USD bn	JUN	-17,5	-27,2
	14:15	USA	Industrial production	mom	JUL	0,3	0,3
	14:15	USA	Capacity utilization	%	JUL	77,9	77,8
	15:00	USA	Philadelphia Fed Index		AUG	15,0	19,8
	15:00	USA	NAHB Housing Market Index		AUG	57	57
16 August	10:00	EUR	Consumer prices	mom	JUL	-0,5	-0,5
				yoy	JUL F	1,6	1,6
			core rate	yoy	JUL F	1,1	1,1
	13:00	PLN	Core rate	mom	JUL	0,1	0,0
				yoy	JUL	0,9	0,9
	13:30	USA	Housing Starts	K	JUL	902	836
			Housing Permits	K	JUL	945	918
	14:55	USA	Michigan consumer confidence		AUG P	85,3	85,1
19 August	00:01	GBP	Rightmove House Prices	mom	AUG	-	0,3
				yoy	AUG	-	4,8
	06:00	JPY	Leading Index CI		JUN F	-	107,0
			Coincident Index CI		JUN F	-	105,2

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