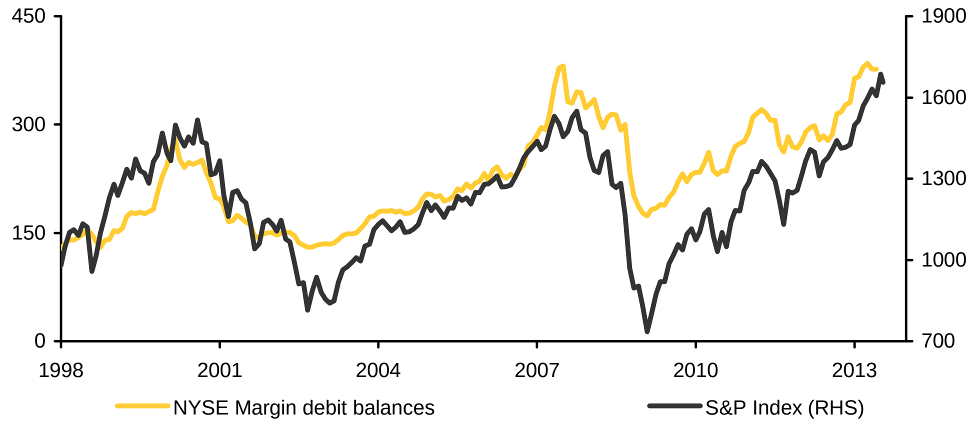
FX Alpha

20 August 2013

Sell Cross – JPY. ASAP.

Sell Cross – JPY. ASAP. US yield developments are a bad omen for risky currencies. Positioning is still massively short JPY and will be subject to the mother of short squeezes.

CHART 1: **Margin traders running out of road…**
&P index, NYSE Margin debit balances in USD million



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. ECB´s forward guidance doesn't fully convince FX markets. Friday's UK Q2 GDP release key data. Markets slowly have to wave goodbye to the idea of further RBA rate cuts.

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

EM Highlights. PLN remains supported by rate hike speculation. CPI release in South Africa should weigh on ZAR. GDP release in Mexico might take a back seat.

Tactical trade recommendations. Establish short AUD-JPY positions.

Technical Analysis. USD-BRL trades in 4 ½ year highs at 2.4166 and targets the 2.5500 region.

Event calendar. Over the coming days, the data calendar is very light and doesn't provide major ideas.

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Sell Cross - JPY. ASAP.

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US yield developments are a bad omen for risky currencies. Positioning is still massively short JPY and will be subject to the mother of short squeezes.

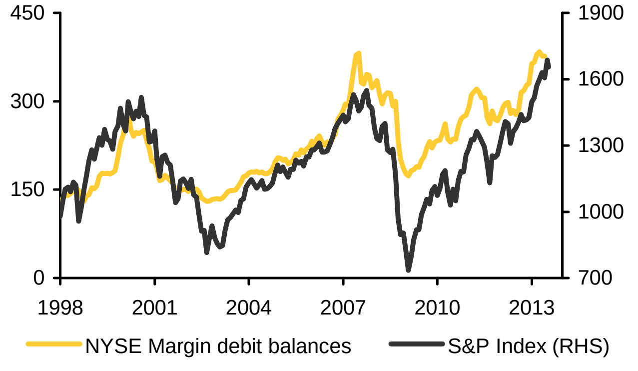
Coming into September it is instructive to look at currency performance to see what dynamics are dominating within the G10 and EM space. Rather than simply following rate spreads, G10 currencies exhibit distinct signals of risk aversion. USD-JPY in particular fails to break higher despite the surge in US yields, gold enjoys an Indian summer and the USD is neither here nor there. Risky currencies, in particular EM currencies such as BRL and MXN continue to lose ground, despite the fact that the USD has not as yet staged its long awaited rally. Should the Fed decide to taper QE3 from September onwards this will arguably make a bad situation worse within the FX space.

US rates have already begun to price in Fed moves on the taper front, such that shorter dated yields remain well anchored in line with the Fed's forward guidance policy, whilst the longer end of the yield curve has seen considerable moves, with US 30 year yields trading significantly higher over the last few weeks. These developments are likely to be a burden for risk assets in general meaning that safe haven currencies will likely benefit. Given that downside in EUR-CHF is capped this means that JPY should stand to benefit. More to the point, market participants are still resolutely short JPY meaning that should a down move in USD-JPY come to pass, investors will have to cover their shorts leading to an even more aggressive move.

To give an idea of how one sided the market currently is, look at chart 2 which illustrates margin account balances at the NYSE. As can be seen, the use of leverage is as pronounced as it was prior to the financial crisis of 2008. Should US rates continue to trend higher it stands to reason that equities will lose ground from their current lofty heights, resulting in steep losses for the speculative community. On previous instances this has been a burden for risky currencies and a boon for safe havens. The question is whether in this instance risk aversion will follow established patterns and what role, if any, the USD will play?

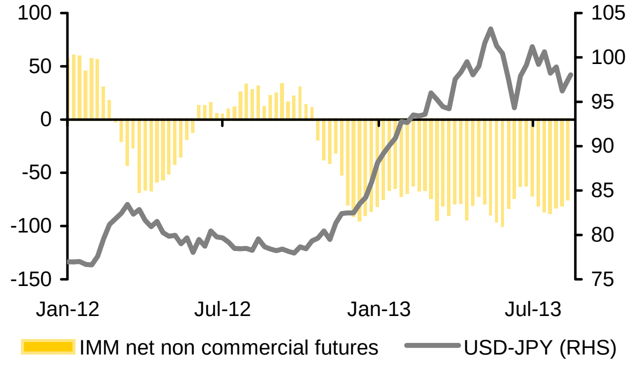
There are two possibilities. The first is that the USD strengthens significantly, in line with a more restrictive Fed policy. The other is that we see safe havens outperform with the USD neither strengthening nor weakening. Given that the moves in short term rates remain somewhat muted, an aggressive strengthening of the USD seems unlikely, leaving the broader trend of risk aversion to dominate within the FX markets. Investors should therefore position for downside in cross JPY, with crosses such as AUD-JPY potentially offering the most scope for underperformance in the coming weeks.

CHART 2: **Margin traders running out of road…**
S&P index, NYSE Margin debit balances in USD million



Sources: Commerzbank Research, Bloomber LP

CHART 3: **Large JPY short still evident**
USD-JPY spot, IMM net non commercial futures



Sources: Commerzbank Research, Bloomberg LP

G10 Highlights

ECB´s forward guidance doesn't fully convince FX markets. Friday's UK Q2 GDP release key data. Markets slowly have to wave goodbye to the idea of further RBA rate cuts.

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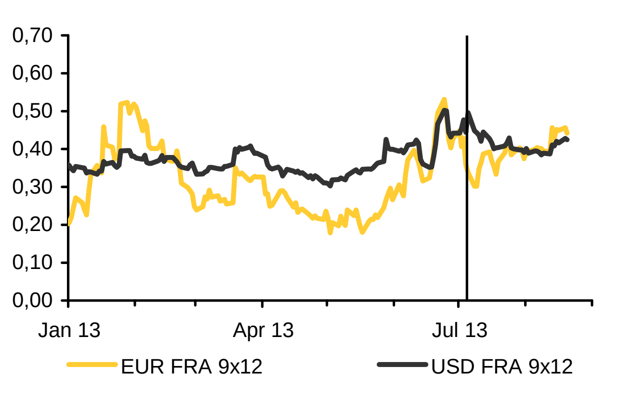
EUR: ECB´s forward guidance still does not fully convince the FX market. On the contrary, after the German Bundesbank mentioned the possibility of future rate hikes in its monthly bulletin EUR-USD gained some ground. Many market participants are unhappy with the rarely concrete communication of the ECB. The Fed´s forward guidance is still considered to be more aggressive, blurring the opposite directions the central banks are in fact adopting. This is what keeps the euro well supported. As long as the euro zone macro data are surprising on the upside this is unlikely to change.

GBP: The key highlight for the pound this week will be Friday's Q2 GDP release. Expectations are for a print around 0.6% qoq, +1.4% yoy. The data should confirm the underlying improvement in the UK economy that has been indicated by PMI and sentiment data over the last number of months. Coming into the release the pound has been trading more robustly, with EUR-GBP moving from 0.87 towards 0.85 whilst GBP-USD continues to trade above 1.56 (though this has more to do with USD weakness). Sonia – OIS swaps indicate that markets now discount any probability of an increase in the asset purchase programme and as such the pound is trading on a more solid footing. The key level in GBP-USD to watch is the 200 week moving average located around 1.5753, we would recommend entering shorts around these levels as we feel the sterling move will look somewhat overdone at that point.

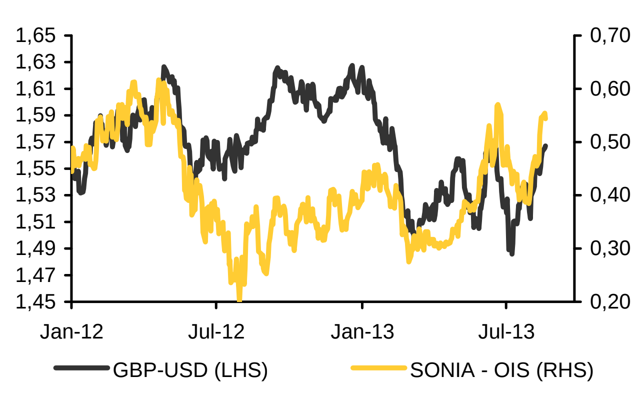
AUD: The minutes of the RBA meeting of 6 August (at which the bank cut its key rate by 25 bp to 2.50%) confirm our view that rates should have troughed now. The rate step at the beginning of August was based on weaker domestic data than expected in May and on the downward revisions of the RBA's growth and investment forecasts. The RBA expects below trend output growth over the coming year or so and declining resources investment over the next several years. The RBA explicitly stated in its minutes that it would neither close off the possibility of reducing rates further, nor signal an imminent intention to reduce rates further. While the bank sticks to its easing bias, future rate cuts will depend on incoming economic data. Moreover, the course of the AUD is important, as a further depreciation of the currency would assist in rebalancing growth in the economy (i.e. in encouraging stronger growth in other sectors than mining). We conclude that, as long as the economic data do not deteriorate further or the AUD experiences a sudden appreciation, the RBA will remain on hold and the cash rate will not be reduced to below 2.50%. The AUD's upward potential should therefore be limited – after all, the RBA can cut its cash rate again or intervene if the currency appreciates sharply and quickly. On the other hand, downward pressure on the AUD will decline as rate cut speculation abates. We remain comfortable with our forecast of a moderate AUD depreciation versus the USD during the remainder of the year. In the short term, support for AUD-USD lies at 0.9030 and 0.8970.

CHART 4: **"Forward Guidance" has gone up in smoke**
Spread of 9*12-FRA rates EUR vs. USD, %-age points; EUR-USD spot; vertical mark: ECB's announcement of "forward guidance"



Source: Commerzbank Research, Bloomberg LP

CHART 5: **GBP benefits as asset purchases priced out**
GBP-USD spot, SONIA-OIS in %



Source: Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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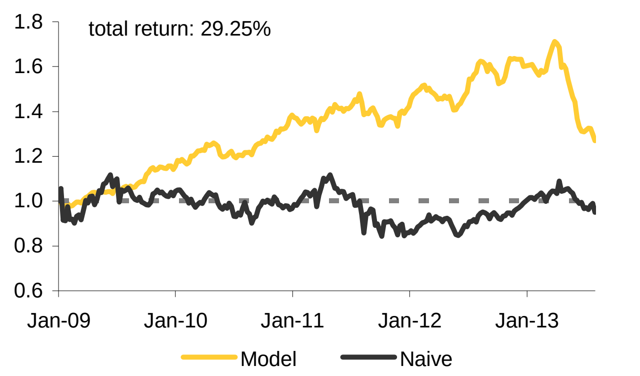
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

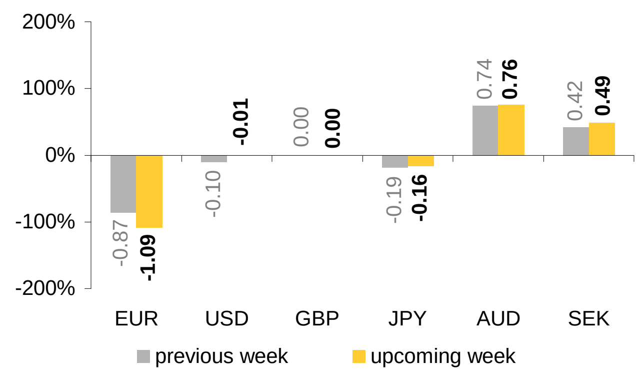
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 20 Aug to 27 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

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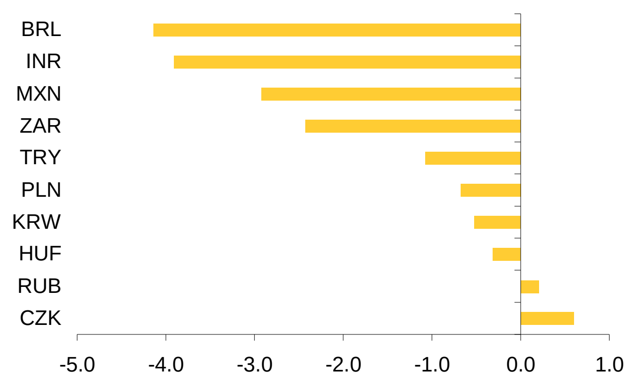
PLN remains supported by rate hike speculation. CPI release in South Africa should weigh on ZAR. GDP release in Mexico might take a back seat.

PLN: The minutes from the July MPC meeting are unlikely to bring much news for the PLN. As the economic data since the meeting has continously surprised on the upside, there should be no doubt left that the easing cycle of the Polish central bank is over. After the unexpected jump in inflation (from 0.2% to 1.1%) the market has even been bringing rate hike expectations forward. Should the data continue to surprise positively rate hike speculation are likely to be fuelled further providing support to the PLN. This should also serve as a good protection against resurging QE tapering speculation. Against this background the upside in EUR-PLN should remain capped in the 4.30 region. The downside provides room for a correction down to 4.15 by year end.

ZAR: USD-ZAR continues to trade in line with developments in US treasury yields, with ZAR following US yields tick for tick. The coming week offers some scope for idiosyncratic weakening of ZAR however when CPI figures are released on Wednesday. Expectations are for a print of +6.2% yoy (+0.9% mom). There is the possibility of an even higher print due to the pass through from the exchange rate depreciation earlier in the year. SARB estimate the pass through to have a coefficient of 0.2 which highlights once more the policy straightjacket that SARB find themselves in; unable to increase rates due to high unemployment, unable to cut rates due to persistently sticky inflation. The bottom line is that there is little to be gained from establishing long ZAR positions, especially ahead of any tapering of QE3 in September.

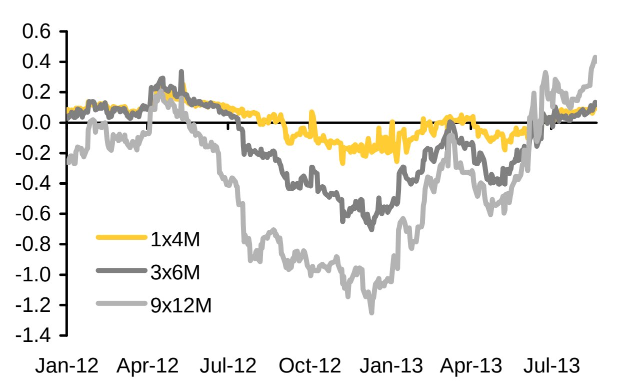
MXN: Amid rising fears that the US Fed might begin to taper already in September MXN came under significant pressure in the last couple of days, with USD-MXN rising to above 13.00. The move started already last week when market participants were disappointed about the energy reform proposal by the Mexican government. Obvisiously there were hopes that the reform proposal would contain more significant steps to open the energy sector to private investors. Ahead of tomorrow's release of the FOMC minutes nervous markets lead to a continuation of the upwards move in USD-MXN. Since external factors currently dominate today's release of Mexico's Q2 GDP might take a back seat. We expect a release of 2.4% yoy and 0.4% qoq which is slightly above consensus. After weak growth in the first half of the year we expect the economy to pick up in the second half of the year which should be supportive for MXN. However, currently the uncertainty surrounding the timing of tapering in the US is the main topic in the market and will therefore be the dominant driver for USD-MXN in the coming weeks.

CHART 8: **Sharp sell off in EM currencies**
% Gain / Loss Vs. USD since 13th August 2013



Source: Bloomberg, Commerzbank Research

CHART 9: **Poland: rate hikes rather sooner than later?**
Difference 3M Wibor and FRAs with different maturities, in %



Source: Bloomberg

Tactical trade recommendation

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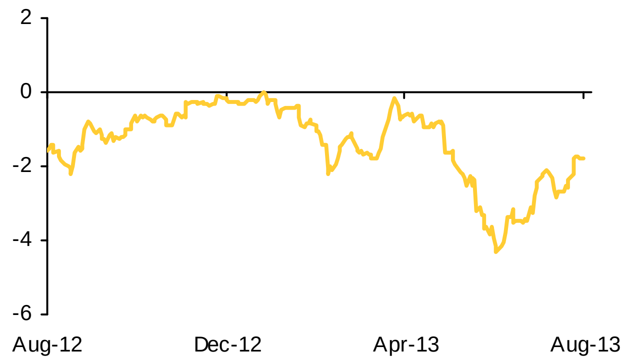
Establish short AUD-JPY positions.

As described above we think there is potential for underperformance of risk assets within the FX space in the coming weeks. Attempting to forecast how the USD will fare in the event of Fed tapering is a difficult task given the dichotomy between risk aversion and whether this will prove to be a boon or a burden for the USD. That being the case a cleaner way of benefitting from this dynamic is through short AUD-JPY positions.

Year to date AUD has underperformed largely for idiosyncratic reasons and should risk aversion be accompanied by an increase in volatility, which is entirely plausible, then it stands to reason that AUD will underperform once more. At the same time JPY suffers from extremely lopsided positioning and will doubtless rally in line with any increase in risk aversion, even moreso given that downside in EUR-CHF is capped by the floor at 1.20.

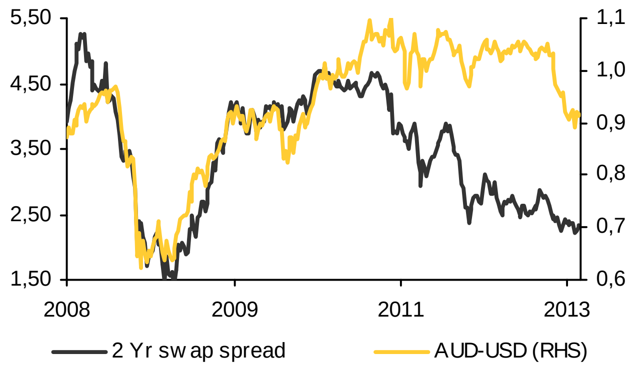
We recommend investors to purchase short dated 1 month AUD put JPY calls at a strike of 87.00 for 0.6% of notional. The position should benefit from the move in spot and consequent increase in volatility which we assume will accompany any return of risk aversion.

CHART 10: **AUD-JPY riskies at a good selling level**
AUD-JPY 25D 1 Month risk reversal in % vol



Source: Commerzbank Research, Bloomberg LP

CHART 11: **Swaps still show further downside for AUD**
AUD-USD spot, 2 Yr swap spread in %



Source: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%	-0.20%	0.90%	Open
26.02.2013	Sell AUDc-USDp 1.06 Buy AUDp-USDc 1.00	22.08.2013	2m x 1m	0.28%	6.40%	6.12%	Open
12.03.2013	Sell CAD-MXN risk reversal 13.00 / 11.90	12.09.2013	2m x 1m	0.28%	-0.23%	-0.51%	Open
28.05.2013	Buy USD-CHF risk reversal 0.94 / 1.00	28.08.2013	1m x 1m	0.23%	-1.30%	-1.53%	Open
08.07.2013	Sell GBP-USD risk reversal 1.51 / 1.46	08.10.2013	1m x 1m	0.01%	-4.40%	-3.39%	Open
20.08.2013	Buy AUDp-JPYc 87.00	20.09.2013	1m	0.43%	0.40%	-0.03%	Open

Sources: Bloomberg L.P., Commerzbank Research

Technical Analysis

USD-BRL trades in 4 ½ year highs at 2.4166 and targets the 2.5500 region

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Over the past few months the US dollar has greatly outstripped the Brazilian real with the greenback having gained some 23% from its March low at 1.9418.

This week USD-BRL made a four and a half year high at 2.4166 and is fast approaching the 2009 peak at 2.4554 and also the 38.2% Fibonacci retracement of the 2002-11 descent at 2.4736.

Further up lies the psychological 2.5000 region which is likely to act as resistance.

Another potential upside target is the 100% Fibonacci extension of the 2011-12 rise, projected higher from the 1.9433 March 2013 low, at 2.5564.

We will retain our medium term bullish view while the currency pair remains above the 2.2637 current August low.

Good support can be seen around the late 2001 and the 2002 lows at 2.2560/40.

CHART 12: **USD-BRL Monthly Chart**
Is surging higher towards the 2.4554 2009 peak and the 38.2% Fibonacci retracement at 2.4736

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
21 August	09:00	ZAR	Consumer prices	mom	JUL	0,9	0,3
				yoy	JUL	6,2	5,5
	12:00	USA	MBA Mortgage Applications	%	AUG 16	-	-4,70
	13:00	RUB	CPI weekly year to date	%	AUG 19	-	4,5
	15:00	USA	Existing Home Sales	mn	JUL	5,15	5,08
				mom	JUL	1,4	-1,2
22 August	08:30	GER	PMI (Markit)		AUG A	51,1	50,7
	08:30	GER	PMI Services (Markit)		AUG A	51,7	51,3
	08:30	SEK	Unemployment rate		JUL	7,6	9,1
	09:00	EUR	PMI (Markit)		AUG A	50,7	50,3
	09:00	EUR	PMI Services (Markit)		AUG A	50,2	49,8
	12:00	RUB	FX and gold reserves	USD bn	AUG 16	-	507,8
		USA	Initial jobless claims	K	AUG 17	330	320
	14:00	USA	OFHEO House Price Index	yoy	JUN	0,6	0,7
	15:00	USA	Leading indicator CB		JUL	0,5	0,0
23 August	09:30	GBP	GDP	qoq	2Q P	0,6	0,6
				yoy	2Q P	1,4	1,4
	13:30	CAD	Consumer prices	mom	JUL	0,2	0,0
				yoy	JUL	1,4	1,2
				mom	JUL	-2,0	8,3
	15:00	USA	New home sales	K	JUL	487	497
	15:00	EUR	Consumer confidence		AUG A	-16,5	-17,4
26 August	08:00	CZK	Composite confidence indicator		AUG	-	-3,4

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