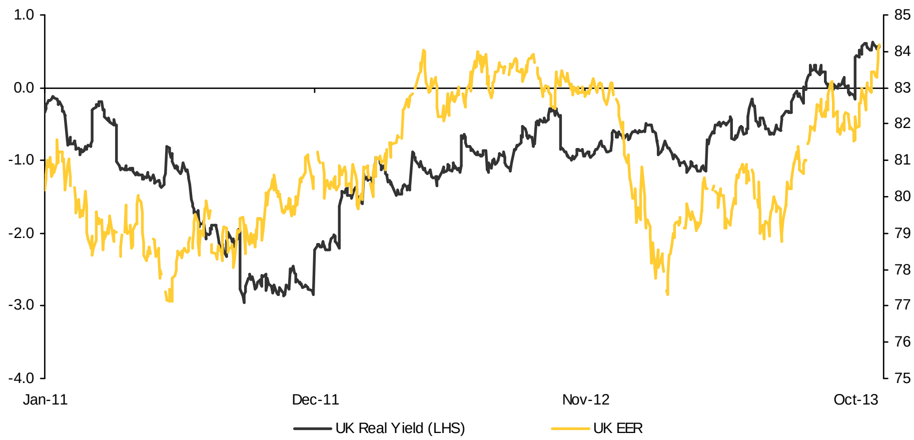
FX Alpha

3 December 2013

GBP: It's a buy it up situation

GBP: It's a buy it up situation. Improvements in UK economic data, improving sentiment and still light positioning mean that sterling's rally is nowhere near done yet.

CHART 1: **Improving UK real yields lead the charge higher**
UK EER, UK Real Yields in %



Source: Commerzbank Research, Bloomberg LP, BoE

G10 Highlights. Busy week in terms of data releases for EUR-USD. 2 Main event risks for GBP. RBA rate meeting a non event.

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

EM Highlights. Unspectacular NBP meeting. Czech GDP upward revision? GDP and minutes should weigh on BRL. UAH devaluation risk rising

FX Portfolio Recommendation. We provide a series of thematic and tactical trade suggestions across G10 and EM.

Technical Analysis. EUR vulnerable Vs. GBP and USD.

Event calendar. The coming week is notable for central bank meetings in the UK and the euro zone on Thursday, whilst attention will shift to the US on Friday for the NFP print.

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GBP: It's a buy it up situation

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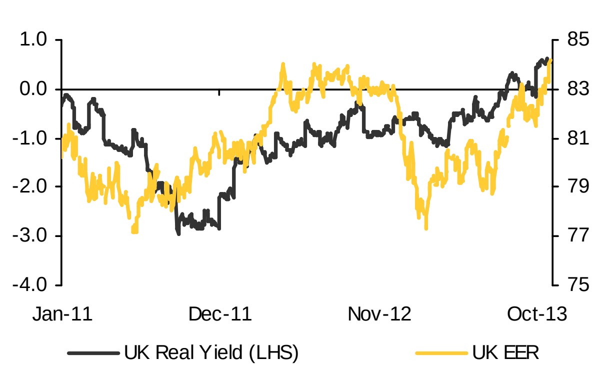
Improvements in UK economic data, improving sentiment and still light positioning mean that sterling's rally is nowhere near done yet.

It seems that GBP is enjoying something of an Indian summer. Since September the pound has been amongst the best performing currencies in G10 and has defied predictions of a pull-back by a majority of analysts. In our view not only is the pound's strength justified on a fundamental basis but in fact there is more to come. Coming into 2013 the pound lost ground as the combination of low growth and relatively high inflation (at least higher than peer countries) took its toll. In addition to this the amelioration of the euro zone crisis weakened safe haven flows towards the UK, which benefitted GBP over the course of 2011 and 2012. This led to a pronounced sterling sell off with EUR-GBP edging towards highs around 0.88 in February. Our view then was that rallies in this region would not be sustained and this has proven to be the case. On a PPP basis the pound is simply too cheap at those levels.

The question is where will the pound go from here? There are three dynamics that investors have to consider. First, the improvement in UK economic growth is not merely a housing story but is also based upon an increasing share of investment meaning that the recovery will be sustainable. Second, gilt yields which have moved in line with US yield developments may well outperform over the course of 2014 as the market starts to price in the possibility of the BoE removing stimulus earlier than other developed market central banks. Indeed, the BoE's decision to remove FLS funding for the mortgage market is perhaps the first step in proto-tightening by any major central bank. Third, trends in inflation paint a better picture than this time last year, with latest CPI data in November printing at +2.2% yoy. All told, this means that UK real yields will likely continue their move higher which has historically been an indicator of future sterling appreciation (Chart 2).

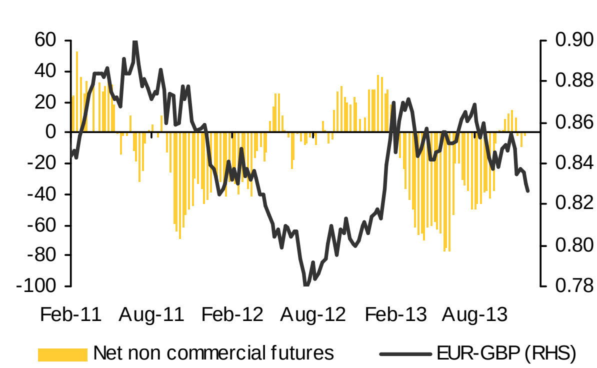
This then moves us to a discussion of whether the pound is overbought at current levels. Positioning data reveal that far from being overbought, there is a very slight short position at present according to CFTC data. Perhaps more interestingly net positioning across G10 is quite low, which illustrates the lack of conviction that speculators hold coming into 2014. The inference from this is that this creates room for unbiased moves in the future. Swaps data also point towards further pronounced downside in EUR-GBP and this is before we consider the possibility of the ECB engaging in a more explicit form of forward guidance or in outright balance sheet expansion via another LTRO programme. The only fly in the ointment from this generally constructive picture lies with developments in the UK's current account, which still shows a deficit of over 4% of GDP. Investors have to keep a keen eye on this in the coming months and quarters as any move towards -4.5% of GDP will be bound to create issues for the pound. For the moment however the pound should continue to benefit from its trend of disinflationary growth.

CHART 2: **Real yields lead the charge higher**
UK Real Yield in %, UK EER



Source: Commerzbank Research, Bloomberg LP, BoE

CHART 3: **No sign of GBP being overbought**
EUR-GBP spot, IMM net non commercial futures



Source:Commerzbank Research, CFTC. Bloomberg LP

G10 Highlights

Busy week in terms of data releases for EUR-USD. 2 Main risk events for GBP. RBA rate meeting a non event.

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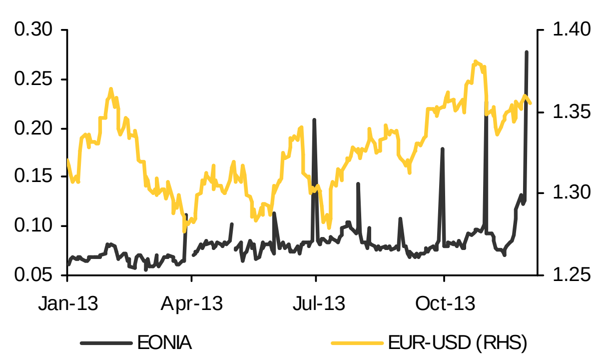
EUR-USD: The coming week is literally packed with potentially market moving data and event risk. On the EUR side of the equation the key highlight will be the ECB's meeting on Thursday. Of particular interest will be whether the ECB give any further clues regarding the imposition of negative deposit rates or whether another LTRO programme will be considered. Various ECB speakers have attempted over recent weeks to talk the EUR down by hinting at the possibility of negative deposit rates although remarkably this has had little impact upon EUR-USD levels (Although this has more to do with up moves in EONIA rates). In fact, EUR-USD now trades above levels that preceded the last rate cut! On the USD side of the equation the release of NFP data on Friday will be closely watched for signs of any improvement, whilst earlier in the week Q3 GDP data will be in focus. Market positioning shows a very small net long EUR position, so the risk is to the downside if US data prints on the upside of expectations.

GBP: The two main events for the pound over the coming week lie with the Chancellor's Autumn statement and the BoE's rate meeting. The Autumn statement is not likely to offer anything in the way of policy innovations, rather just political grandstanding. The MPC on the other hand have the potential to surprise markets and investors should concentrate on the statement accompanying the rate decision for any signs of commentary regarding the UK housing market. The pound continues to trade robustly this week and in the absence of a large increase in long GBP positioning we find it hard to see why the pound should weaken significantly in the coming weeks.

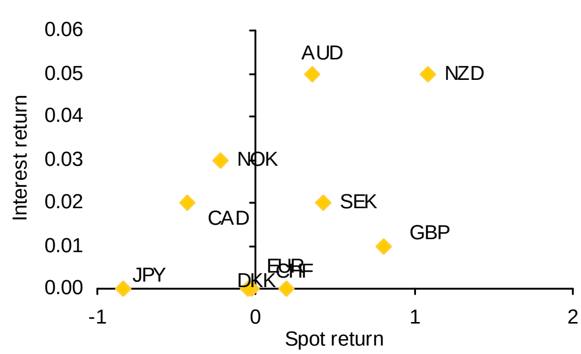
AUD: As we had expected the RBA rate meeting was one of the most unspectacular this year. The RBA is in a position to enjoy the Australian summer and to wait for further data on economic developments and above all on inflation since the next rate meeting will not be held until February. In view of the positive leading indicators and the relatively good Chinese data the RBA was under no pressure to take any action. This is reflected in the statement: the key rate remains at 2.50% and the wording is unchanged compared with November. According to the central bank the AUD remains "uncomfortably high" and a lower level of the exchange rate is likely to be needed to achieve balanced growth in the economy. As rates have bottomed the RBA has little choice but to rely on a weaker AUD to support the economy – besides low interest rates. That means that more or less strong verbal interventions depending on the strength of the AUD will remain on the agenda in the future. Therefore markets remain sceptical about the AUD. Even though it is getting more difficult to justify an even weaker AUD considering the rather optimistic economic outlook markets will likely want to test the 0.90 mark in AUD-USD – in particular if the GDP data for Q3 should disappoint tomorrow.

CHART 4: **EONIA causing jumps in EUR-USD**
EUR-USD spot, EONIA



Source: Commerzbank Research, Bloomberg LP

CHART 5: **NZD and GBP lead the way**
% Gain / Loss Vs. USD since 27th November 2013



Source:Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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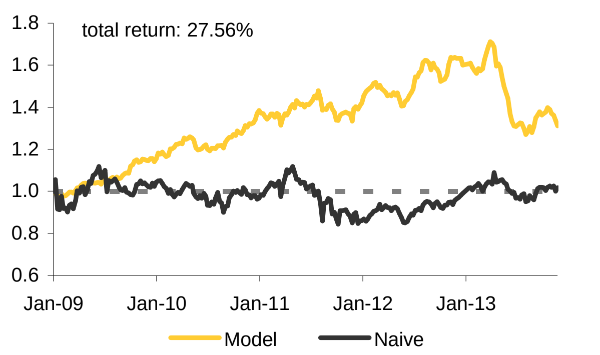
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

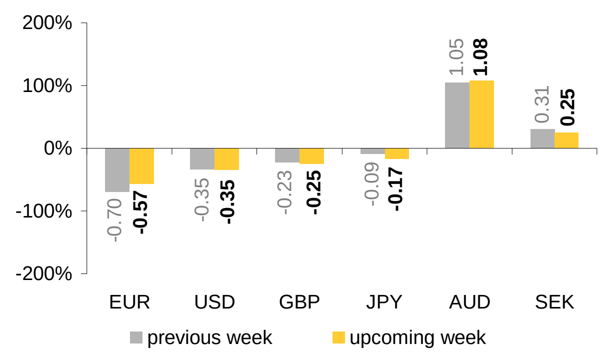
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 3 Dec to 10 Dec**
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

Unspectacular NBP meeting. Czech GDP upward revision? GDP and minutes should weigh on BRL. UAH devaluation risk rising.

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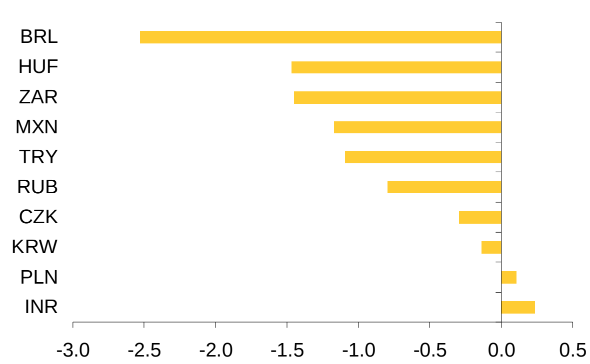
PLN: The Polish central bank is expected to end the year on a quite boring note. Again, the NBP will keep key rates unchanged on Wednesday and repeat its pledge to keep rates unchanged at least until the middle of next year. Recent comments by MPC members have pointed to an even more cautious stance of possibly extending stable rates into Q3 next year. However, seeing that the economy is showing strong signs of an economic recovery, the NBP is unlikely to see the acute need of changing its forward guidance yet again. The main driver for EUR-PLN this week will thus be the ECB meeting.

CZK: Tomorrow, the details of Q3 GDP growth will be released. As the figure had surprised massively on the downside with an unexpected decline of -0.5% qoq, it will be interesting to learn what the decisive factor behind the slump was. As external demand has remained robust, it will boil down to the development of domestic consumption and investment. We see a chance that the figure will be revised upward, which would calm fears that the Czech Republic is at the brink of falling back into recession. This could push EUR-CZK back toward the 27.40 region.

BRL: The Brazilian data calendar is very full this week. Today GDP data for the third quarter disappointed with a contraction by 0.5% qoq against expectation of a 0.3% decline confirming that the positive surprise in the second quarter was a one-off and that the economy gives cause for concern. The next major event is the release of the minutes on Thursday. As expected the central bank raised the key rate by a further 50bps last Wednesday, but the statement was altered slightly so that there has been speculation on the market whether the central bank will take a break. The minutes might provide additional references. November inflation data is due for publication on Friday. It is unlikely to signal any relief. Altogether the data publications are likely to create pressure for the real. The budget data published last Friday had already disappointed, fuelling further concerns about a rating downgrade. A weak economy combined with high inflation puts additional pressure on the currency. However, the US data calendar is also very full this week so that local events might be pushed into the background once again with moves in USD-BRL possibly being predominantly driven by the USD.

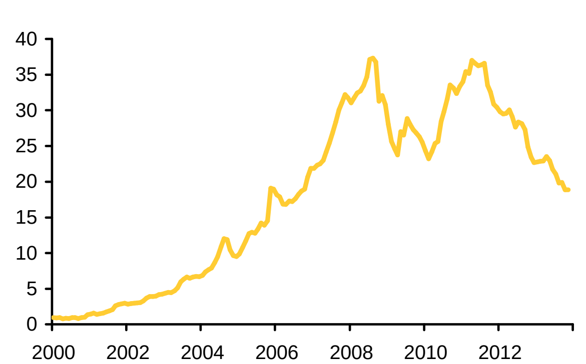
UAH: The political as well as the economic situation in Ukraine is deteriorating. The local currency cannot escape that either. Since the beginning of the month USD-UAH has been approaching the 2012 high at 8.25. Even though central bank governor Ihor Sorkin pointed out yesterday that if necessary the Ukrainian central bank (NBU) would be able to strengthen "its presence" on the market, in view of the NBU's rapidly decreasing FX reserves that is anything but a credible warning. The coming days and weeks will become a nail-biter for UAH and we advise hedging for a strong depreciation of the currency.

CHART 8: **Next wave of EM weakness?**
% Gain / Loss Vs. USD since 26th November 2013



Sources: Bloomberg LP, Commerzbank Research

CHART 9: **Ukraine reserves melting away**
USD bn



Source: IMF, Commerzbank Research

FX portfolio recommendation

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Core trading views:

- Short volatility in selected crosses (EUR-GBP, EUR-CHF)
- We retain low delta downside in USD-JPY as a tail hedge
- Short AUD via downside put spread
- Position for mild GBP outperformance

Tactical trading views:

- We initiate a long USD-TRY call, 2.10 strike, 3 week expiry for 0.25% of notional.

Our decision to close the short EUR-USD strangle position last week now looks to have been an inspired choice given the further up move in EUR-USD above 1.36. At the same time the remaining short volatility positions continue to perform reasonably well and we are content to hold them for the moment, albeit that should EUR-GBP continue its descent we may have to hedge the position somewhat. Coming into year end equity sentiment remains incredibly robust and this is a strong argument against a large pickup in volatility.

We took profit on our long GBP-CHF position as it hit our take profit level, although in hindsight this could be premature in that the 200 week moving average at 1.4872 looks set to go. If we see a clear break we will consider reinstating the position.

The downside put spread in AUD-USD performed well also over the course of the week although better than expected capex data led to a slight rally in AUD. Nonetheless we retain the position given that AUD is perhaps the most risk sensitive currency in G10 to tapering concerns; hence we are happy to have the position coming into the New Year. Again, the downside put in USD-JPY was the underperformer over the course of the week but as this is a tail hedge to the portfolio we are not overly concerned.

TAB. 1: **Global FX Strategy Spot Portfolio**

Trade date	Strategy	Size (€ mln)	Entry level	Stop	% Gain / Loss	Take Profit	Open
15.10.2013	Short EUR-PLN	1	4.1850	4.22	**0.25%**	4.1750	T/P
21.10.2013	Long GBP-USD	1	1.6150	1.5960	-1.20%	1.6480	Stopped
29.10.2013	Long EUR-USD	1	1.3780	1.3680	-0.70%	1.3920	Stopped
12.11.2013	Long GBP-CHF	1	1.4620	1.4650	**1.70%**	1.4860	T/P

Source: Commerzbank Research, Bloomberg LP

TAB. 2: **Discretionary Option Trade Recommendations (base currency EUR)**

Trade date	Strategy	Expiry	Size (€ mln)	Premium	Value	P&L	Open / Closed
04.02.2013	Short EURp-CHFc 1.2050	04.12.2013	1	+1.10%	0.0%	1.10%	Open
15.10.2013	Short EUR-GBP strangle 0.81 / 0.87	15.01.2013	1 x 1	+0.47%	-0.25%	0.22%	Open
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1	-0.42%	0.02%	-0.40%	Open
05.11.2013	Long AUD-USD put spread 0.92 / 0.88	04.02.2013	1 x 1	-0.48%	0.98%	0.50%	Open
26.11.2013	Short EURp-CHFc 1.22	25.02.2013	1	+0.60%	-0.18%	0.42%	Open
03.12.2013	Long USD-TRY call 2.10	23.12.2013	1	-0.18%	0.16%	-0.02%	Open

Source: Commerzbank Research, Bloomberg LP

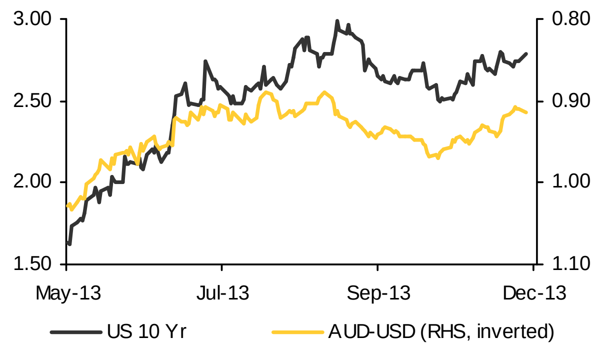
Tactical trading views:

- We took profit on the long GBP-CHF position as it hit our take profit level just below the 200 week moving average (1.4872). The publication of much better than expected UK Manufacturing PMI data led to another round of sterling appreciation. As such we will consider reinstating the long GBP-CHF position should we close above the 200 wma at the end of the week.
- We are adding a 2.10 USD-TRY call to the portfolio with a 3 week tenor. The rationale is that the coming week offers a lot in terms of event risk for the USD with Q3 GDP and NFP data, which if they surprise positively could lead to a large spike in US yields. USD positioning is not excessive and likewise EM currencies continue to trade weakly, which are arguments in favour of a potentially large USD-EM move. The trade offers a compelling risk reward at a cost of only 0.25% of notional. We will look to take profit on the position should the value increase to approx 0.7% of notional.

Portfolio Risk:

- The portfolio is negatively correlated with volatility

CHART 10: **AUD vulnerable to tapering concerns**
AUD-USD spot, US 10 Yr Yield in %



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **G10 vols remain subdued**
G10 3 Month Aggregate Implied Volatility in % vol

Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

EUR vulnerable Vs. GBP and USD

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The EUR remains vulnerable Vs. GBP and USD and is expected to remain weak as we head into the last month of the year. EUR-GBP has sold off further and has now eroded the .8286/50% retracement of the move up from the 2012 low. We acknowledge in the very near term that the market looks over-extended, but while capped by .8400 it will remain directly offered with downside targets of .8160 then .8000. These are the 61.8% retracement of the move up from 2012 and psychological support.

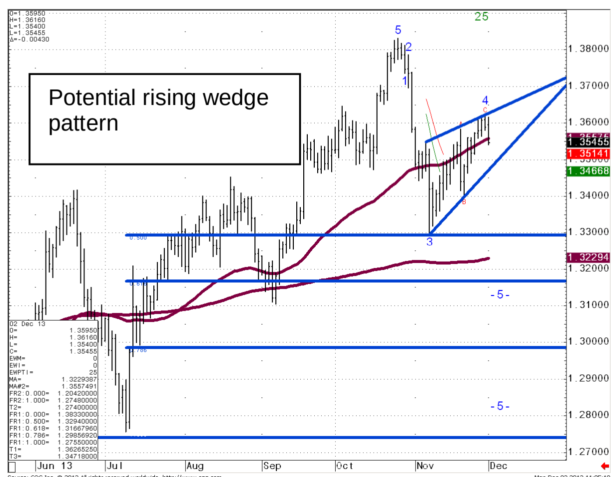
The EUR also looks vulnerable Vs. USD. We believe that the pattern developing on the daily chart is a potential rising wedge pattern. These are negative patterns and we regard the 1.3622 high seen last week as the end of the corrective rally seen during November (end of wave 4 – Elliot wave count). We should now see the market come under pressure and head back to the 1.3295/94 November low and 50% retracement. This should now be eroded for ongoing losses to the 1.2985/1.2933 78.6% retracement of the move up from July.

Slightly longer term, we believe that the EUR has begun its next leg lower, we view the high charted in October at 1.3833 as an intermediate peak and we should head to the low 1.20 region by the end of 2014.

CHART 12: **EUR-GBP weekly**
Heading to base of channel

Source: CQG, Commerzbank Research

CHART 13: **EUR-USD daily**
Potential rising wedge pattern evident



Source: CQG, Commerzbank Research

Event Calendar

Date	Time (GMT)	Region	Release	Unit	Period	Survey	Prior
04 December	10:00	EUR	Retail sales	mom	OCT	00	-01
				yoy	OCT	01	00
	10:00	EUR	GDP	qoq	3Q P	00	00
				yoy	3Q P	00	00
		GBP	HBOS house prices	mom	NOV	01	01
			3 month av.	yoy	NOV	07	07
	-	PLN	Interest rate decision	%	DEC 4	003	003
	12:00	RUB	CPI weekly year to date	%	DEC 2	-	06
	12:00	USA	MBA Mortgage Applications	%	NOV 29	-	000
	13:15	USA	ADP report	K	NOV	170	130
	13:30	USA	Trade balance	USD bn	OCT	-40	-42
	15:00	USA	New home sales	K	OCT	429	421
	15:00	USA	ISM non-manufacturing		NOV	55	55
	15:00	CAD	Interest rate decision	%	DEC 4	001	001
05 December	08:00	RON	Net wages	yoy	OCT	-	05
	09:00	NOK	Interest rate decision	%	DEC 5	002	002
	09:30	ZAR	SACOB business confidence		NOV	-	91
	11:00	RUB	FX and gold reserves	USD bn	NOV 29	-	506
	12:00	GBP	Interest rate decision	%	DEC 5	001	001
	12:45	EUR	ECB Interest rate decision	%	DEC 5	000	000
	13:30	USA	Initial jobless claims	K	NOV 30	325	316
	13:30	USA	GDP annualized	qoq	3Q S	03	03
	15:00	USA	New orders	mom	OCT	-01	02
06 December	05:00	JPY	Leading Index CI		OCT P	110	109
			Coincident Index CI		OCT P	110	108
	08:00	HUF	Industrial production	mom	OCT P	-	02
				yoy	OCT P	05	03
	08:15	CHF	Consumer prices	mom	NOV	00	00
				yoy	NOV	00	00
	09:00	NOK	Industrial production	mom	OCT	-	01
				yoy	OCT	-	-01
	11:00	GER	New orders	mom	OCT	-01	03
				yoy	OCT	04	08
	13:30	USA	Personal income	mom	OCT	00	01
			Personal spending	mom	OCT	00	00
			PCE-deflator	yoy	OCT	01	01
			PCE core rate	mom	OCT	00	00
				yoy	OCT	01	01
	13:30	USA	Nonfarm Payrolls	K	NOV	180	204
			Unemployment rate	%	NOV	07	07
	14:55	USA	Michigan consumer confidence		DEC P	76	75
08 December	23:50	JPY	GDP	qoq	3Q F	02	02
09 December	08:00	CZK	Consumer prices	mom	NOV	00	00
				yoy	NOV	01	01
	08:00	CZK	Industrial production	yoy	OCT	01	07
	08:00	TRY	Industrial production	yoy	OCT	-	06
	08:15	CHF	Retail sales	yoy	OCT	-	01
	09:30	EUR	Sentix		DEC	-	09
	11:00	GER	Industrial production	mom	OCT	-	-01
				yoy	OCT	-	01

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