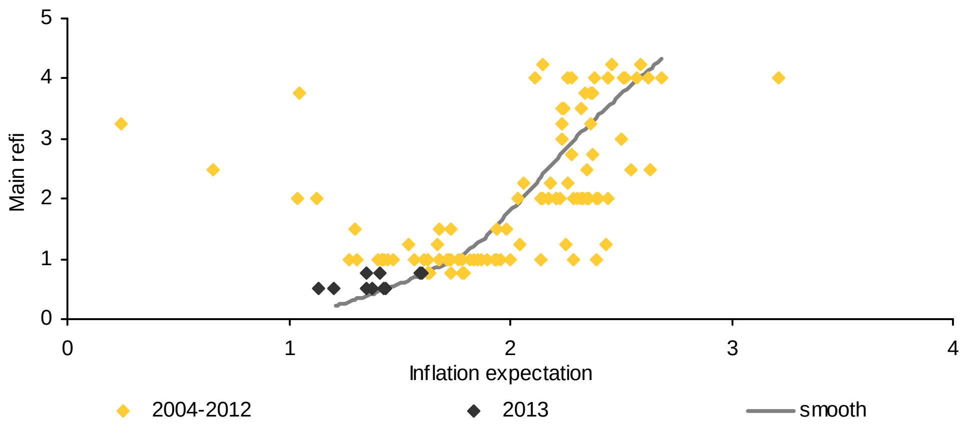
FX Alpha

5 November 2013

Misguided reaction of EUR-USD to low euro zone inflation?

Misguided reaction of EUR-USD to low euro zone inflation? Misguided reaction of EUR-USD to low euro zone inflation? We argue that the euro-positive effect of lower inflation will dominate the negative effect of potential rate cuts in the long run. In that sense low EUR prices are a buying opportunity – regardless of the ECB reaction next Thursday.

CHART 1: **Low inflation causes ECB to become passive**
ECB main refinancing rate and 2 year inflation expectations from inflation swaps in percentage points



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. More action in EUR-USD towards the end of the week with risks tilted to the upside. More downside in EUR-GBP possible. RBA can't do much more than talk down the AUD.

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

EM Highlights. CNB: to intervene or to not intervene? Polish NBP to maintain neutral stance. Brazil: no relief on the inflation front. Banxico's inflation report and meeting minutes of less interest this time.

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

Technical Analysis. EUR-USD – technical evidence is overwhelmingly bearish.

Event calendar. Focus lies on the two big events this week: the ECB meeting and on the US employment report.

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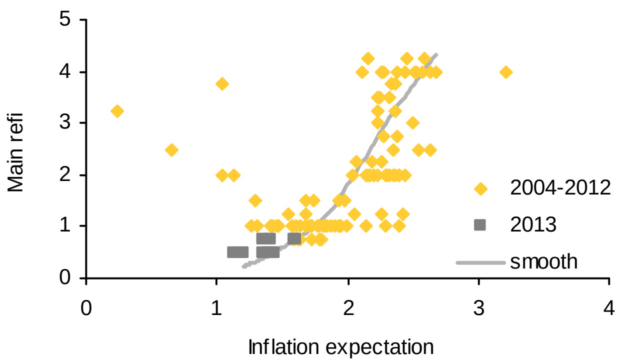
Inflation data for the euro zone clearly surprised to the downside last Thursday. At 0.7% yoy the published inflation data for October came in well below the expected 1.1% and sent the euro on a nose dive, as this immediately led to speculation about an ECB rate cut, possibly as early as Thursday's ECB meeting. However, the FX market's EUR-negative view of an ECB rate cut ignores the EUR-positive effects of low inflation. But is the FX market's view appropriate?

In "normal times" when inflation rates were close to the 2% inflation target the ECB reacted with a disproportionate decrease of the interest rate to deviations in inflation: The answer to a deviation of the inflation rate from the ECB target by *x* percent was a key rate change of more than *x* percent. This kind of monetary policy is referred to as being "active". In case of lower inflation rates on the other hand it is "passive": the key rate eases less than proportionately. This is due to the fact that the hurdle for further rate cuts is getting increasingly high as the scope of interest rate policy with respect to rate cut opportunities and negative deposit rates or a smaller gap between main refi rate and deposit rate has almost been exhausted. Chart 2 illustrates this clear fissure in ECB rate policy.

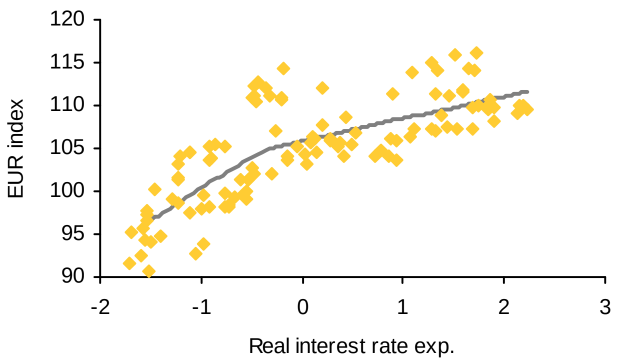
However, medium term the external value of a currency does not depend on inflation nor on nominal rates alone, but mainly on the differential, the real interest rate. The positive correlation between EUR real interest rates and EUR exchange rates is illustrated in chart 3. Particularly in the area of negative real interest rates, real interest rates have a notable effect on the euro. That shows: inflation does matter! But the fact alone that the ECB might lower interest rates or put pressure on long term money market rates with the help of other measures is no reason for a weaker euro. As the ECB is forced to pursue a passive monetary policy it can only compensate for some of the inflation effect. So in the end negative inflation surprises lead to higher real interest rates – which points towards a stronger euro medium term. The possibility of an ECB rates cut should therefore be no reason to become more EUR-pessimistic medium to long term. As a result there is even potential for a recovery of the EUR exchange rate during the course of the week.

CHART 2: **Low inflation causes ECB to become passive**
ECB main refinancing rate and 2 year inflation expectations from inflation swaps in percentage points



Source: Bloomberg, Commerzbank Research

CHART 3: **Real interest rates are decisive for the euro**
2 year real interest rates (in %) and EUR index from our G10 factor model (1999=100)



Source: Bloomberg, Commerzbank Research

G10 Highlights

More action in EUR-USD towrds the end of the week with risks tilted to the upside. More downside in EUR-GBP possible. RBA can't do much more than talk down the AUD.

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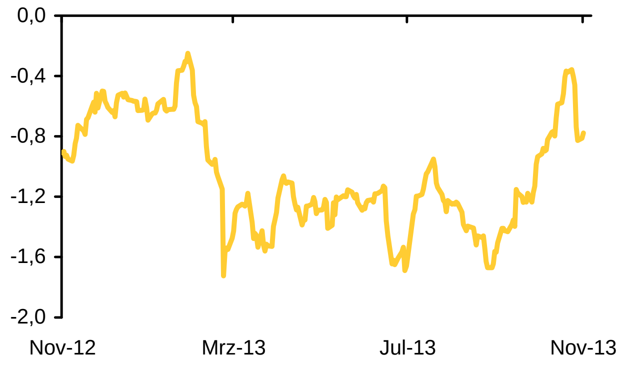
EUR-USD: Until Thursday at least, trading in EUR-USD will be slow and rangy. The major risk events are the ECB meeting on Thursday after the surprise fall in the euro zone inflation rate and the US employment report on Friday. The market will eagerly await any signal from the ECB towards an even more dovish stance or the possibility of a rate cut in the near future. There is room for negative surprises, though, since the market is likely to have priced in a too dovish ECB, which in turn means correction potential for EUR-USD of the recent down move. US non-farm payrolls will show a moderate increase in employment in October but no collapse since the government shutdown is likely to have influenced the numbers only marginally. Nevertheless, an unemployment rate largely above 7% definitely closes the door to a start of QE3 tapering this year. Bottom line: the risks in EUR-USD are tilted to the upside, with the ECB not satisfying market expectations and with the last hopes of an early QE3 tapering being erased.

GBP: The coming week offers much in the way of hard data. So far PMI data have printed robustly for the October survey period with Construction PMI especially surprising to the upside at 59.4, its highest ever recorded level. Next up will be industrial and manufacturing production data on Wednesday before the BoE rate decision on Thursday. EUR-GBP failed to sustain its recent rally above 0.85 with the result that it is now trading back in the middle of its recent range. Swap spreads and risk reversals point towards further downside in EUR-GBP, all the more so after last week's euro zone CPI reading. All told, we see some chances for more downside in EUR-GBP towards 0.8390.

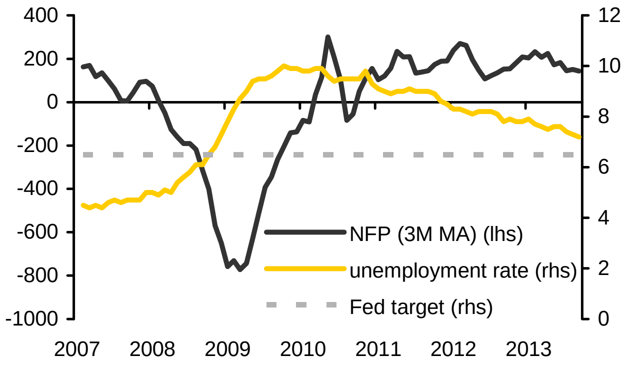
AUD: The RBA's stance remains neutral, but it has to include two small positive aspects into its statement: further ahead private consumption outside the mining sector is likely increase at a faster pace even if the outlook in this surrounded by considerable uncertainty, and the strength of the housing and equity markets should support investment in time. The RBA simply cannot afford to sound too optimistic as otherwise the AUD would rise even further, which it still considers to be "uncomfortably high", something which is new in the RBA's wording. In the end the RBA cannot do more than try to cap the AUD verbally to make the transition from mining to other sectors of the economy easier. The problem with verbal interventions is: once you start them, the currency will rise once you stop them. So we will continue to hear this RBA mantra as it simply hopes to limit the upside in AUD. The AUD would probably have to rise towards parity against the USD to cause the RBA to openly intervene on the FX market, though. We stick to our view that quotations below 0.90 are getting increasingly less likely in AUD-USD unless the USD experiences a comeback due to QE3 tapering.

CHART 4: **Options market prices in ECB rate cut**
EUR-USD 3 month 25D risk reversal in % vol



Source: Commerzbank Research

CHART 5: **US labour market to continue recovery?**
Non farm payrolls (3M moving average) in thousands on left axis, unemployment rate in % on right axis



Source: BLS

FX Metrics

G10 carry trade indices

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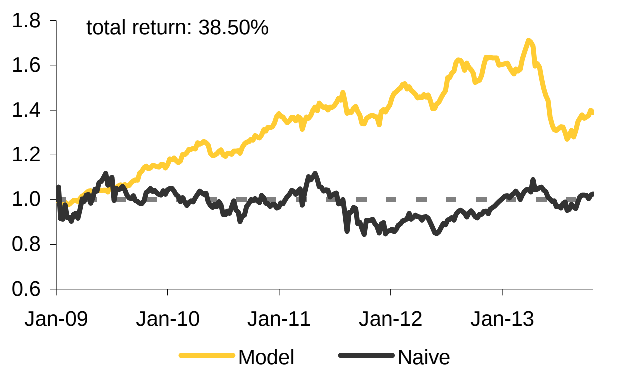
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

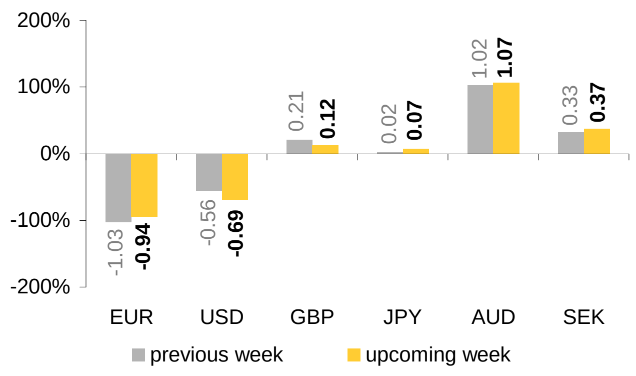
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 5 Nov to 12 Nov**
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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CNB: to intervene or to not intervene? Polish NBP to maintain neutral stance. Brazil: no relief on the inflation front. Banxico's inflation report and meeting minutes of less interest this time.

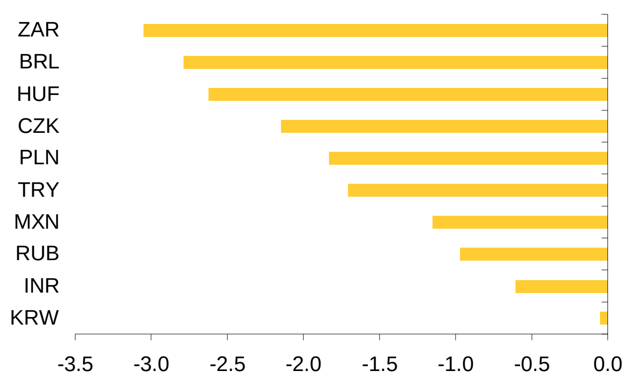
CZK: The CNB's rate meeting on Thursday is likely to get interesting. Since recent inflation figures have again come in softer than expected, the likelihood of FX interventions has increased. However, in our view there are still significant risks in connection with a weakening of the CZK which the hawks within the MPC are going to raise. One being the problem of a future exit from interventions, the other problem being balance sheet risks from the accumulation of FX reserves, both of which the SNB is currently facing. Nonetheless, it cannot be excluded that the ultra-doves will be able to convince one more member to vote in favour of FX interventions as deflation risks have increased. There is therefore a significant risk to the upside in EUR-CZK.

PLN: The Polish central bank is again expected to keep key rates unchanged at its meeting tomorrow. The focus will thus be on the NBP statement and in particular, its forward guidance regarding interest rates. Several MPC members have already indicated that they see interest rates to remain unchanged not only until the end of this year, but through the entire first half of next year. Benign inflation indeed gives the NBP sufficient room to maintain its neutral stance. However, the MPC might want to wait for further evidence that the economy is not picking up faster than it is currently expecting, before it indeed decides to adjust its forward guidance. So there is a great chance that the statement will remain broadly unchanged tomorrow, thus providing no impetus for the PLN.

BRL: Inflation data for October is due this Thursday. The data is unlikely to have much effect on the rate decision this month. A further 50bp rate hike is very likely. The question is whether the BCB has then reached the end of the cycle. Should inflation pressure have increased further the market might bet on more rate hikes next year. The effect on the real is likely to be limited though as tapering in the US has become the main driver in USD-BRL again. That is unlikely to change ahead of the US labour market report. The report will probably not provide much reason for markets to bring expectations for tapering forward. Therefore after the strong upwards move in USD-BRL the lower end in USD-BRL should be the weaker one this week.

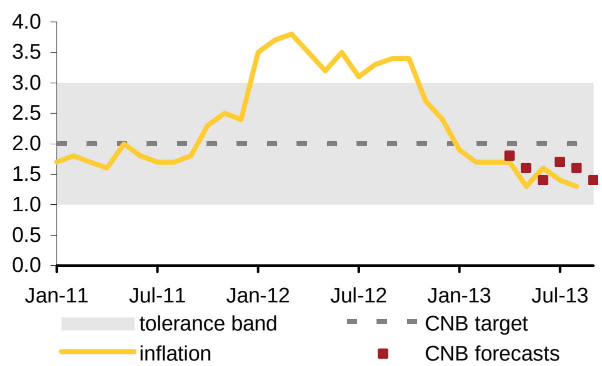
MXN: This time the release of the inflation report (tomorrow) and the meeting minutes (Friday) might be of less interest since the central bank made it quite clear in the accompanying statement after its latest rate decision that no more rate cuts are on the agenda in the foreseeable future. Therefore the focus lies on the US data calendar with the US labour market report and the Q3 GDP release the main events. After the strong recovery of the USD we see some scope for a counter move since the US data should not be able to bring forward expectations for tapering in the US.

CHART 8: **Weaker across the board**
% Gain / Loss Vs. USD since 29th October 2013



Source: Commerzbank Research

CHART 9: **Czech Republic: Deflation risks rising?**
inflation in % yoy



Source:Commerzbank Research

FX portfolio recommendation

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Core trading views:

- Exit long low beta EMFX
- Sell volatility in selective G10 crosses (EUR-CHF, EUR-USD and EUR-GBP)
- We retain low delta downside in USD-JPY as a tail hedge
- Establish short AUD positions

Tactical trading views:

- We initiate fresh short AUD positions

What a difference a day makes! Last week EUR-USD dropped like a stone as euro zone CPI disappointed to the downside at 0.7% yoy, which increased market expectations of an ECB rate cut. At the same time the Fed statement was less dovish than expected leading to broad USD appreciation. We stopped out on both of our short USD positions although losses were muted given the tight stops employed. The question is how to trade this new dynamic?

For starters we are exiting the basket of long low beta EMFX which we have recommended for the past number of weeks. Although this has performed well, the increase in US yields coupled with the very poor performance of higher beta EM currencies makes us more inclined to think that the risk reward of continuing to hold long positions here is rather uncompelling. As such we close the short EUR-PLN, with a small profit.

We continue to hold short strangle positions in EUR-GBP and EUR-USD which both performed very well last week with the move lower in spot. We also maintain the long USD-JPY put at 94.00 as a tail hedge.

We recommend initiating strategic short AUD-USD positions. Monetary tightening in China could burden AUD exchange rates, whilst the tapering debate will likely place some pressure upon those G10 currencies with traditionally higher betas. From an idiosyncratic point of view the RBA have been explicit in their desire for a weaker exchange rate and as such we propose an option structure below to take advantage of this dynamic.

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	-1.2%	1.6480	Stopped
29.10.2013	Long EUR-USD	1	1.3780	1.3680	-0.70%	1.3920	Stopped

Source: Bloomberg L.P., Commerzbank Research

TAB. 1: **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%	-0.02%	1.08%	Open
24.09.2013	Short EUR-USD strangle 1.38 / 1.25	23.12.2013	1 x 1	+0.61%	-0.33%	0.28%	Open
15.10.2013	Short EUR-GBP strangle 0.81 / 0.87	15.01.2013	1 x 1	+0.46%	-0.37%	0.11%	Open
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1	-0.42%	0.25%	-0.17%	Open
05.11.2013	Long AUD-USD put spread 0.92 / 0.88	04.02.2013	1 x 1	-0.50%	0.45%	-0.05%	Open

Source: Bloomberg L.P., Commerzbank Research

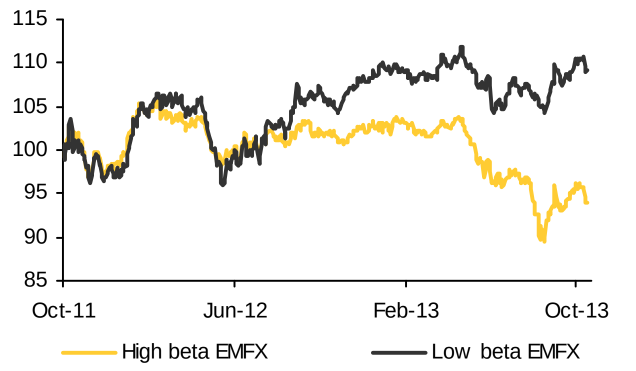
Tactical trading views:

- We suggest initiating short AUD-USD positions via a 0.92 / 0.88 put spread equally weighted over a 3 month tenor, for a total cost of 0.7% of notional. Although costing more than a risk reversal, the structure benefits from a long gamma profile which is by no means a bad thing given the risks described above. Also the risk reward is a compelling one, with the cost of 0.7% comparing favourably to a potential gain of approximately 4%

Portfolio Risk:

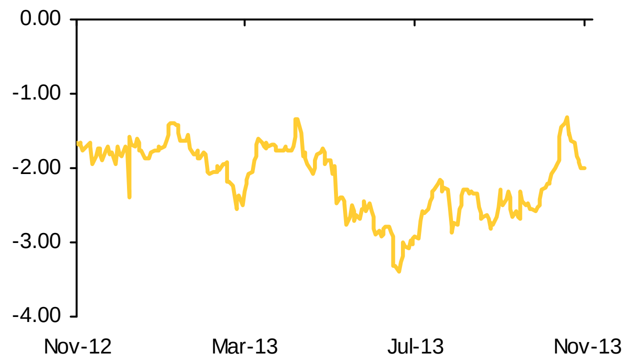
- The portfolio is negatively correlated with volatility
- The portfolio is negatively correlated with the USD

CHART 10: **EMFX takes a turn for the worse**
High beta and low beta EM FX, Oct 2011 = 100



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **AUD-USD riskies moving lower**
AUD-USD 3 month 25D risk reversal in % vol



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

EUR-USD – technical evidence is overwhelmingly bearish

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There are a number of technical developments which need to be highlighted on the longer term EUR-USD charts as they all suggest that the high at 1.3833 is likely to be a key intermediate turning point for the market (top).

The first one to mention is that the market has rallied to and seen emphatic rejection from the 61.8% retracement of the move down from 2011. This implies that the entire move higher from the 1.2042 July 2012 low was nothing more than a correction. Secondly the Elliott wave count on the weekly chart is also implying that this is the end of the 4th wave and the next leg should be on the downside. Thirdly we have seen a complex divergence of the weekly RSI, price action represents a bearish weekly engulfing pattern and on the monthly chart we have an inverted hammer. Fourthly the market has failed just ahead of the 1.3958/1.4002 key resistance – this represents the 50% retracement of the move down from the 2008 peak and also the 2008-2013 resistance line.

Lastly we have a 13 count on the daily and on the weekly charts, we have not seen a 13 count on the weekly chart since 2008.

For the last piece of evidence, we would like to see a CLOSE below the weekly uptrend at 1.3446 for added confirmation, **however the technical evidence is overwhelmingly bearish at this juncture.**

This suggests that we will see EUR-USD resume its longer term bear trend. We would expect to see the market drop towards its 200 MONTH moving average at 1.2082 by end of 2014.

CHART 12: **EUR-USD – Weekly Chart**
Market has reversed from the 61.8% retracement

Source: CQG, Commerzbank Research

CHART 13: **EUR-USD – Monthly Chart**
Market has failed at the 2008-2013 resistance line

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
05 November	15:00	USA	ISM non-manufacturing		OCT	54,0	54,4
	21:45	NZD	Employment change	qoq	3Q	0,5	0,4
	21:45	NZD	Unemployment rate	%	3Q	6,2	6,4
06 November	08:00	CZK	Trade balance	CZK bn	SEP	33,3	20,6
	08:00	CZK	Industrial production	yoy	SEP	6,0	1,6
	08:55	GER	PMI Services (Markit)		OCT F	52,3	52,3
	09:00	EUR	PMI Services (Markit)		OCT F	50,9	50,9
	09:30	ZAR	SACOB business confidence		OCT	-	91,4
	09:30	GBP	Industrial production	mom	SEP	0,6	-1,1
				yoy	SEP	1,8	-1,5
	10:00	EUR	Retail sales	mom	SEP	-0,4	0,7
				yoy	SEP	0,6	-0,3
		GBP	HBOS house prices	mom	OCT	0,9	0,3
			3 month av.	yoy	OCT	7,0	6,2
	11:00	GER	New orders	mom	SEP	0,5	-0,3
				yoy	SEP	5,6	3,1
	12:00	RUB	CPI weekly year to date	%	NOV 4	-	5,3
	12:00	USA	MBA Mortgage Applications	%	NOV 1	-	6,40
	12:59	PLN	Interest rate decision	%	NOV 6	2,50	2,50
	15:00	USA	Leading indicator CB		SEP	0,6	0,7
07 November	00:30	AUD	Employment change	K	OCT	10,0	9,1
			Unemployment rate	%	OCT	5,7	5,6
	05:00	JPY	Leading Index CI		SEP P	109,4	106,8
			Coincident Index CI		SEP P	108,3	107,6
	09:00	NOK	Industrial production	mom	SEP	-	-3,8
				yoy	SEP	-	-4,4
	11:00	GER	Industrial production	mom	SEP	0,0	1,4
				yoy	SEP	0,8	0,3
	11:00	ZAR	Industrial production	mom	SEP	-1,2	-3,6
				yoy	SEP	0,0	0,2
		RUB	FX and gold reserves	USD bn	NOV 1	-	517,0
	12:00	CZK	CNB interest rate decision	%	NOV 7	0,05	0,05
		GBP	Interest rate decision	%	NOV 7	0,50	0,50
	12:45	EUR	ECB Interest rate decision	%	NOV 7	0,50	0,50
	13:30	USA	Initial jobless claims	K	NOV 2	335	340
	13:30	USA	GDP annualized	qoq	3Q A	2,0	2,5
	15:00	HUF	Budget balance	bn, ytd	OCT	-	-949
08 November	08:00	HUF	Industrial production	mom	SEP P	-	0,7
				yoy	SEP P	1,7	0,9
	08:00	TRY	Industrial production	yoy	SEP	2,1	-0,1
	08:15	CHF	Retail sales	yoy	SEP	2,7	2,4
	08:30	SEK	Industrial production	mom	SEP	1,3	-2,3
				yoy	SEP	-0,1	-6,9
	13:30	USA	Personal income	mom	SEP	0,3	0,4
			Personal spending	mom	SEP	0,2	0,3
			PCE-deflator	yoy	SEP	1,0	1,2
			PCE core rate	mom	SEP	0,1	0,2
				yoy	SEP	1,3	1,2
	13:30	USA	Nonfarm Payrolls	K	OCT	120	148
			Unemployment rate	%	OCT	7,3	7,2
	14:55	USA	Michigan consumer confidence		NOV P	74,5	73,2
11 November	08:00	CZK	Consumer prices	mom	OCT	0,2	-0,4
				yoy	OCT	0,9	1,0
	08:00	RON	Consumer prices	mom	OCT	-	-0,6
				yoy	OCT	-	1,9
	09:00	NOK	Consumer prices	mom	OCT	-	0,5
				yoy	OCT	-	2,8

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