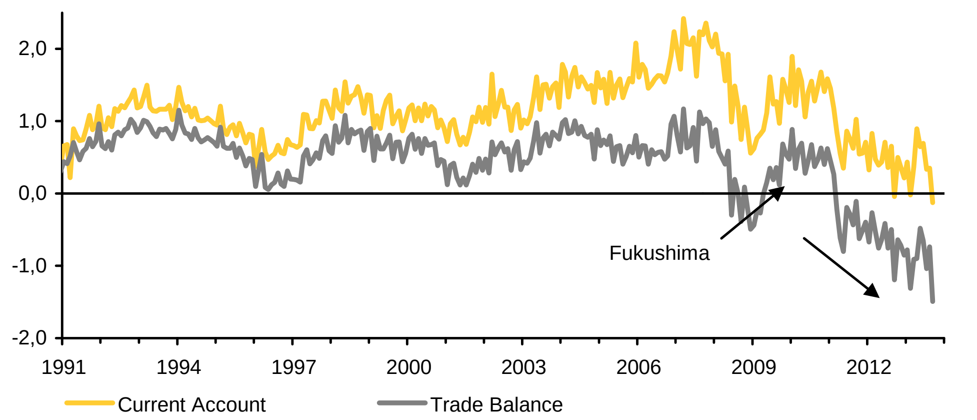
FX Alpha

26 November 2013

USD-JPY: Do not fear new highs

USD-JPY: Do not fear new highs. Even if USD-JPY appreciated notably recently, its upward potential is still considerable. From a balance of payments point of view a weak yen is exactly what Japan needs. Yet so far markets are not pricing in sustainable inflation.

CHART 1: **Japans trade balance: Fukushima effect visible but ongoing structural problems**
Trade and current account balance in trillion JPY



Source: Ministry of Finance Japan

G10 Highlights. Euro shrugging of discussion about negative interest rates. UK mortgage data watched closely. RBA can be satisfied by recent AUD move on verbal intervention.

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

EM Highlights. Polish detailed GDP results and PMI. Rates on hold in Israel. Political pressure on CNB to continue.

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

Technical Analysis. AUD-USD longer term down move has reasserted.

Event calendar. Little momentum from the US data calendar due to Thanksgiving; market focussing on euro zone inflation data.

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USD-JPY: Do not fear new highs

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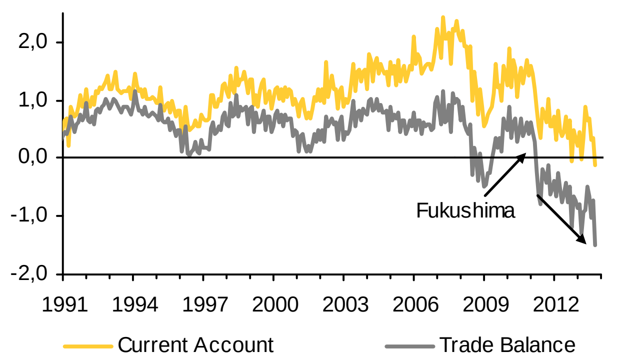
Even if USD-JPY appreciated notably recently, its upward potential is still considerable. From a balance of payments point of view a weak yen is exactly what Japan needs. Yet so far markets are not pricing in sustainable inflation.

Since the beginning of November JPY is under increasing pressure again. Of course demand for safe havens has fallen recently. Compared with EUR-CHF the upmove in USD-JPY is nonetheless notable. In cases such as this analysts often recommend shorts in USD-JPY or the purchase of EUR-CHF. After all, the imbalance is likely to be reduced again. We generally consider this strategy to be very questionable. In the case of the JPY I am convinced that it will fail.

A further rise in USD-JPY makes sense both from a fundamental and from the market's point of view. Fundamentally a weaker yen seems the only possibility for Tokyo to prevent the trade deficit to also pull the current account into negative territory. Interest income from abroad (Japan remains a large net creditor) would then be worth more in JPY and would take the pressure off the current account via improved earnings and investment income. The trend of the trade balance on the other hand seems unstoppable at the moment. The fact that there is an increasing deficit developing is not due to the catastrophe in Fukushima (see chart 2) but is instead the result of structural reasons, which will be solved long term at best. If the trade balance trend continues this would require a permanent depreciation of the JPY. If that does not happen Tokyo will depend on foreign capital once its FX reserves have been depleted – if not before. The resulting rise in interest rates does not bode well. So Tokyo does not need to push JPY to a lower level, the country needs a permanently weak currency.

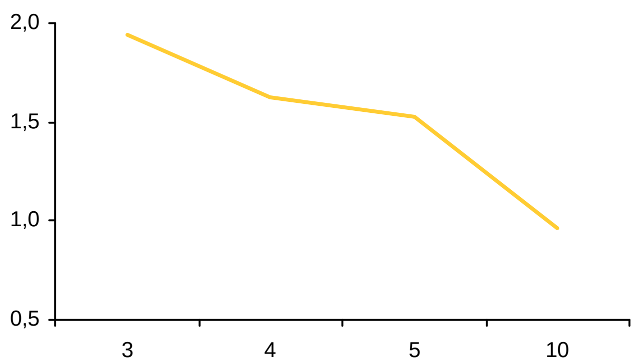
That leads us to the market view. The Bank of Japan's announcement of fighting deflation with massive bond purchases is the perfect breeding ground for a weak currency. So from this point of view one could argue that the BoJ has had nothing new to offer since its meeting in early April, so that additional JPY weakness cannot be expected. This line of thought is also incorrect. It is a fact that so far the market does not really believe that the BoJ will be able to lift inflation to 2% as promised. Even though the break even rates illustrate that the market really expects inflation to reach 2% in 3 years' time. That is mainly due to the imminent VAT rise. Inflation expectations for 5 years from now are back at 1.5% and in 10 years inflation is expected below 1% again. That means so far markets do not believe the BoJ's promise. And as a result the central bank's comments about its future approach still have potential to weaken JPY. And of course there is also the possibility of BoJ taking further measures should inflation remain too low.

CHART 2: **Japans trade balance: Fukushima effect visible but ongoing structural problems**
Trade and current account balance in trillion JPY



Source: Ministry of Finance Japan

CHART 3: **More room for BoJ easing?**
Break even inflation rates, x-axis: years



Source:Commerzbank Research

G10 Highlights

Euro shrugging of discussion about negative interest rates. UK mortgage data watched closely. RBA can be satisfied by recent AUD move on verbal intervention.

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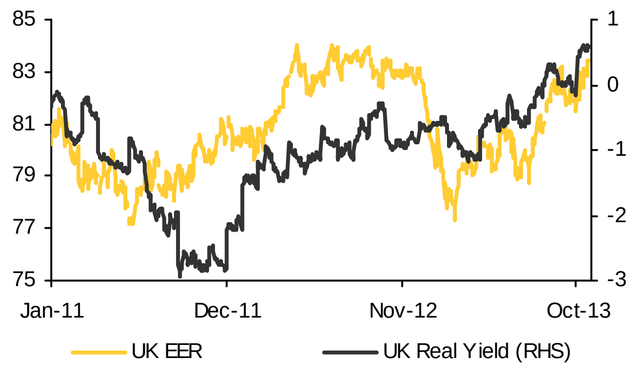
EUR-USD: The euro has shrugged off discussion about another ECB rate cut and negative interest rates. Considering the fact that this week is Thanksgiving week in the US, momentum out of the USD will be limited, especially in the second half of the week. Markets will focus on euro zone CPI data for November on Friday in order to get an idea about next week's ECB meeting. EUR-USD is likely to remain under upside pressure unless US data surprises strongly to the upside tomorrow. On the upside, though, 1.3650 should cap for the moment. Note that liquidity is already fading, which means that players have to get used to jumps in case of surprising news, data releases or events.

GBP: The coming week is relatively quiet in terms of data releases so the focus will shift towards the end of the week when UK mortgage approval data will be released. In recent years this data series has taken something of a back seat which is understandable given the moribund state of the UK housing market. That said, the data will be watched closely to see whether signs of the nascent recovery filter through to an increase in mortgage applications. In any case trade weighted sterling continues to appreciate in line with the increase in UK real yields and better than expected economic growth. We remain of the view that EUR-GBP is a sell on rallies.

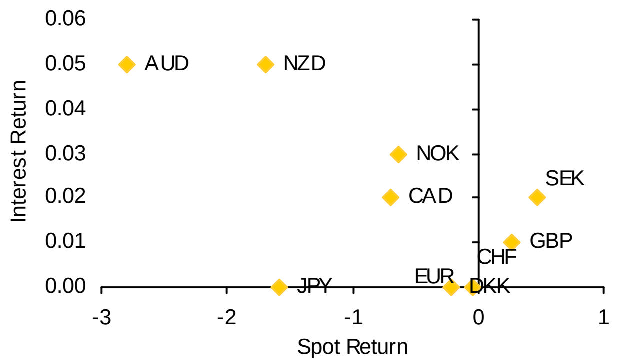
AUD: There is one thing that the Reserve Bank of Australia (RBA) can be proud of: it has sufficiently scared the market with its increased verbal interventions for AUD to have been on a nosedive since the middle of last week. The Vice-Governor of the RBA, Philip Lowe, sang from the same hymn sheet last night. However, at the same time the RBA is aware that real interventions have only little and short term effect. Governor Glenn Stevens for example did not want to exclude interventions last week, but referred to them as probably being ineffective and costly. Lowe noted that the threshold for interventions was fairly high. That means that the RBA can be pleased about the developments seen over the past few days and can hope that the market will continue to take its verbal interventions seriously. In particular in view of better sentiment indicators and the recently friendly data from China a rate cut in December has become less likely so that there will be little pressure on the AUD on this front. With the exception of the capex for Q3 on Thursday there is little to expect from the data calendar. The capex will confirm the picture of an economy that – outside the mining sector – is struggling to gain a foothold and is therefore more likely to put pressure on AUD. The Chinese PMI will provide some interesting news in early December – so before the RBA meeting on Dec 3rd. On the whole markets remain sceptical about the AUD. We too remain cautious as the central bank could comment on the AUD again at any time and as the fundamental data is more likely to put pressure on AUD. To the upside there is good resistance at 0.9230 and 0.9250 in AUD-USD, while 0.9120 and 0.9075 provide support on the downside.

CHART 4: **GBP appreciates with increasing real yields**
UK EER, UK Real Yield in %



Source: Commerzbank Research, Bloomberg LP

CHART 5: **Higher yielders take the pain week on week**
% Gain / Loss Vs. USD since 19th November 2013



Source:Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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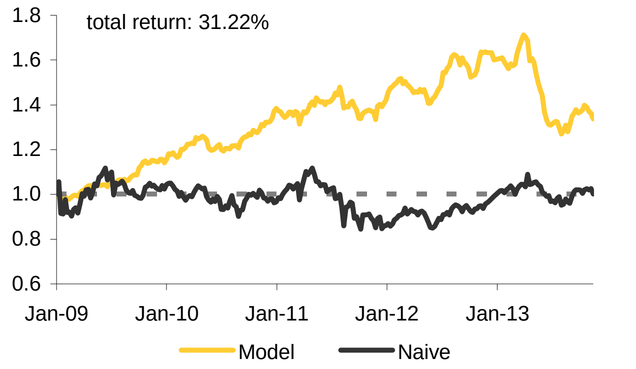
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

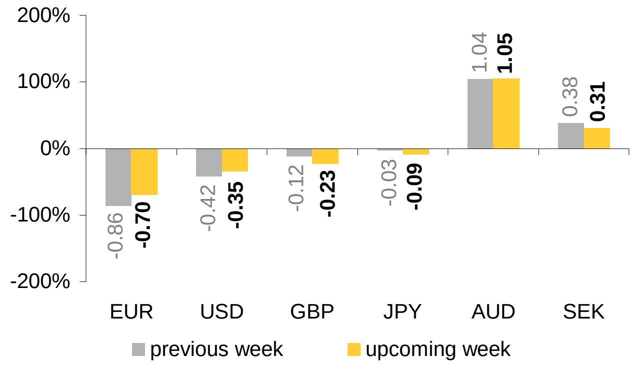
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 26 Nov to 3 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

Polish detailed GDP results and PMI. Rates on hold in Israel. Political pressure on CNB to continue.

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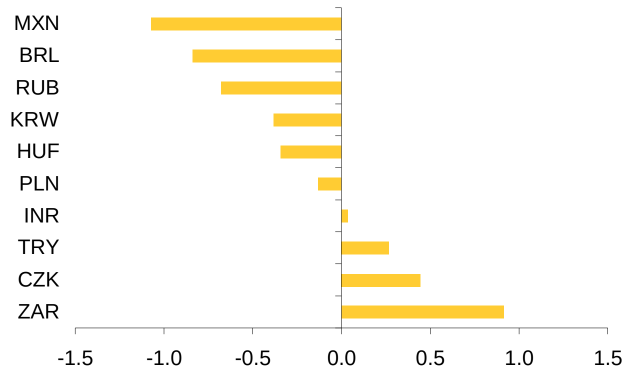
PLN: The detailed Q3 GDP results due on Friday will give an insight into the growth drivers of the past three months. At its recent rate meeting the NBP had remarked that domestic demand growth remained relatively limited while external demand was robust. Thus exports are expected to again have contributed significantly to growth, while domestic demand as well as investments remain lacklustre. Overall, the pickup in growth remains solid and is expected to accelerate on a more broad basis in the quarters ahead. Thus, forward looking indicators will be of more interest for the PLN. Should the manufacturing PMI due on Monday should record another strong print, this might fuel expectations of a slightly more optimistic NBP and thus provide some tailwind for the PLN.

ILS: BoI kept rates on hold yesterday at 1% in a move that was expected by a majority of analysts. Our view coming into the announcement was that there was a small chance of a rate cut given the poor print for Q3 GDP (2.2%), however it seems as though BoI are content to wait for the release of inflation data in the coming weeks before deciding upon another rate cut. The weakening of the shekel in recent weeks no doubt played a part in the decision and this can only be a welcome development as far as the MPC are concerned. Although in recent weeks BoI interventions have been more muted than before one must point out that in REER terms the shekel is still an expensive currency compared to its EMEA peers. So we cannot discount further interventions anytime soon, despite the recent weakening of the shekel.

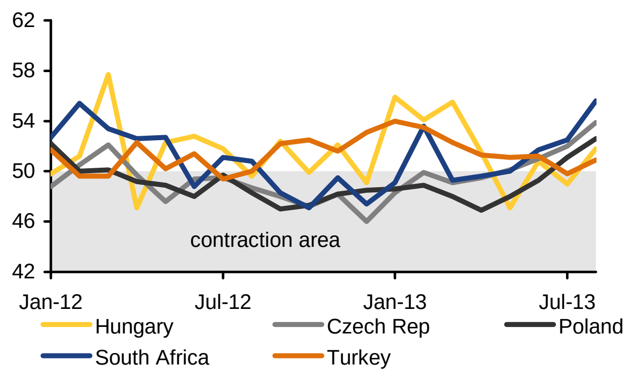
CZK: CNB chief Miroslav Singer revealed that the central bank had sold around CZK 200 bn following the introduction of its EUR-CZK target of 27 on Nov 7th which is an impressive figure at roughly 20% of the CNB's reserves. Although the CNB claims that it will invest its newly acquired reserves in higher yielding government bonds (from Germany, US, Sweden, Canada and Australia), one still wonders if this will be sufficient to reduce the significant balance sheet risk the central bank has entered. Against this background criticism from Czech politicians is likely to continue and put pressure on the CNB to eventually stop intervening.

CHART 8: **Mixed EM picture**
% Gain / Loss Vs. USD since 19th November 2013



Source: Bloomberg

CHART 9: **Sentiment picking up?**
Manufacturing PMIs



Source: Markit

FX portfolio recommendation

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Core trading views:

- We close our EUR-USD short strangle and retain short vol positions in EUR-GBP and 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 increase the stop level in GBP-CHF and implement another short volatility position in EUR-CHF.

Over the week our strangle positions performed reasonably well although we are now taking profit on the EUR-USD short strangle position. Coming into year end EUR-USD can experience lumpy moves due to low liquidity so this is a prudent decision from our point of view. We retain the short EUR-GBP strangle which is performing well with spot in the middle of its recent range. In general volatility remains well offered in the market and given the bullish equity sentiment it is difficult to see a pronounced move higher in the short term.

The downside put spread in AUD-USD performed very well over the week as the RBA mentioned the possibility FX interventions. We are happy to retain the position coming into year end. The only fly in the ointment was the underperformance of the USD-JPY downside put, which is explained by bullish equity sentiment feeding through into an appreciation of USD-JPY. As this is a tail hedge for our portfolio we are happy to retain the position, which we think offers some protection in case of excessive profit taking coming into year end.

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	**0.65%**	1.4860	Open

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
24.09.2013	Short EUR-USD strangle 1.38 / 1.25	23.12.2013	1 x 1	+0.61%	-0.15%	0.46%	T/P
15.10.2013	Short EUR-GBP strangle 0.81 / 0.87	15.01.2013	1 x 1	+0.47%	-0.20%	0.27%	Open
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1	-0.39%	0.03%	-0.36%	Open
05.11.2013	Long AUD-USD put spread 0.92 / 0.88	04.02.2013	1 x 1	-0.48%	1.05%	0.56%	Open
26.11.2013	Short EURp-CHFc 1.22	25.02.2013	1	+0.60%	-0.24%	0.35%	Open

Source: Commerzbank Research, Bloomberg LP

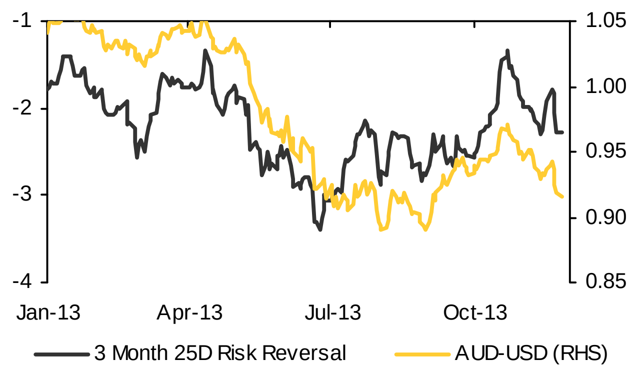
Tactical trading views:

- We increase the stop level on the long GBP-CHF position to 1.4650 given the appreciation in spot since we initiated the position. At worst this means we'll close the position with a slight profit.
- We initiate another short EUR-CHF downside put, this time with a 1.22 strike on a three month tenor. The rationale is the same as before; we expect volatility to remain at reasonably low levels whilst from a spot point of view we think levels below 1.22 will prove difficult to manifest.

Portfolio Risk:

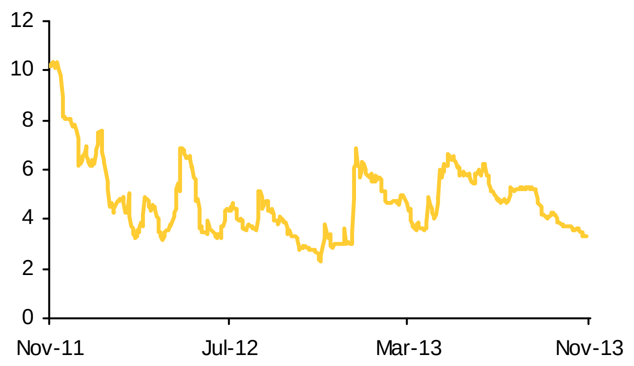
- The portfolio is negatively correlated with volatility
- The portfolio is negatively correlated with the USD

CHART 10: **AUD options market skwewed to the downside**
AUD-USD spot, 25D 3 Month Risk Reversal



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **EUR-CHF vol comes lower**
EUR-CHF 3 Month At-the-money volatility in % vol



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

AUD-USD longer term down move has reasserted.

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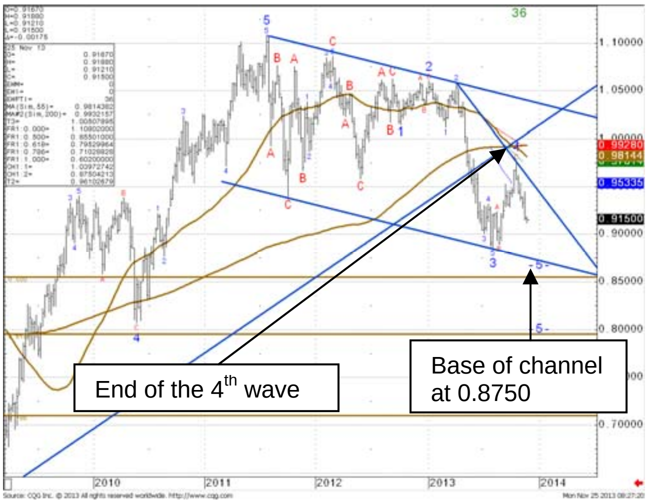
AUD-USD went into free fall last week and finished the week near 2 month lows. The market's recent failure at its 200 day moving average in October circa 0.9757 proved to be a key turning point for the market. We regarded that as the end of the 4th corrective wave and the market has now embarked on its 5th leg lower. It remains very much in a longer term down move.

Shorter term, we regard last weeks high at 0.9449 as an interim peak and we look for losses to 0.9034, the 78.6% Fibonacci retracement of the same move. This is the last defence for the 0.8848 August low and 0.8750, the base of a 2 year down channel. This is the medium term downside target and we would anticipate a corrective rebound from this vicinity.

Much longer term there is potential for losses to extend all the way back to the 0.8068 2010 low. This target is achievable by the end of 2014.

CHART 12: **AUD-USD - weekly**
heading to base of channel



Source: CQG, Commerzbank Research

CHART 13: **AUD-USD - monthly**
has failed at the 55 month moving average

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
26 November	14:00	USA	Case-Shiller house price index	yoy	SEP	13,0	12,8
	14:00	USA	OFHEO House Price Index	yoy	SEP	0,4	0,3
	15:00	USA	Consumer confidence CB		NOV	72,6	71,2
27 November	09:00	GER	GfK Consumer Confidence		DEC	7,1	7,0
	09:30	GBP	GDP	qoq	3Q P	0,8	0,8
				yoy	3Q P	1,5	1,5
	12:00	RUB	CPI weekly year to date	%	NOV 25	-	5,6
	12:00	USA	MBA Mortgage Applications	%	NOV 22	-	-2,30
	13:30	USA	Durable Goods New Orders	mom	OCT	-2,0	3,8
			ex Transportation	mom	OCT	0,5	-0,2
	13:30	USA	Initial jobless claims	K	NOV 23	330	323
	14:45	USA	Chicago PMI		NOV	60,0	65,9
		USA	Michigan consumer confidence		NOV F	73,1	72,0
	15:00	USA	Leading indicator CB		OCT	0,0	0,7
	23:50	JPY	Retail trade	mom	OCT	-0,8	1,7
				yoy	OCT	2,1	3,0
28 November	07:00	GER	Import Prices	mom	OCT	-0,3	0,0
				yoy	OCT	-2,6	-2,8
	08:30	SEK	Retail sales	mom	OCT	0,4	0,2
				yoy	OCT	4,0	1,6
	09:00	EUR	M3 money supply 3 month av.	yoy	OCT	2,0	2,2
	10:00	EUR	Consumer confidence		NOV F	-15,4	-15,4
			Industrial confidence		NOV	-4,4	-4,8
			Business confidence		NOV	98,0	97,8
	11:00	RUB	FX and gold reserves	USD bn	NOV 22	-	507,7
	13:00	GER	Consumer prices	mom	NOV P	0,1	-0,2
				yoy	NOV P	1,2	1,2
			ex fresh food and energy	mom	NOV	-0,1	-0,2
	23:30	JPY	CPI	yoy	NOV	0,7	0,6
			ex fresh food	yoy	NOV	0,4	0,3
		JPY	Unemployment rate	%	OCT	3,9	4,0
	23:50	JPY	Industrial production	mom	OCT P	2,0	1,3
				yoy	OCT P	6,3	5,1
29 November	00:05	GBP	GfK Consumer Confidence		NOV	-10	-11
	07:00	GBP	Nationwide House Price Index	mom	NOV	0,6	1,0
				yoy	NOV	6,2	5,8
	07:00	GER	Retail sales	mom	OCT	0,5	-0,6
				yoy	OCT	1,4	0,3
	08:00	CHF	KOF leading indicator		NOV	1,81	1,72
	08:00	TRY	Trade balance	USD bn	OCT	-7,20	-7,50
	08:00	HUF	Producer price index	mom	OCT	-	0,0
				yoy	OCT	1,3	1,6
	08:30	SEK	GDP	qoq	3Q	0,5	-0,2
				yoy	3Q	0,4	0,1
	09:00	PLN	GDP	yoy	3Q F	-	1,9
	09:30	GBP	Mortgage approval	K	OCT	69	67
	10:00	EUR	Consumer price index	yoy	NOV	0,8	0,7
			core rate	yoy	NOV A	0,9	0,8
	12:00	ZAR	Trade balance	ZAR bn	OCT	-13,5	-12,0
	13:30	CAD	GDP	mom	SEP	0,2	0,3
02 December	07:30	SEK	Swedbank PMI Survey		NOV	-	52,0
	08:00	NOK	Puchasing Manager Index		NOV	-	53,6
	08:30	CHF	SVME- PMI		NOV	-	54,2
	08:55	GER	PMI (Markit)		NOV F	-	52,5
	09:00	EUR	PMI (Markit)		NOV F	-	51,5
	09:00	ZAR	Investec PMI		NOV	-	50,7

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