

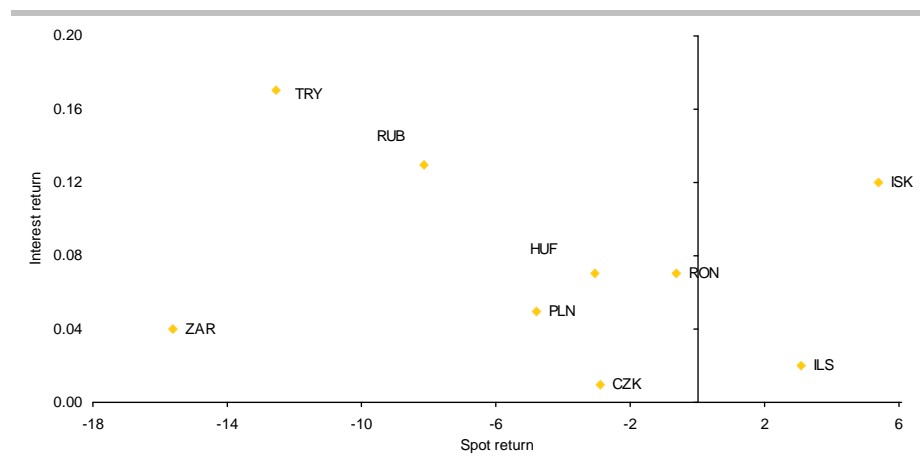
# FX Alpha

10 September 2013

## Cause and effect

**Cause and effect.** Recent price action in Emerging Market currencies represents a mere lull in what is likely to be a more prolonged and sustained period of EMFX weakness.

**CHART 1: Year to date EMFX underperformance is evident**  
% Gain / Loss Vs. USD since 1<sup>st</sup> Jan 2013



Source: Commerzbank Research, Bloomberg LP

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**G10 Highlights.** EUR – making ground with market doubting ECB’s forward guidance. JPY weakens in line with higher GDP revision. NOK – No election impact...yet.

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

**EM Highlights.** Current account data in South Africa still a burden for ZAR. Strong CPI should provide tailwind for PLN. Economic data in Brazil may disappoint.

**Tactical trade recommendation.** Establish tactical long GBP-USD positions ahead of the US Retail Sales data this week.

**Technical Analysis.** EUR-USD’s bounce off the 50% retracement at 1.3104 should be followed by a sell-off

**Event calendar.** As always the week following NFP is relatively quiet in terms of data releases. The main focus this week will be upon US Retail Sales and PPI data towards the end of the week.

## Cause and effect

**Recent price action in Emerging Market currencies represents a mere lull in what is likely to be a more prolonged and sustained period of EMFX weakness.**

EM currencies were able to stop their downward trend of late, though they failed to pare the significant losses recorded since May. Friday's US labour market report was neither fish nor fowl. However, looking at the volatilities of NFP and unemployment rate shows that the drop in the latter to 7.3 % might weigh more than the disappointing NFP figures. So it should not surprise that most of the market participants still expect the Fed to start tapering in September. Against this backdrop the latest stabilization of EM currencies could be seen as a signal that this time the countries will not be hit as hard as in the 1997 Asian crisis. Or will the situation in the respective countries deteriorate further?

Some analysts perceive the latest depreciation as helpful due to the positive impact on foreign trade. Exports are gaining price competitiveness. Is it reasonable to argue that the flexibility of their exchange rates makes countries less vulnerable to the recent turmoil? This argument risks conflating cause and effect. Certainly pegged currencies were one of the main causes of the Asian crisis. And it was the crisis itself which ushered in the era of more freely floating Asian currencies, with subsequent economic benefits.

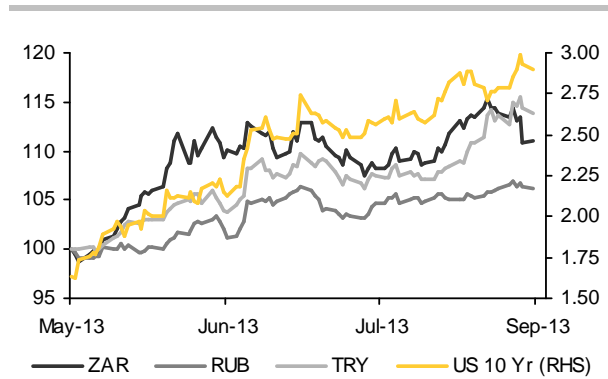
Admittedly, the EM countries under pressure do not have to adjust due to an overvalued currency. But they again run rising current account deficits and face more and more problems to finance these imbalances. They have even created these deficits while depreciating in real terms thus gaining price competitiveness. The recent depreciation is even supporting capital outflows out of the respective countries while the positive impacts on foreign trade will be temporary and can be expected only with some time lag. Above all the problem countries face already high inflation rates, as their central banks refrained from hiking rates when it was appropriate. And a weak currency provides even more inflationary pressure. This was not different during the Asian crisis.

But this time a depreciation does not automatically solve the underlying problem. This is rather due to an expected shift in Fed policy intensified by a slowdown of the Chinese economy. This makes it much more difficult for the troubled countries to react, particularly as fiscal measures are hardly possible. Currently these states are just trying to be able to pay for their previous import volume. The flexibility of their currencies does not help in this respect. Flexibility as an argument for a better crisis resistance of Emerging Markets seems to underestimate the real problem. It is too early for an all clear for EM currencies.

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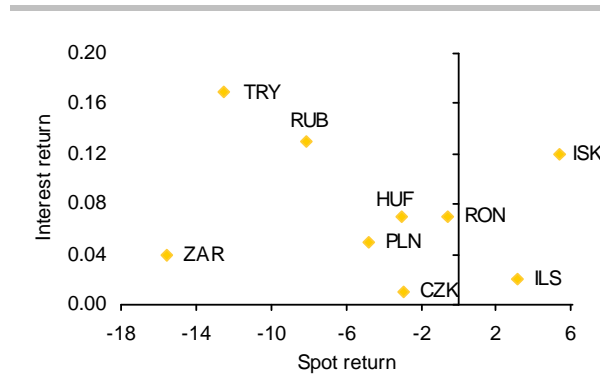
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**CHART 2: EMFX ceases to lose ground**  
US 10 Yr in %, USD Vs. RUB, TRY, ZAR rebased 100= 1<sup>st</sup> May



Source: Commerzbank Research, Bloomberg LP

**CHART 3: Year to date EMFX has underperformed**  
% Gain / Loss Vs. USD since 1<sup>st</sup> Jan 2013



Sources: Commerzbank Research, Bloomberg LP

## G10 Highlights

**EUR – making ground with market doubting ECB’s forward guidance. JPY weakens in line with higher GDP revision. NOK – no election impact...yet.**

**EUR:** It seems that the recent downward trend in EUR-USD is running out of steam. And once more bond markets are in the driving seat. While yields for 10-year T-notes eased after the disappointing US labour market report yields for 10-year Bunds seem to be locked around 1.95. A similar picture can be observed on the money market. While 9M3M EONIA forward levels remain more or less unchanged slightly above 25 bp, their USD-OIS counterpart continues to ease. Put differently: The market still does not trust the ECB’s forward guidance (promised to keep rates at current or lower levels for an extended period of time) and also doubts Bernanke’s signals to reduce asset purchases soon. This said, it seems more likely that EUR-USD will face some tailwind in the run up to the FOMC-meeting next Wednesday.

**JPY:** Q2 GDP figures were revised up to 0.9% qoq (first reading 0.6%) after an already strong first quarter (1.0%). However, this did not trigger any JPY strength. It seems that the FX market is pretty much aware that Abenomics will fuel the economy at least short term. The medium term impact is much more uncertain though. With global risk perception declining the JPY faces downward pressure once more. We stick to our view that USD-JPY will trade significantly above the mark of 100 at the end of the year.

**NOK:** As expected the Norwegians voted out the centre-left coalition. It looks as if we are going to see a coalition between the Conservatives and the Progress Party – probably supported by one or two smaller parties. The result of the elections had been expected and therefore had no effect on the NOK exchange rates. Over the coming days it will become relevant whether the Progress Party will be able to get the Conservatives to agree to a NOK-positive compromise regarding the use of the national oil revenue. It stands a good chance as no government to the right of the old coalition can be formed without it. Under these circumstances the elections would end up having an effect on NOK after all.

**GBP:** The key data release for the pound this week will be on Wednesday when the latest unemployment data are released. Expectations are for an unchanged rate at 7.8%, but given the improvement in cyclical economic data (PMI’s etc) there is the possibility of a lower print. That being the case sterling will undoubtedly benefit. Our view is that sterling is playing catch up with the improvement in economic data and this can be clearly seen in crosses such as GBP-JPY, GBP-CHF amongst others. The stage is set for more sterling strength.

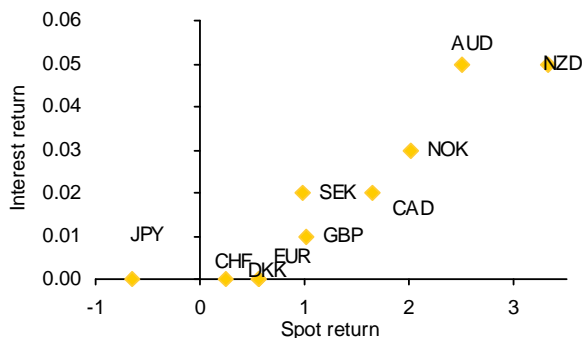
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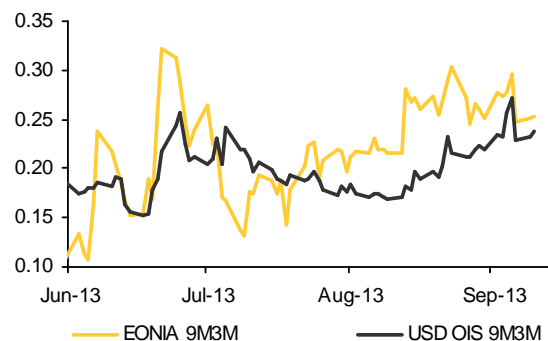
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CHART 4: **G10 crosses gain over the week**  
% Gain / Loss Vs. USD since 3<sup>rd</sup> September



Source: Commerzbank Research, Bloomberg LP

CHART 5: **Money market curves move in favour of EUR-USD**  
Money market forward rates, in %



Source: Commerzbank Research, Bloomberg LP

# FX Metrics

## G10 carry trade indices

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.

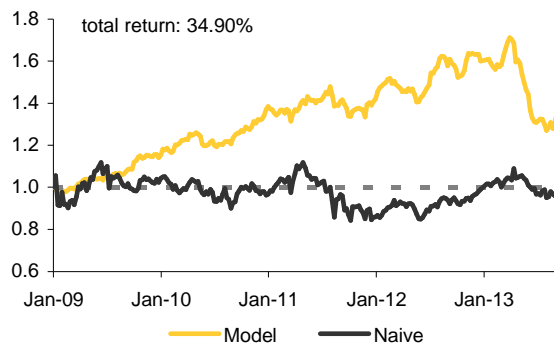
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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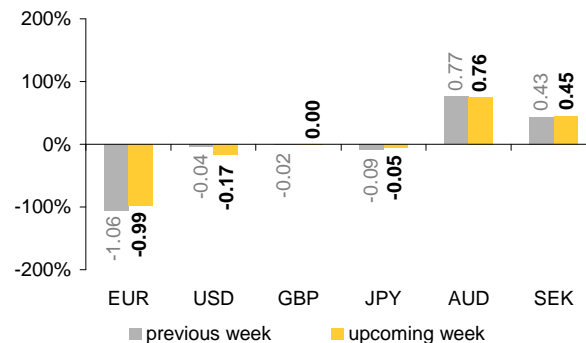
**CHART 6: Historic performance of optimized Carry Trade Portfolio**

Cumulative return<sup>1</sup> 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 10 Sep to 17 Sep**  
 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.

<sup>1</sup> Returns are based on Tuesdays' London opening

## EM Highlights

### Current account data in South Africa still a burden for ZAR. Strong CPI should provide tailwind for PLN. Economic data in Brazil may disappoint

**ZAR:** Yesterday South Africa successfully issued \$2 billion of 12 year bonds, which is an illustration that despite difficulties of high inflation, high unemployment and a large current account deficit (Q2 -6.5% of GDP), emerging market nations can still issue debt relatively easily. USD-ZAR fell below 10.00 in what was more a short covering move rather than investors initiating ZAR longs. It would be a mistake to think that this signals the all clear as far as ZAR exchange rates are concerned. The authorities there (and elsewhere) are issuing bonds at current levels probably because they think that global interest rates will trade at higher levels in years to come, which ultimately will be a burden for ZAR. If anything this dynamic could create decent entry levels for long USD-ZAR positioning.

**PLN:** August CPI data is due on Friday. According to consensus the inflation rate will remain stable at 1.1% which is still well below the NBP target but at least at a comfortable safety distance to its recent low at 0.2%. After the NBP has recently made clear again that it does not intend to hike key rates this year, in our view only a surprisingly strong inflation rate (i.e. above 1.3%) would have a significant impact on PLN exchange rates as it might lead the central bank to overthink its neutral stance. The 4.25 level in EUR-PLN provides the next support on the downside.

**BRL:** On Thursday retail sales are due and more important the Economic Activity Index for July will be released on Friday. After the better than expected GDP for the second quarter it will be interesting to see if the recovery of the economy will continue. We expect the index to rise by roughly 2% yoy, which is below consensus (2.55%). If the release disappoints the BRL should quickly move above the level of 2.30 against the USD again, which it was able to breach recently supported by the positive GDP release, by a slightly weaker USD and by the BCB's intervention program. Since we think that this move went a little bit too far we do not see much scope for a stronger real, even if the Economic Activity Index surprises to the upside. Fundamentals in Brazil remain weak and ahead of next week's FOMC meeting investors might not want to take on additional risk.

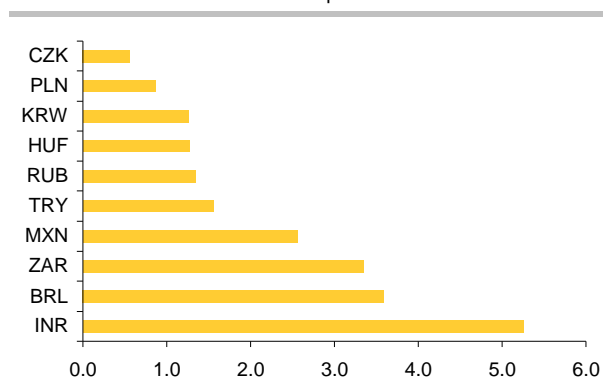
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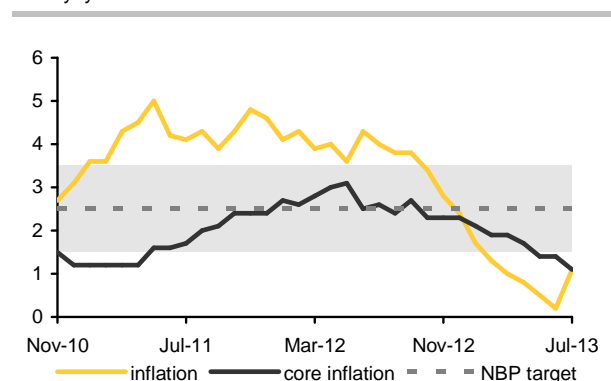
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CHART 8: EM currencies recovering  
% Gain / Loss Vs. USD since 3<sup>rd</sup> September



Source: Commerzbank Research, Bloomberg LP

CHART 9: Polish CPI turning  
in % yoy



Source: Commerzbank Research, Bloomberg LP

# Tactical trade recommendation

## Enter into tactical long GBP-USD positions ahead of US retail sales data

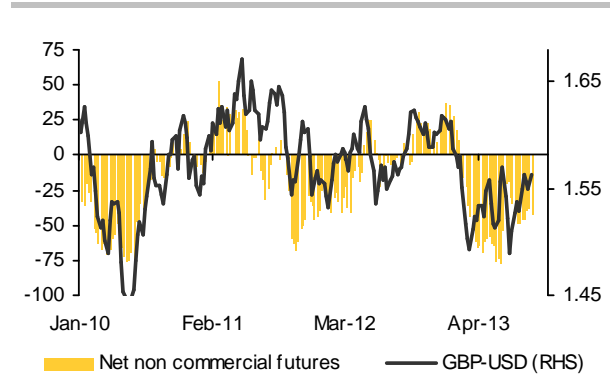
The coming week has a host of UK and US data releases which provide considerable event risk for GBP-USD. In the UK, Wednesday's unemployment data will be important in the sense that any positive surprise to the data should lead to sterling appreciation. This is a not insignificant risk in the sense that PMI data have printed at very robust levels in recent months. The USD continues to trade with a lack of conviction and following last week's disappointing NFP, so any data releases that print on the downside of expectations will doubtless be met with USD weakness.

Add to all of the above a still large short GBP position and the ingredients are there for a move higher in GBP-USD. To be clear, we remain of the view that longer term lower levels in GBP-USD should prevail, but the chances of a data driven short squeeze indicate to us that market participants would do well to establish tactical long GBP-USD positions around current levels with a view to taking profit around 1.5990. We maintain a tight stop around 1.5610.

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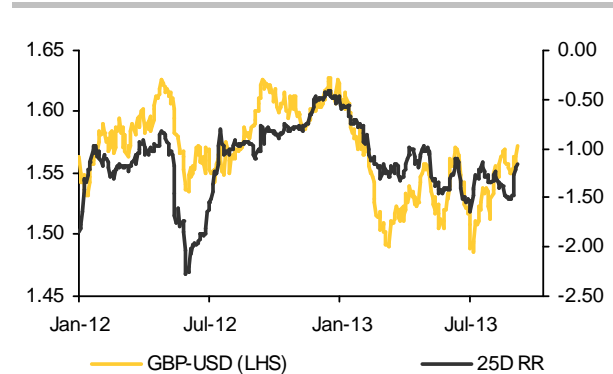
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**CHART 10: Positioning still short GBP**  
GBP-USD spot, IMM net non commercial futures



Sources: Commerzbank Research, Bloomberg LP

**CHART 11: Riskies flip to the upside**  
GBP-USD spot, 25 Delta Risk Reversal in % vol



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-CHF <sub>c</sub> 1.2050	04.12.2013	1m	+1.10%	-0.14%	0.96%	Open
12.03.2013	Sell CAD-MXN risk reversal 13.00 / 11.90	12.09.2013	2m x 1m	0.28%	-0.03%	-0.31%	Open
08.07.2013	Sell GBP-USD risk reversal 1.51 / 1.46	08.10.2013	1m x 1m	0.01%	-4.50%	-4.51%	Open
20.08.2013	Buy AUDp-JPY <sub>c</sub> 87.00	19.09.2013	1m	0.42%	0.03%	-0.39%	Open
03.09.2013	EUR-GBP seagull 0.86, 0.845, 0.825	14.10.2013	1m x 1m x 1m	0.25%	0.63%	0.38%	Open

Sources: Bloomberg L.P., Commerzbank Research

# Technical Analysis

## EUR-USD's bounce off the 50% retracement at 1.3104 should be followed by a sell-off

Over the past few weeks EUR-USD slipped from its seven month August high at 1.3453 to the 50% retracement of the July-to-August rally at 1.3104. From there a minor bounce back towards the 1.3243 May high is expected to be seen before another down leg is to be made.

While the currency pair stays below the 1.3300 region the odds favour a drop to below the current September low at 1.3104 being seen with the psychological 1.30000 region then being back on the cards.

The 78.6% Fibonacci retracement at 1.2904 is another downside target en route to the 1.2755/40 March, April and July lows.

Should key support at 1.2755/40 be fallen through, the psychological 1.2000 region will be back in the picture.

Only an unexpected rise above the August 1.3453 high will allow for gains to the 1.3500/20 region. This is not our favoured view and we believe that the currency pair will see another leg lower towards the psychological 1.3000 region being made instead.

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**CHART 1: EUR/USD Daily Chart**

The minor bounce off the 1.3104 level should be followed by another down leg towards the 1.3000 mark



Source: CQG, Commerzbank Research

## Event Calendar

Date	Time (GMT)	Region	Release	Unit	Period	Survey	Prior
11 September	06:00	GER	Consumer prices	mom	AUG F	0.0	0.0
				yoy	AUG F	1.5	1.5
	07:00	HUF	Consumer prices	mom	AUG	-0.1	-0.3
				yoy	AUG	1.6	1.8
	07:00	RON	Consumer prices	mom	AUG	-0.3	-0.3
				yoy	AUG	3.7	4.4
	08:30	GBP	Unemployment rate	%	JUL	7.8	7.8
	10:59	RON	Current account balance	EUR mn	JUL	-	695
	11:00	ZAR	Industrial production	mom	JUL	2.0	-3.0
				yoy	JUL	1.6	0.4
	11:00	USA	MBA Mortgage Applications	%	SEP 6	-	1.30
	12:00	RUB	CPI weekly year to date	%	SEP 9	-	4.5
	12:00	PLN	Current account balance	yoy	JUL	73	574
21:00	NZD	Interest rate decision	%	SEP 12	2.50	2.50	
12 September	01:30	AUD	Employment change	K	AUG	10.0	-10.2
				Unemployment rate	%	AUG	5.8
	07:00	TRY	Current account balance	USD bn	JUL	-5.5	-4.5
	07:30	SEK	Consumer prices	mom	AUG	0.1	-0.1
				yoy	AUG	0.1	0.1
	07:30	SEK	Unemployment rate		AUG	7.3	7.2
	09:00	EUR	Industrial production	mom	JUL	-0.3	0.7
				yoy	JUL	-0.2	0.3
	11:00	RUB	FX and gold reserves	USD bn	SEP 6	-	510.8
	12:30	USA	Initial jobless claims	K	SEP 7	330	323
	12:30	USA	Import Prices	mom	AUG	0.5	0.2
				yoy	AUG	0.7	1.0
	13 September	04:30	JPY	Industrial production	mom	JUL F	-
yoy					JUL F	-	1.6
07:00		HUF	Industrial production	mom	JUL F	-	0.3
				yoy	JUL F	-	2.5
07:15		CHF	Producer and import prices	mom	AUG	0.2	0.0
				yoy	AUG	0.5	0.5
07:30		SEK	GDP	qoq	2Q F	-0.1	-0.1
				yoy	2Q F	0.6	0.6
12:00		PLN	Consumer prices	mom	AUG	-0.2	0.3
				yoy	AUG	1.1	1.1
12:30		USA	Producer price index	mom	AUG	0.2	0.0
				yoy	AUG	1.3	2.1
				core rate	mom	AUG	0.1
	yoy			AUG	1.3	1.2	
12:30	USA	Retail sales less vehicles	mom	AUG	0.4	0.2	
			mom	AUG	0.3	0.5	
13:55	USA	Michigan consumer confidence		SEP P	82.0	82.1	
15 September	23:01	GBP	Rightmove House Prices	mom	SEP	-	-1.8
				yoy	SEP	-	5.5
16 September	07:00	CZK	Producer price index	mom	AUG	0.1	0.2
				yoy	AUG	0.7	1.1
	09:00	EUR	Consumer prices	mom	AUG	-	0.1
				yoy	AUG F	-	1.3
		core rate	yoy	AUG F	-	1.1	



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