

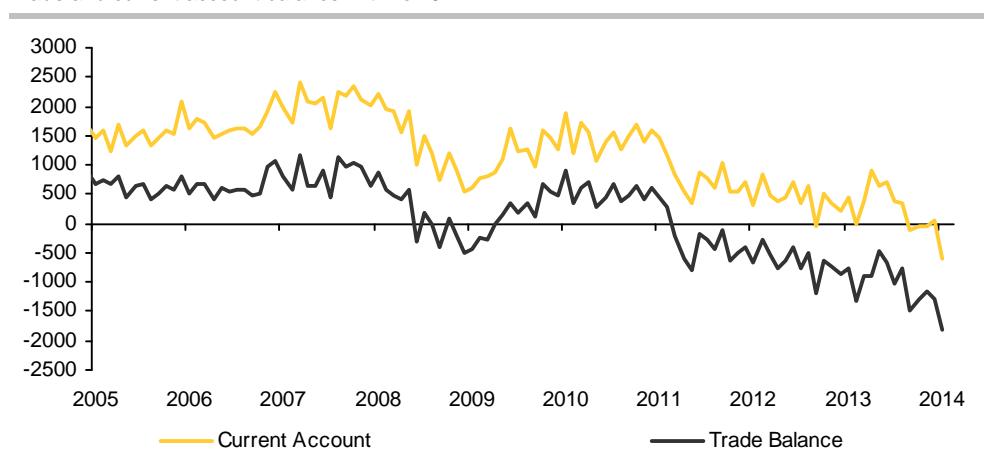
FX Alpha

11 March 2014

JPY: No light at the end of the tunnel

JPY: No light at the end of the tunnel. With adjusted -588 billion JPY in January a permanent Japanese current account deficit is closer than ever before. We show that it is not driven by temporary factors in the trade balance. The trade deficit is likely to worsen – with effects for USD-JPY.

CHART 1: Trade balance drags the current account down
Trade and current account balance in trillion JPY



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. For the moment, EUR-USD likely to remain at high levels. GBP losing steam? Key rate to rise in NZ. Risk of a Riksbank rate cut still persists.

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

EM Highlights. Busy week in Brazil. CZK remains resilient. ZAR – Current account in focus.

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

Technical Analysis. USD-CAD is holding sideways but this is viewed as a bullish consolidation.

Event calendar. More focus on EM calendar this week, but rate decision in NZ and employment report in Australia will attract attention as well.

CONTENTS

JPY: NO LIGHT AT THE END OF THE TUNNEL 2

G10 HIGHLIGHTS 3

FX METRICS 4

EM HIGHLIGHTS..... 5

FX PORTFOLIO RECOMMENDATION ... 6

TECHNICAL ANALYSIS..... 8

EVENT CALENDAR 9

DISCLAIMER 10

JPY: No light at the end of the tunnel

With adjusted -588 billion JPY in January a permanent Japanese current account (CA) deficit is closer than ever before. We show that it is not driven by temporary factors in the trade balance. The trade deficit is likely to worsen – with effects for USD-JPY.

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Yes, the Japanese trade deficit looks bad. No, that is not a problem. The trade balance will improve as soon as (1) energy imports are reduced as nuclear plants are reopened after the Fukushima-accident, (2) domestic production catches up on the demand shock driven by “Abenomics” and (3) the volume effects of JPY-depreciation succeed the price effects. This line of argumentation is not only adopted by the Japanese Government but also by many analysts. If they are not correct, however, dramatic consequences loom: a CA deficit needs to be financed by international capital flows. But the highly indebted Japanese economy cannot afford higher rates. In the worst case, a current account crisis is threatening. The bad news: we took a closer look at above arguments, and do not find strong evidence supporting them.

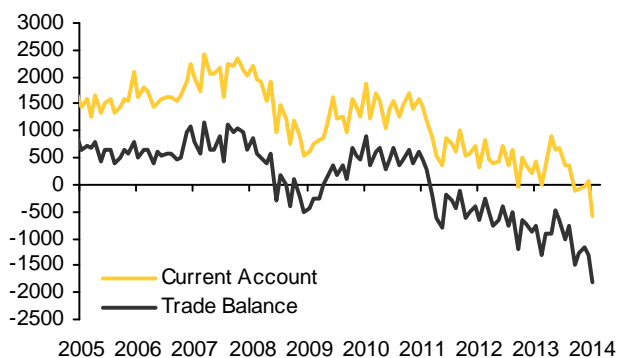
Between October 2012 and July 2013 the yen lost more than 20% versus the dollar – and the trade balance deteriorated. This is expected in the short run: since a depreciating currency increases import prices but decreases export prices, the price effects lead to a higher import-value and a lower export value. But in Japan, no volume adjustment was observed. In contrary, real imports increased despite higher costs and real exports did not pick up, although export prices decreased. Therefore argument (3) cannot be confirmed.

Japan supporters often argue that the reflationary programme known as “Abenomics” triggered a demand shock that could not be satisfied by domestic production (2). Thus the export potential is limited from the supply side, and excess demand needs to be covered by imports. But the share of imports in total demand has not increased since the election of Shinzo Abe and the trend in increasing real imports and stagnating real exports already exists since 2010. If the trade deficit cannot be related to Abenomics, normalizing demand is unlikely to improve it.

Last but not least, nearly every new trade number since March 2011 was accompanied by the explanation that expensive energy imports distort the Japanese trade balance (1). Chart 3 breaks down nominal import growth in mineral fuel and other imports. A Fukushima-effect is possible, but not evident. The more important take-away is that the strong trade balance deterioration in 2013 is mostly due to increasing non-energy related imports. Thus, the restart of nuclear plants expected for later in 2014 is unlikely to improve the trade deficit notably.

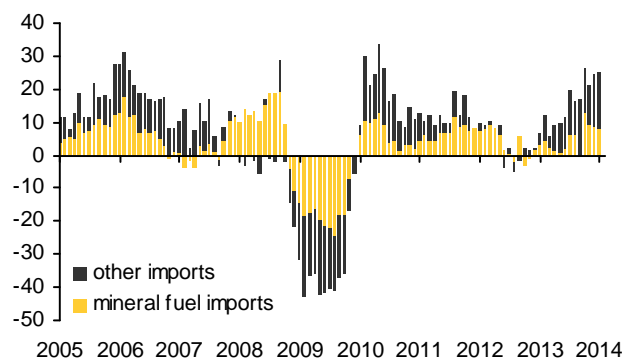
The preceding analysis allows one conclusion only: The Japanese trade deficit will sustain for some time to come. As Japan needs to prevent a CA deficit, further JPY depreciation is unavoidable. The remaining alternative to get the hang of the trade balance are fast and effective structural reforms, the third arrow of Abenomics. But reforms never come without pain, and Japanese consumers already suffer from increased prices. Further reforms are therefore not feasible. In line with our forecast, we will have to face a much weaker JPY in the next years.

CHART 2: Trade balance drags the current account down
Trade and current account balance in trillion JPY



Source: Ministry of Finance Japan , Commerzbank Research

CHART 3: No predominant Fukushima effect
Yoy nominal import growth in percent



Source: Ministry of Finance Japan , Commerzbank Research

G10 Highlights

For the moment, EUR-USD likely to remain at high levels. GBP losing steam? Key rate to rise in NZ. Risk of a Riksbank rate cut still persists.

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EUR-USD: Last week the round went to the euro. Even the surprisingly strong US NFP report didn't manage to counter ECB President Draghi's statements. No word of a possible expansion of monetary policy. It seems that the hawks didn't even have to argue for a second against any additional expansionary measure, that there wasn't a discussion at all. Consequently, EUR-USD trades just shy of 1.39. For the moment, this is likely to continue, a test of 1.40 can't be excluded. Until the market realises that a strong euro weighs on inflation, increasing the risk of new expansionary measures in the fight for price stability. This will take some time, though.

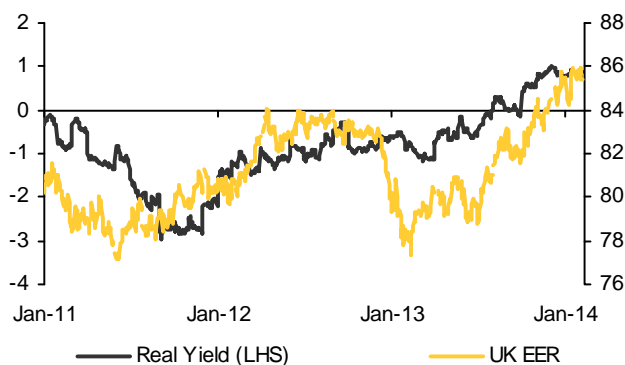
GBP: Last week sterling lost ground, in particular against the EUR following the ECB meeting on Thursday when the ECB refrained from further expansionary measures. The losses come despite the fact that UK PMI data for February printed at robust levels indicating that the UK economy continues to expand at quite a rapid pace. Likewise real yield developments continue to underpin further sterling gains. Indeed IMM data indicate that speculators actually increased their net long sterling positioning last week, hence we are of the view that the move in EUR-GBP will not last and recommend investors to re-enter short positions around 0.8380.

NZD: Neither low interest rates in other industrialised countries nor a strong NZD will prevent the RBNZ from raising the key rate this week. There is even the chance that it will go for 50 bps. Since 3 years now the key rate has been at a historically low 2.5%, which means a very expansionary policy. Due to the rising inflation the RBNZ already signalled in January that it will hike the OCR. Recent data confirm that the RBNZ has to act quickly in order to avoid an over-heating. Business confidence has reached 20-year highs, consumer confidence 7-year highs, the outlook for investment and employment being excellent. Construction is booming, house prices have risen strongly and inflation expectations are increasing. It is time to act. A 25 bp hike is priced in and will have limited effect on the NZD. It may even trigger some disappointment and weigh on the NZD. More important will be the statement. If it signals further near term and/or a series of quick rate hikes, the NZD will rise. A 50 bp rate hike would be a surprise and catapult the NZD above 0.8550 towards last year's highs at 0.8677.

SEK: A look at the most recent CPI data for February in Sweden shows that the risk of another rate cut persists. Y-o-y inflation fell by 0.2%, core rose only by 0.4%. Riksbank expects a 0.6% inflation rate for 2014 and a core rate of 0.9%. The longer inflation remains low at the beginning of the year, the more difficult it will be to reach these projections. Since Riksbank expects quite solid growth this year (2.4%), it is a matter of inflation if it will cut the key rate again. If inflation remains too low, the Executive Board will be unanimous to cut again. The risk is not imminent, though, since economic dynamics should drag inflation higher over time. This means that EUR-SEK can move lower over the next few weeks if upcoming economic data is positive.

CHART 4: UK real yields remain GBP supportive

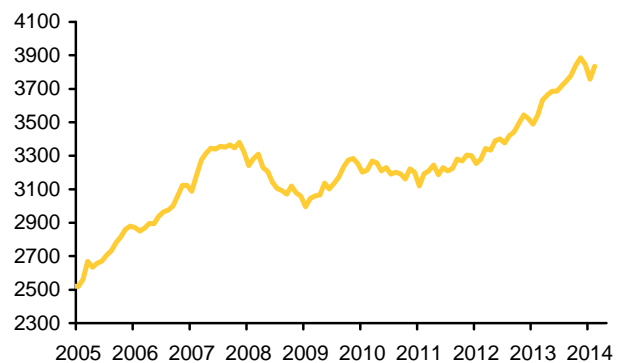
UK Real Yield in %



Source: Commerzbank Research

CHART 5: House prices in NZ continue to rise

REINZ house price index, 1992=1000



Sources: Real Estate Institute of NZ, Commerzbank Research

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.

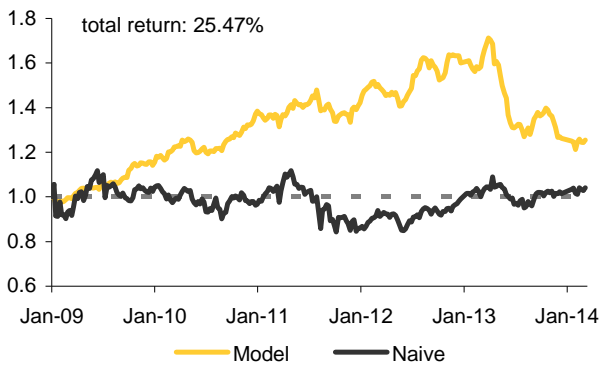
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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CHART 6: Historic performance of optimized Carry Trade Portfolio

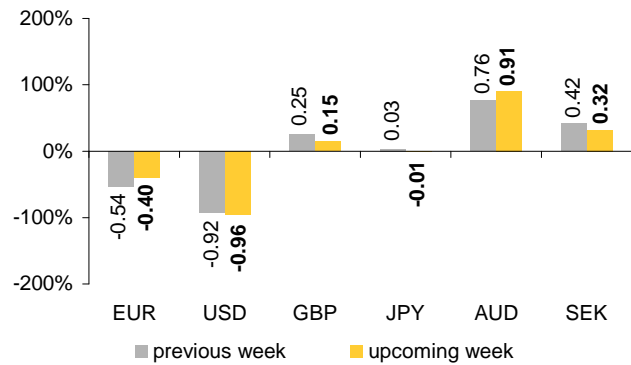
Cumulative return¹ since 6 January 2009, weekly rebalancing, target variance: 6%; Naïve strategy: B&H strategy, 3 high yielders long, 3 low yielders short; Currency basket: EUR (base), USD, GBP, JPY, AUD, SEK, CHF (excluded after Sept 2011)



Source: Commerzbank Research

CHART 7: Portfolio weights for week 11 to 18 March

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

Busy week in Brazil. CZK remains resilient. ZAR – Current account in focus.

BRL: The minutes of the late February meeting signalled that the Brazilian central bank is prepared to take further rate steps. While we consider a further rate hike in April to be relatively likely it is not clear how things are going to progress after that. The central bank’s decisions will depend on future data publications – more so than is already the case. Following rate hikes of 350bp since April 2013 the central bank is likely to favour an imminent pause. For it to do so inflation in particular would have to develop favourably. As a result the focus is on the publication of February price data on Wednesday. A notable rise of the inflation rate following 5.6% in January would therefore cause speculation that the central bank will not only hike the key rate in April but also at the following meetings. The BRL is likely to benefit in a first reaction. However, there is not much downside scope in USD-BRL. There are numerous risks this year – e.g. presidential elections in October, risk of a rating downgrade – and the economy is still cause for concern. There is some important data due for publication on the latter this week: industrial production today, retail sales on Thursday as well as the economic indicator on Friday. Only generally positive surprises and increasing rate speculation would be able to push USD-BRL below the 2.30 mark on a sustainable basis. However, we see more of a risk of the economic data disappointing and therefore consider a scenario of this nature to be rather unlikely.

CZK: Despite dovish comments by CNB governor Singer, the CZK is holding up its ground. In Singer’s view there is a chance that the central bank will extend its intervention regime beyond the beginning of 2015. This is due to the fact that inflation remains subdued and might possibly reach the CNB’s target only at the beginning of 2015 instead of at the end of this year. Due to the safe haven status of the CZK, this is however doing little to weaken the currency. Moreover, Czech economic data generally has been surprising on the upside, e.g. Q4 GDP growth, which is balancing out weak inflation.

ZAR: The main event for ZAR traders this week will be the release of current account data for Q4, released on Wednesday. Expectations are for a print of -5.4% of GDP, which would be a clear improvement on Q3’s 6.8% deficit. The risk is that improvements in cyclical data such as manufacturing production are not picked up yet in the data, meaning that ZAR may well reverse its recent gains. However, given the lagged impact of ZAR’s depreciation since June of last year, the current account deficit should begin to narrow in the coming quarters.

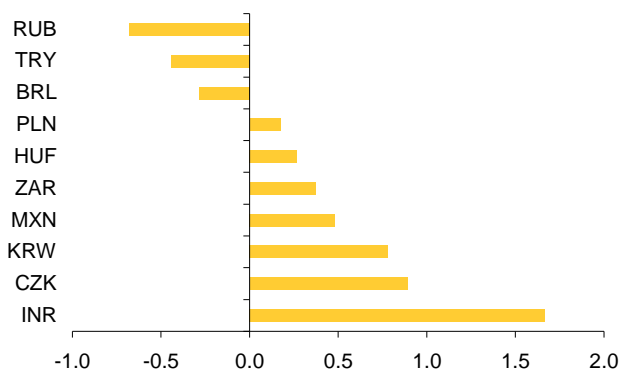
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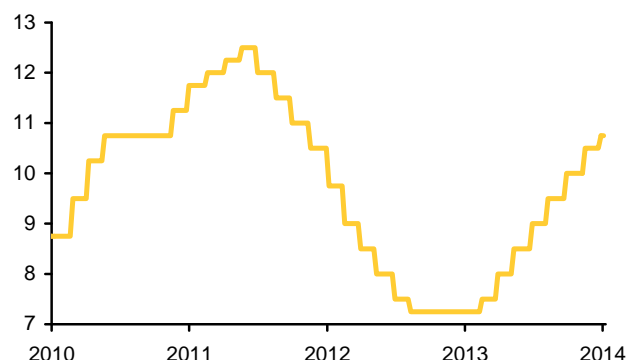
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CHART 8: CZK remains strong
Gains/losses against USD since 4th March 2014



Source: Commerzbank Research

CHART 9: BCB already tightened aggressively, but signals at least one more rate hike
Brazil target rate in percent



Source: Commerzbank Research

FX portfolio recommendation

Core trading views:

- Position for sterling outperformance in Q1
- Expect USD weakness to persist in the short term
- Sell upside volatility in USD-RUB
- Maintain low delta downside in EUR-JPY as a tail hedge

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Tactical trading views:

- We take profit on the USD-CHF 0.87 put

Last week the theme of broad USD weakness continued and was given further momentum following the ECB's decision to refrain from further easing measures. Nonetheless we take profit on the USD-CHF put in our portfolio for reasons which we explain below.

We added a short USD-RUB put, 39.00 strike, for a premium of 1% to the portfolio following CBR's moves last week to increase the amount of daily interventions required for shifts in the trading corridor. These actions will decrease volatility and at the same time limit further upside in the RUB trading basket.

Our remaining positions exhibited slight losses over the week. The NZD-USD risk reversal underperformed due to USD weakness and modest gains for G10 high yielders. That said we are of the view that NZD gains are likely to be fleeting and are content to hold the position. At the same time, EUR-GBP appreciated following the ECB rate decision and took out stops above 0.83. We are content to maintain the position at present given the strong UK PMI data last week and should the move continue towards 0.8380 we will consider initiating short EUR-GBP cash positions.

Finally the downside position in EUR-JPY, which is basically worthless by now, will be allowed to expire in 2 weeks time.

TAB. 1: Global FX Strategy Spot Portfolio

Trade date	Strategy	Size (€mln)	Entry level	Stop	% Gain / Loss	Take Profit	Open / Closed
14.01.2014	Short EUR-USD	1	1.3680	1.3780	0.17%	1.2610	Closed
14.01.2014	Long USD-CHF	1	0.9015	0.8745	1.05%	0.9730	Closed
14.01.2014	Long USD-CAD	1	1.0900	1.0560	0.56%	1.1760	Closed

Source: Commerzbank Research, Bloomberg LP

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

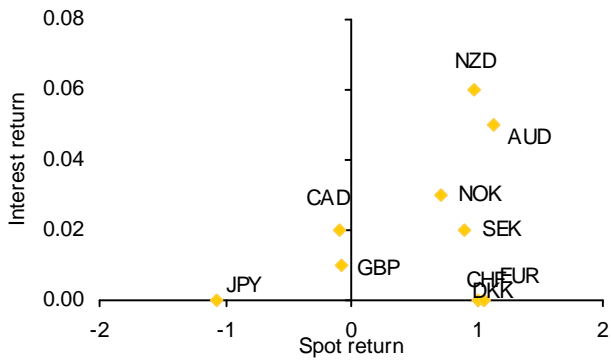
Trade date	Strategy	Expiry	Size (€mln)	Premium	Value	P&L	Open / Closed
28.01.2014	Long EUR-JPY 127.00 put	24.03.2014	1	-0.15%	0.00%	0.15%	Open
18.02.2014	Long EUR-GBP put spread 0.81 / 0.78	15.05.2014	1	-0.78%	0.23%	0.55%	Open
18.02.2014	Long USD-CHF 0.87 put	31.03.2014	1	-0.21%	0.26%	0.05%	Closed
04.03.2014	Short USD-RUB 39.00 call	04.07.2014	1	+1.00%	0.98%	0.02%	Open
04.03.2014	Short NZD-USD risk reversal 0.86/ 0.78	03.09.2014	1 x 1	-0.13%	0.29%	0.42%	Open

Source: Commerzbank Research, Bloomberg LP

Tactical trading views:

- We take profit on the USD-CHF 0.87 put. We originally implemented the position to benefit from USD weakness and the possibility of an increase in risk aversion. However data releases in the meantime continue to underpin broadly positive risk sentiment and as such we are content to close the position for a small profit.

CHART 10: Classic 'risk on' week on week
% Gain / Loss Vs. USD since 4th March 2014



Sources: Commerzbank Research, Bloomberg LP

CHART 11: USD-RUB volatilities fall after CBR step in
USD-RUB 3 Month ATM vol in % vol



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

USD-CAD is holding sideways but this is viewed as a bullish consolidation

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Our initial upside target of 1.1187/1.1244 was met at the end of January and since then the market has basically consolidated sideways. This band of resistance represents the 1991 low and the 50% retracement of the move down from 2009-2011 and while we acknowledge that it is a tough barrier to break, the market is we suspect simply consolidating below this level, building the stamina to break higher. We suspect that the market is developing a potential bullish symmetrical triangle and while above the 1.0950/12 region is actually well placed to resume its bull move.

We maintain that the USD-CAD chart is bullish longer term. It has completed a large base between 1.0660 and 0.9403. This base took almost 3 years to complete, and the pattern broke higher earlier this year. It offers an upside measured target to 1.19 longer term. Given that the base took 3 years to complete, this target is achievable in approximately half of that time, i.e. by Q2 2015. We should therefore see the Canadian Dollar come under pressure throughout much of this year.

Below the 1.0912 February low would trigger a deeper sell-off, we suspect back towards the previous high charted in 2011 at 1.0660. However key support remains the 1.0439 2012-2014 uptrend. While above here, a longer term upside bias is maintained.

CHART 12: USD-CAD daily
 Bullish consolidation



Source: CQG, Commerzbank Research

CHART 13: USD-CAD weekly
 Is consolidating below Fibon support



Source :CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
12 March	08:00	HUF	Industrial production	mom	JAN F	-	3,1
				yoy	JAN F	-	6,1
	08:00	TRY	Current account balance	USD bn	JAN	-5,3	-8,3
	10:00	EUR	Industrial production	mom	JAN	0,5	-0,7
				yoy	JAN	1,9	0,5
	11:00	USA	MBA Mortgage Applications	%	MAR 7	-	9,40
	12:00	RUB	CPI weekly year to date	%	MAR 10	-	1,4
20:00	NZD	Interest rate decision	%	MAR 13	2,75	2,50	
13 March	00:01	GBP	RICS housing market index		FEB	52,0	53,0
	00:30	AUD	Employment change	K	FEB	15,0	-3,7
				%	FEB	6,0	6,0
	08:30	SEK	Unemployment rate		FEB	8,4	8,6
				ZAR	Industrial production	mom	JAN
				yoy	JAN	1,9	2,5
	11:00	RUB	FX and gold reserves	USD bn	MAR 7	-	493,3
	12:30	USA	Initial jobless claims	K	MAR 8	330	323
	12:30	USA	Import Prices	mom	FEB	0,5	0,1
				yoy	FEB	-1,9	-1,5
	12:30	USA	Retail sales less vehicles	mom	FEB	0,2	-0,4
mom				FEB	0,1	0,0	
14 March	04:30	JPY	Industrial production	mom	JAN F	-	4,0
				yoy	JAN F	-	10,6
	07:00	GER	Consumer prices	mom	FEB F	0,5	0,5
				yoy	FEB F	1,2	1,2
	08:00	CZK	Industrial production	yoy	JAN	6,7	9,3
	08:15	CHF	Producer and import prices	mom	FEB	-0,1	0,0
				yoy	FEB	-0,5	-0,3
13:00	PLN	Consumer prices	mom	FEB	0,1	0,1	
			yoy	FEB	0,8	0,7	
13:55	USA	Michigan consumer confidence		MAR P	82,0	81,6	
17 March		GBP	Rightmove House Prices	mom	MAR	-	3,3
				yoy	MAR	-	6,9
		CZK	Producer price index	mom	FEB	0,0	-1,3
				yoy	FEB	-0,6	-0,7
	10:00	EUR	Consumer prices	mom	FEB	-	0,4
yoy				FEB F	-	0,8	
core rate				yoy	FEB F	-	1,0
-	RON	Current account balance	EUR mn	JAN	-	-1506	

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