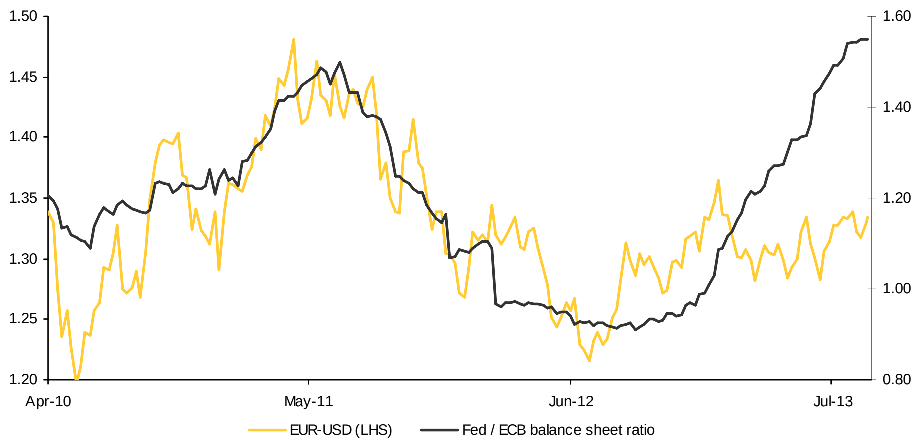
FX Alpha

17 September 2013

Tapering – What's priced in for the USD?

Tapering – What's priced in for the USD? Markets have priced in the Fed tapering by a small amount. The risk is not just that they do more rather than less but also a change of forward guidance criteria.

CHART 1: **USD enjoys the benefit of the doubt**
EUR-USD spot, Fed / ECB Balance Sheet Ratio



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. GBP tighten up on stops. EUR benefits from positive data, will it last? RBA in wait and see mode.

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

EM Highlights. CPI data the main event risk for ZAR. Banxico minutes hold key to further rate cuts in Mexico. CBR moves towards inflation targeting regime.

Tactical trade recommendation. Fade the move in AUD to establish long GBP-AUD positions.

Technical Analysis. AUD-USD short term strength viewed as corrective. Maintain a longer term negative bias

Event calendar. It's all about the Fed meeting on Wednesday. Apart from this, Retail sales in the UK will be an important data release as well as German PMI readings.

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Tapering – What's priced in for the USD?

Markets have priced in the Fed tapering by a small amount. The risk is not just that they do more rather than less but also a change of forward guidance criteria.

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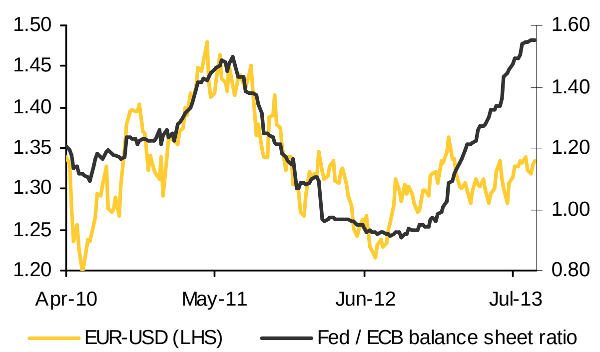
Coming into the Fed's meeting this week markets have priced in a modest tapering of QE3. 10 Yr yields have rallied over the summer and now trade around 2.80%. The USD has been given the benefit of the doubt by markets (Chart 2) and trades at levels below what might be suggested on the basis of relative liquidity policy. The decision to taper is not based on an improvement in US economic data alone. Fed members are no doubt concerned about the risks posed by a balance sheet that is now coming close to $3.4 trillion. Tapering in this sense is clearly justified and expected. There are two dynamics to consider: one is if the Fed does more than the market expects (they could hardly do less!) and the second is a change in forward guidance criteria.

Regarding the amount by which the Fed will taper, market consensus is for a decrease of between $10 and $15 billion USD. The risk to the scenario is that the Fed do slightly more, which is understandable in the context of a generally improving economic outlook. This would be a clearly positive development for the USD and would be consistent with the normalization of monetary policy (Chart 3). The impact would likely be seen in the 10 yr part of the yield curve and therefore USD-EM would come under a more pronounced appreciation pressure. Investors could therefore use the recent bout of USD-EM weakness to establish small long USD-EM positions coming into the meeting.

The Fed however seems keen to ensure that tapering does not impact upon expectations of rate hikes. Whether this is a realistic view on the part of the Fed is another matter. It really strikes of the Fed as wanting its cake and eating it too! To this end the Fed could well announce a shift in its forward guidance criteria towards an unemployment rate of 6%. As such, the recent move in short term spreads in favour of the USD could well take a breather and so too, could any signs of nascent USD strength. Indeed such a move for us would cause more problems than it solves. For a start the market could well begin to question the usefulness of guidance policies altogether if central banks (and the Fed especially) make up the rules as they go along (though one might hasten to say that this dynamic hasn't done the EUR any harm!). Another view would be whether an extended easing of monetary policy is likely to impact upon unemployment rates in a meaningful manner. Our view is that it would not. The US labour market clearly suffers from structural deficiencies that no amount of QE can ever hope to resolve.

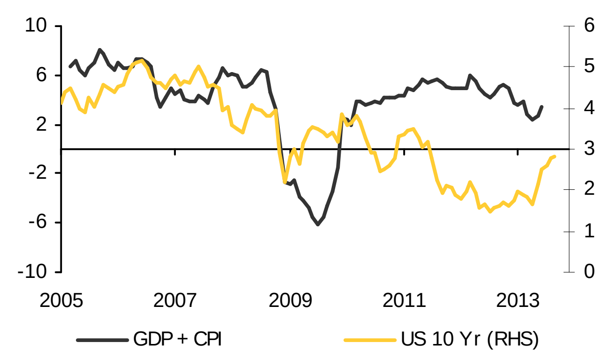
Therefore markets face a difficult decision in terms of interpreting the Fed's decision to taper on a short term basis. On a longer term basis however, the arguments in favour of a broadly stronger USD are starting to mount; positive real yield developments, a normalization of monetary policy, positive economic growth to name but a few. It's just a matter of time.

CHART 2: **USD enjoys the benefit of the doubt**
EUR-USD spot, Fed / ECB Balance sheet ratio



Source: Commerzbank Research, Blomberg LP, ECB, Federal Reserve

CHART 3: **Longer term yields going higher**
US 10 Yr yields in %, US GDP yoy + CPI yoy in %



Sources: Commerzbank Research, Bloomberg LP

G10 Highlights

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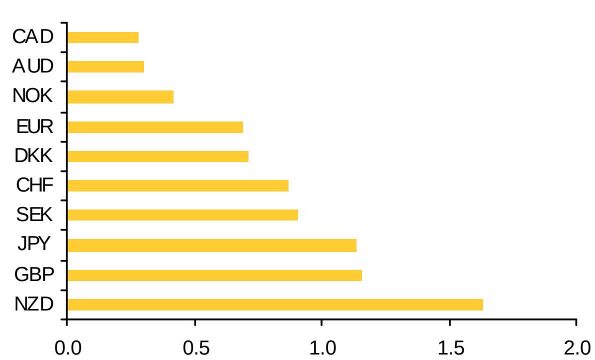
GBP-Time to tighten up stops. EUR benefits from positive data, will it last? RBA in wait and see mode.

GBP: The main highlight for sterling investors over the coming week lies with the publication of BoE minutes from the last MPC meeting and retail sales data on Friday. The BoE minutes will likely highlight the improvement in cyclical UK economic data but also mention the nascent tightening in financial conditions since August (sterling appreciation, gilt yields higher etc). What will be of interest is whether concerns of a housing bubble will register in the MPCs thinking. On a broader note, it is probably prudent to tighten stops on long sterling positions. Composite UK economic data has printed at multi year highs and is sure to give way to a more balanced profile in the coming weeks. The base case for modest sterling appreciation remains, albeit that it might be getting slightly ahead of itself at the moment.

EUR: The USD is suffering from the perspective of Janet Yellen becoming the next Fed President. Looking at the EUR things seem to be rather quiet so far. Everybody knows that Greece will need more money and even the German elections do not contain any threat that the money might not flow. However, after the German election problems might pop up not only in Greece. There are several other countries which might not be able to service their debt without help from other countries. This would sooner or later lead the market conclude that the ECB will in fact not be able to hike interest rate any time soon. Concerns about ECB's forward guidance could fade with the problems within the euro zone becoming more obvious again. In the meanwhile the latest economic data out of the euro zone were pretty positive signalling once more that the recession seems to be over. However, positive macro data usually support the respective currency due to rate hike expectations. If these would be dampened in the euro zone due to weak state finances the euro might not benefit from an economic recovery in the medium term.

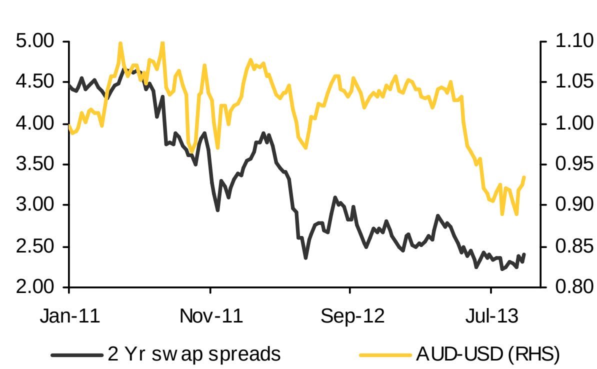
AUD: The RBA will remain in a wait and see mode for the time being. At the rate meeting at the beginning of September, the statement was almost entirely unchanged compared to August, which wasn't a surprise considering the fact that the RBA had revised its forecasts lower in August already. In September, the reference to the inflation outlook providing scope for further cuts was dropped, signalling a shift to a neutral bias. On the backdrop of recent friendly Chinese data and improving sentiment indicators in Australia as well as positive signs from consumption and housing, we stick to our view that the RBA will remain on hold now and count on a weak and further declining AUD in order to help the rebalancing of the economy – meaning less growth in the mining sector and more growth in other sectors of the economy. Therefore, the upside in the AUD is limited and we are sellers at 0.94 or higher in AUD-USD, with a year-end target of 0.90.

CHART 4: **USD the laggard over the week**
% Gain / Loss Vs. USD since 10th September



Source: Commerzbank Research, Bloomberg LP

CHART 5: **Aud moves, swaps don't…**
AUD-USD spot, 2 Yr swap spread



Source: Commerzbank Research, Bloomberg LP

FX Metrics

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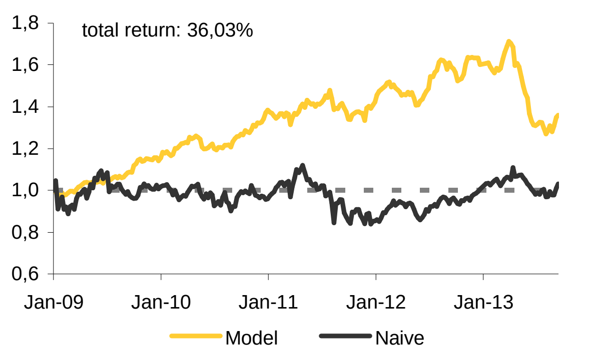
G10 carry trade indices

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.

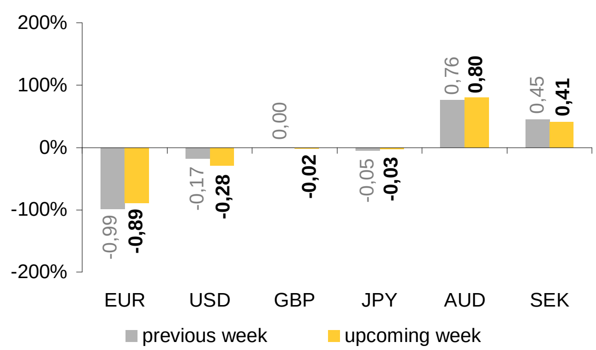
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 17 Sep to 24 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.

[1] Returns are based on Tuesdays' London opening

EM Highlights

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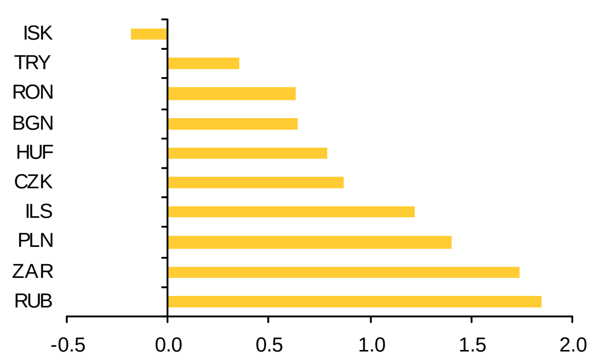
CPI data the main event risk for ZAR. Banxico minutes hold key to further rate cuts in Mexico. CBR moves towards inflation targeting regime.

ZAR: CPI data released tomorrow and retail sales released on Thursday are the key highlights for ZAR over the coming week, not to mention the Fed meeting on Wednesday night. ZAR moves since May have primarily been a function of the moves in US treasury yields with domestic data having relatively little impact upon exchange rates. That said, the domestic situation obviously remains problematic with inflation continuing to print at relatively high levels. Expectations are for a print in the region of 6.4% yoy, which remains above the target band. This leaves SARB with little room for maneuvre on Thursday's rate meeting where we expect rates to remain on hold at 5.0%.

MXN: After the surprise rate cut at its last meeting the release of the central bank minutes this Friday will be watched carefully for any hints of another rate cut in October. We do not see much room for the central bank to be much more expansionary. Although economic data proved to be weak recently we expect a turning point in the second half of the year. The Mexican economy should benefit from the US recovery and from the countercyclical measures and reforms announced by the government. Additionally, inflation stands at 3.50 % (inflation target: 3.0%) which leaves only limited room for rate cuts. Hence, although we see the chance that the central bank might cut its target rate by another 25 bps, it should stay on hold afterwards for some time. Therefore monetary policy should be no major burden for the MXN. However, since the main event of this week is the meeting of the Fed the release of Banxico's meeting minutes might take a backseat and have only a small impact on the peso.

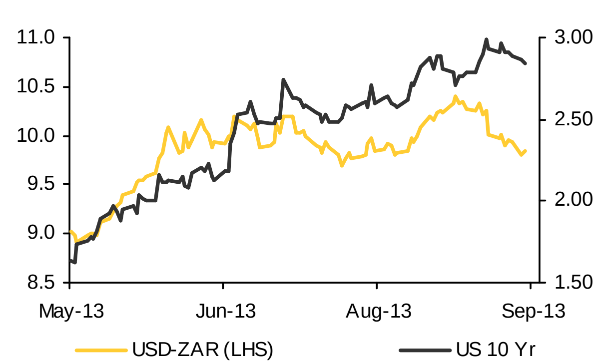
RUB: Last Friday CBR left key rates on hold at 5.50% as expected. CBR also took another step towards an inflation targeting regime by announcing that they would move towards a single key rate, the one week auction rate. It is hoped that this will improve the efficiency and transperancy of monetary policy in Russia over the longer term. In the meantime risk premia on local market bonds continue to fall in line with falls seen in US treasury yields, such that the RUB has been able to appreciate. However we maintain a moderately bearish stance on the RUB over the medium term given the slowdown in growth and persistently sticky inflation outlook.

CHART 8: **EM back in the black over the week**
% Gain / Loss Vs. USD since 10th September



Source: Commerzbank Research, Bloomberg LP

CHART 9: **ZAR moves in line with US 10 Yr yields**
USD-ZAR spot, US 10 Yr in %



Source: Commerzbank Research, Bloomberg LP

Tactical trade recommendation

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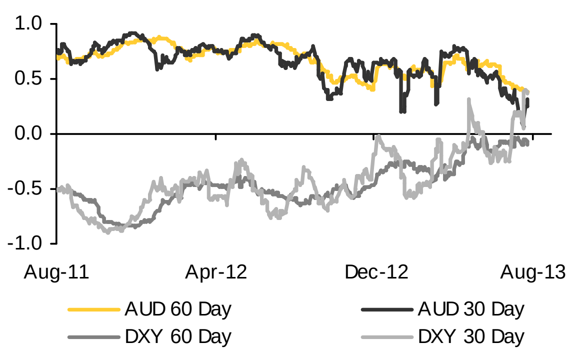
Fade the move in AUD to establish long GBP-AUD positions

Coming into the Fed meeting this week we see the USD weakening and higher yielding currencies appreciating in a move that resembles the typical risk on - risk off regime that investors have become used to over the last number of years. However we know that there has been a significant breakdown in correlations amongst higher yielding currencies since the Fed indicated its intention to taper. Despite all the noise surrounding the taper and the future chairmanship of the Fed, investors should focus on one thing; the days of abundant liquidity are at an end. AUD will not appreciate to the same extent as before.

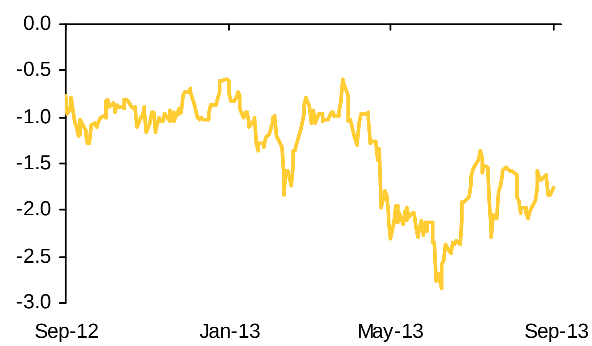
We therefore think that initiating long GBP-AUD positions offers decent scope for appreciation. For a start the pound will not be burdened by leadership issues nor by changing forward guidance criteria as might the USD. At the same time, AUD should struggle to rally given the RBA's attitude regarding the currency (which they still think will trade lower in the coming quarters). We recommend investors to buy a dip in GBP-AUD with a view to taking profit around 1.7480. We maintain a tight stop at 1.6660.

CHART 10: **AUD will not benefit as before**
AUD TWI & DXY correlation with S&P Index



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **AUD Riskies still skewed to downside**
AUD-USD 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-CHFc 1.2050	04.12.2013	1m	+1.10%	-0.07%	1.03%	Open
08.07.2013	Sell GBP-USD risk reversal 1.51 / 1.46	08.10.2013	1m x 1m	0.01%	-6.30%	-6.31%	Open
20.08.2013	Buy AUDp-JPYc 87.00	19.09.2013	1m	0.42%	0.02%	-0.40%	Open
03.09.2013	EUR-GBP seagull 0.86, 0.845, 0.825	14.10.2013	1m x 1m x 1m	0.25%	0.84%	0.59%	Open

Sources: Bloomberg L.P., Commerzbank Research

Technical Analysis

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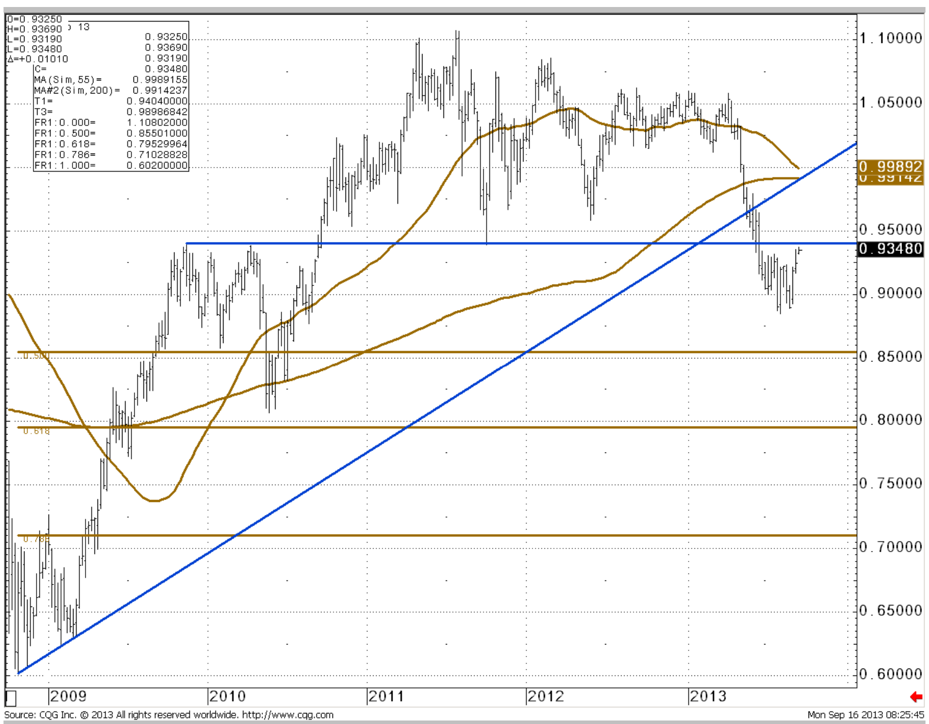
AUD-USD short term strength viewed as corrective. Maintain a longer terem negative bias.

The rebound seen from the end of August from the .8848/93 supports has been fairly solid, but remains well within the confines of a correction only. The rally will shortly encounter the previous break down point at .9388/.9404. This represents the November 2009 high, the April 2010 high and the October 2011 low, it is considered to be tough resistance and our favoured view is that we will see failure between here and the 0.9510/38.2% retracement of the move that we have seen this year so far.

We note that the daily chart is suggesting that the sideways to higher corrective move which has been evident since the beginning of August is in fact an 'a-b-c' correction which is nearing completion. We do have a another Elliot wave count on the weekly chart, which suggests that the correction could reach the 50% retracement resistance at .9715, however this is less favoured.

Longer term the market completed a large top in June 2013 (1.1080-.9388), which offers a downside measured target to approximately 0.7700. This top and target will remain entrenched while capped by the 0.9715 resistance.

CHART 1: **AUD/USD Weekly Chart**
Major reistance at .9388/.9404



Source: CQG, Commerzbank Research

Event Calendar

Date	Time (GMT)	Region	Release	Unit	Period	Survey	Prior
18 September	12:00	PLN	Producer price index	mom	AUG	0.1	0.2
				yoy	AUG	-0.7	-0.8
		RUB	CPI weekly year to date	%	SEP 16	-	4.6
	12:00	PLN	Sold Industrial Output	mom	AUG	-3.8	1.5
				yoy	AUG	2.7	6.3
	12:30	USA	Housing Starts	K	AUG	920	896
			Housing Permits	K	AUG	950	954
	18:00	USA	Interest rate decision	%	SEP 18	0.25	0.25
19 September	05:00	JPY	Leading Index CI		JUL F	-	107.8
			Coincident Index CI		JUL F	-	106.4
	07:30	CHF	Interest rate decision	%	SEP 19	0.00	0.00
	08:00	NOK	Interest rate decision	%	SEP 19	1.50	1.50
	08:30	GBP	Retail sales	mom	AUG	0.4	1.1
				yoy	AUG	3.3	3.0
	10:59	ZAR	Interest rate decision	%	SEP 19	5.00	5.00
	11:00	RUB	FX and gold reserves	USD bn	SEP 13	-	503.9
	12:30	USA	Initial jobless claims	K	SEP 14	330	292
	14:00	USA	Philadelphia Fed Index		SEP	10.4	9.3
	14:00	USA	Leading indicator CB		AUG	0.6	0.6
	14:00	USA	Existing Home Sales	mn	AUG	5.25	5.39
				mom	AUG	-2.6	6.5
20 September	12:30	CAD	Consumer prices	mom	AUG	0.1	0.1
				yoy	AUG	1.1	1.3
	14:00	EUR	Consumer confidence		SEP A	-14.5	-15.6
23 September	07:30	GER	PMI (Markit)		SEP A	-	51.8
	07:30	GER	PMI Services (Markit)		SEP A	-	52.8
	08:00	EUR	PMI (Markit)		SEP A	-	51.4
	08:00	EUR	PMI Services (Markit)		SEP A	-	50.7
24 September	07:00	CZK	Composite confidence indicator		SEP	-	-2.0
	08:00	GER	ifo business climate		SEP	-	107.5
			Current assessment		SEP	-	112.0
			Business expectation		SEP	-	103.3
	-	GER	Import Prices	mom	AUG	-	0.3
				yoy	AUG	-	-2.6

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