

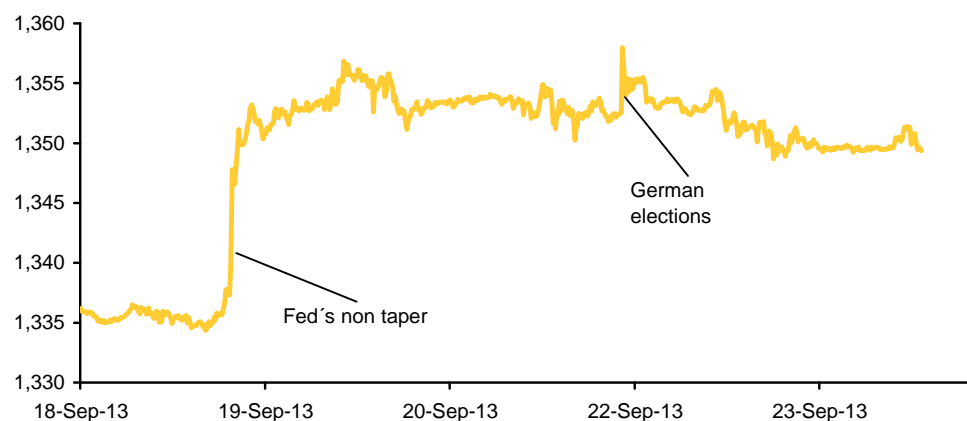
FX Alpha

24 September 2013

How fantastic is Angela Merkel's victory?

How fantastic is Angela Merkel's victory? Despite an overwhelming victory the lack of its coalition partner could turn Angela Merkel's triumph into a dilemma. Investors should have in mind the even a delay of building a new government can not completely ruled out.

CHART 1: Euro not effected by German elections so far
EUR-USD, spot, 10 minute data



Source: Commerzbank Research

CONTENTS

HOW FANTASTIC IS ANGELA MERKEL'S VICTORY? 2

G10 HIGHLIGHTS 3

FX METRICS 4

EM HIGHLIGHTS..... 5

TACTICAL TRADE RECOMMENDATION6

TECHNICAL ANALYSIS..... 7

EVENT CALENDAR 8

G10 Highlights. Markets are already focussing on next week's US employment report and ECB meeting. Tighten stops on long sterling positions. We warn against excessive NOK pessimism.

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

EM Highlights. Bol surprises markets. Capital market still frozen in Iceland. In EM, fundamentals matter.

Tactical trade recommendations. Sell strangles in EUR-USD.

Technical Analysis. GBP-USD's recent sharp advance looks to be on its last up leg.

Event calendar. US data like consumer confidence, durable goods, existing and pending home sales or private spending don't give hints about the future approach of the Fed on tapering.

How fantastic is Angela Merkel's victory?

Despite an overwhelming victory the lack of its coalition partner could turn Angela Merkel's triumph into a dilemma. Investors should have in mind the even a delay of building a new government can not completely ruled out.

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The German election result was of no great significance for the FX market so far. First of all it had generally been expected that Angela Merkel would win the election and secondly the euro-critical "Alternative für Deutschland" (AfD) did not manage to obtain 5% of the vote and therefore does not get any seats in parliament.

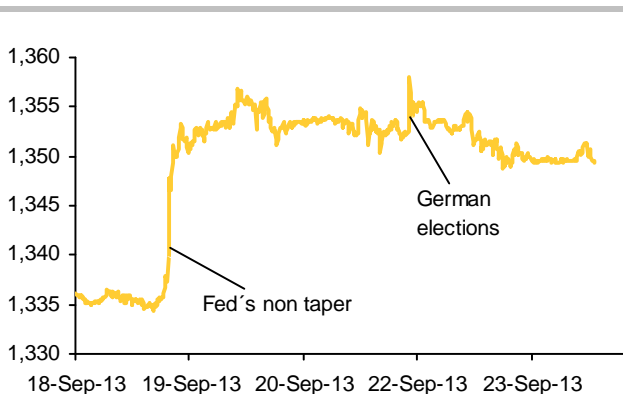
While the global media are celebrating the election result as Merkel's big victory she will probably struggle to form a government – and will struggle to govern thereafter. As the Liberals did not reach 5 per cent of the vote and have no seats the Christian Democrats lack a suitable coalition partner. While it does not usually take very long for a government to be formed following an election in Germany, the situation is particularly tricky this time round.

A cliff hanger would end up affecting the euro as well. A situation such as that could arise if the Social Democrats initially decided against a grand coalition. From the Social Democrats' point of view that would make tactical sense. After all the past eight years have shown that being Merkel's junior partner in a coalition leads to an election defeat. While it was the Social Democrats who suffered in the 2005 elections following the grand coalition it was now the turn of the Liberals. The same applies for a coalition with the Greens, which some Christian Democrats had been suggesting. Moreover this solution seems rather unlikely. First of all, the Bavarian sister party, the CSU, has reservations regarding the Greens. Secondly actual coalition negotiations with the Christian Democrats might tear the Greens apart.

So for the first time German politicians could disappoint the international financial markets, should it be impossible to form a government before the new parliament convenes in 30 days. Even if this is not the most likely outcome, investors should keep this possibility in mind. After all it is no secret that European politicians will soon have to decide about new aid programmes again. While a third aid packet for Greece has already been openly referred to, it does not require prophet like abilities to predict that other countries will soon announce that they are also in trouble. Under these circumstances markets might get nervous even if there is no opposition of note against further aid measures amongst German parliamentarians. The delayed formation of a German government would still leave the euro zone incapable of action.

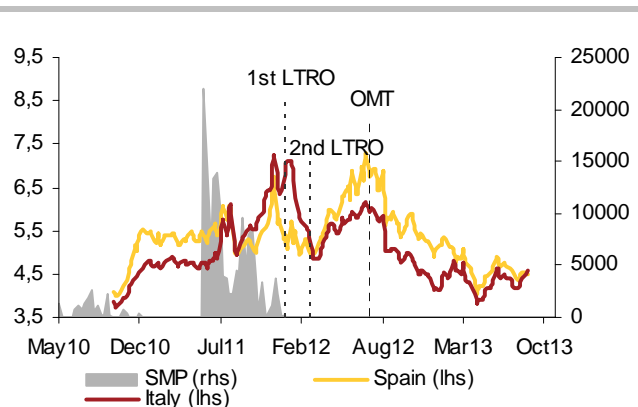
Admittedly, the financial markets seem to have shaken off the debt crisis since Draghi's OMT promise. But this does not mean that the underlying problems within the euro zone are solved. And it is not the ECB's job to keep the euro zone together even if central banks around the world currently tend to pretend that they can achieve almost any goal.

CHART 2: Euro not effected by German elections so far
EUR-USD, spot, 10 minute data



Source: Commerzbank Research

CHART 3: It is all about OMT promise
ECB bond purchases within the SMP in EUR ban and yield of 10 year government bonds in percent



Source: Commerzbank Research

G10 Highlights

Markets are already focussing on next week's US employment report and ECB meeting. Tighten stops on long sterling positions. We warn against excessive NOK pessimism.

EUR: A couple of big events are behind us: the FOMC meeting, which increased uncertainty among market players about the Fed's policy on QE3 tapering, and the German parliamentary election. EUR-USD has settled around the 1.35 level. Considering the limited event calendar this week, the market will continue to lick its wounds after the surprising FOMC outcome and was happy to take some profit after the German election. US or EZ fundamental data are good for a couple of pips these days but don't generate a new assessment of the overall situation since they don't give any major hints about the Fed's taper approach or the ECB's future policy. Therefore, ahead of next week's first tier US economic data, especially the ISM index and the unemployment report, as well as the ECB meeting, which markets expect to bring more clarity about the LTRO talk of several ECB members and the possibility of another rate cut, trading is likely to be technically driven and rather slow.

GBP: In an interesting speech yesterday, MPC member Broadbent outlined his thinking behind conditional forward guidance, specifically saying that it would be 'appropriate to consider withdrawing some of the monetary easing in place if we see a marked decline in the single most reliable, albeit lagged, measure of spare capacity, namely the rate of unemployment'. Markets seem to echo this sentiment as they have priced out any increase in asset purchases for some-time, and sterling has appreciated as a result. This is not to say that all is rosy in the garden. Current account data due for publication later in the week will continue to show that the UK runs a sizeable deficit at over 3% of GDP, whilst Q2 GDP data revisions are forecast to print at +0.7% qoq (+1.5% yoy). Data releases are unlikely to print at robust levels continually and as such it makes sense to tighten stops on long sterling positions, especially against the EUR.

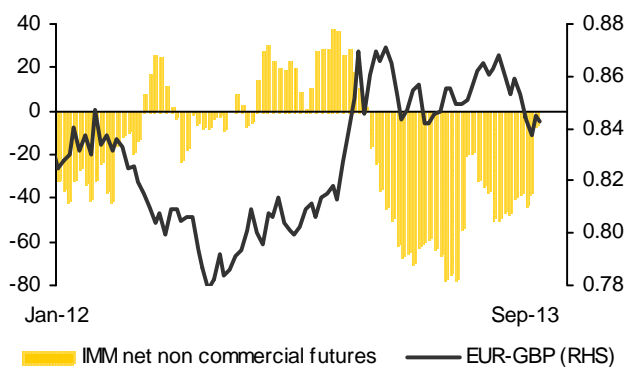
NOK: The NOK is under pressure again. The recent move is predominantly due to strong fluctuations in NOK-SEK as investors are clearly trading the different central bank monetary policies. Riksbank Governor Stefan Ingves referred to the Swedish krona as reflecting the Swedish economy. The fact that Norges Bank acted rather cautiously last Thursday will now be interpreted in favour of SEK and against NOK. During the course of the week the Norwegian unemployment rate as well as some important Swedish data such as sentiment indicators and retail sales will be on the agenda. If the Swedish data convinces, NOK-SEK will ease towards the August lows. However, we warn against excessive NOK pessimism: first of all the interest rate policies of the two central banks do not differ that dramatically (first rate rise in the second half of 2014) and secondly Norges Bank can react quickly should inflation continue to rapidly move upwards. That means investors should pay close attention to Norwegian inflation data due for publication on 10th October.

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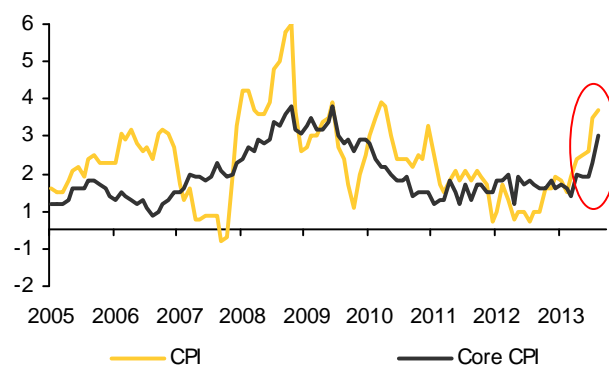
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CHART 4: Large decrease in short GBP positioning
EUR-GBP spot, IMM net non commercial futures



Source: Commerzbank Research

CHART 5: Beware of rising inflation rates in Norway
CPI and core CPI yoy, in percent



Source: 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.

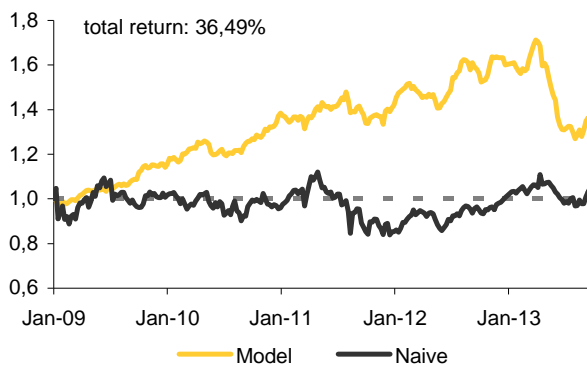
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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CHART 6: Historic performance of optimized Carry Trade Portfolio

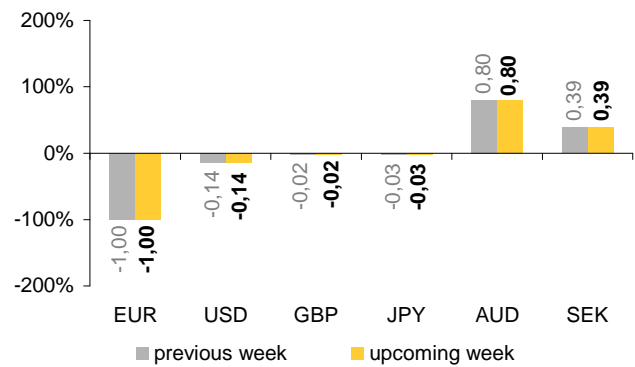
Cumulative return¹ since 6 January 2009, weekly rebalancing, target variance: 6%; Naïve strategy: B&H strategy, 3 high yielders long, 3 low yielders short; Currency basket: EUR (base), USD, GBP, JPY, AUD, SEK, CHF (excluded after Sept 2011)



Source: Commerzbank Research

CHART 7: Portfolio weights for week 24 Sept to 1 Oct

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

Bol surprises markets. Capital market still frozen in Iceland. In EM, fundamentals matter.

ILS: Yesterday the Bank of Israel surprised markets by cutting interest rates by 25 bps to 1.0%. We assumed that Bol had reached the trough in their rate cutting cycle because inflation data have started to rise, albeit at a modest pace, whilst house price appreciation pressures are once again an issue. Perhaps the cut to interest rates was in response to the appreciating shekel and following last week's Fed meeting one might say that this is a case of the Bol attempting to front run the market. It is clear that FX interventions have had limited success and now it seems Bol want to try another means of attenuating appreciation pressure. Irrespective of the reasons for the rate cut, the effect on the markets was hardly spectacular with USD-ILS appreciating by only 0.7%.

ISK: How are things looking in Iceland? Is there any hope for foreign investors to be able to bring their frozen assets back? Not really. We have always been sceptical whether Iceland would be able to and would want to remove the capital controls quickly. The Prime Minister elected in April, Sigmundur Gunnlaugsson, also dampens these hopes. Of course Iceland principally wants to ease the restrictions. However, that depends on those, whose funds are locked, assisting the country. If all investors were to remove their money at the same time as soon as capital movement was liberalised, Iceland would be facing the same problem as 5 years ago when the ice age of the Icelandic capital markets began. Of course the banks that went bankrupt as well as their creditors are trying to reach an agreement with the government, but so far negotiations have not even started. In the end the country has settled into the new circumstances and the economy is doing well: the unemployment rate is below 4% (just to illustrate: in early 2010 it stood at 9.3%), consumer propensity to consume is vigorous and the economic recovery will continue, but will lose some momentum in the second half of the year. In a situation such as this external creditors struggle to put pressure on Iceland. As a result the ice age on the Icelandic capital markets is likely to continue next winter.

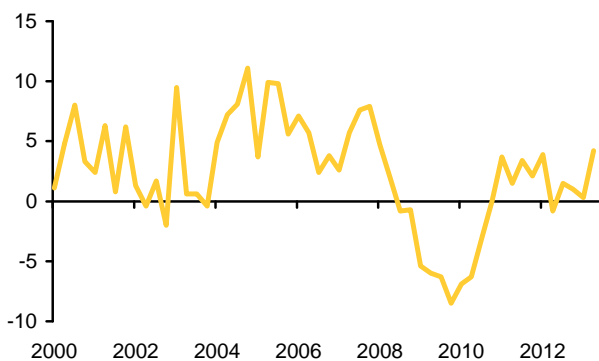
EMFX after the Fed: Following last week's Fed meeting investors bought EM currencies given the rather more benign outlook for external financing as the market started to price in less extreme rate scenarios as far as the Fed is concerned. Whilst this development is now fully priced in, what is rather more interesting is that investors can once again focus upon idiosyncratic issues within the EM complex. To some extent they already have. The chart below illustrates how investors are rewarding those currencies which have seen rate increases whilst those currencies which have done little or nothing in the way of rate rises have seen rather more limited gains, or in the case of ZAR, actual losses since the Fed meeting. The bottom line is that irrespective of external developments investors have to take a more selective approach towards investing in EMFX. Put simply, fundamentals matter and in this respect ZAR remains an unconvincing investment given its rate profile.

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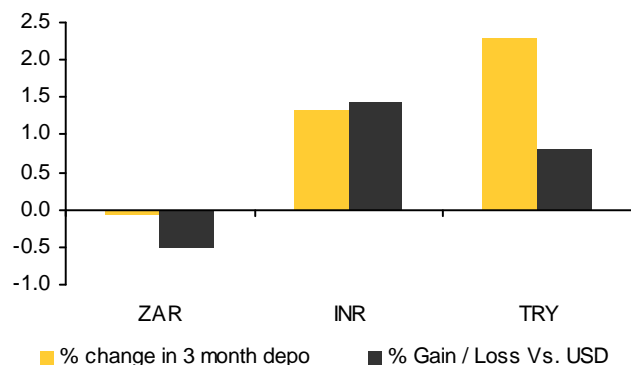
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CHART 8: Icelandic economy back on track
GDP, yoy, in percent



Source: Commerzbank Research

CHART 9: Idiosyncratic factors in the driving seat
% Change in 3 month depo since 1st May, % Gain / Loss Vs. USD since 17 Sep



Source: Commerzbank Research

Tactical trade recommendation

Sell strangles in EUR-USD.

Following the Fed's decision to refrain from tapering its QE3 program, investors should consider selling 3 month 1.38 / 1.25 strangles in EUR-USD.

The decision to refrain from tapering effectively means that EUR-USD will remain trapped within its recent range. The long awaited USD rally has been placed on hold. Significantly higher levels in EUR-USD are not likely to manifest due to valuation concerns whilst lower levels in EUR-USD are also unlikely because both short term rate spreads (which were moving in favor of the USD) and a lessened pace of balance sheet expansion will now not take place as previously assumed in the short term.

Once the Fed gives some clarity regarding their likely course of action investors can also expect volatilities to decline or at least stay at current levels. Significant increases in volatilities, which we assumed would take place as central banks were pulled and pushed in different directions, will not manifest to the same degree as we previously thought. Indeed, the one clear reaction from financial markets was for risk premia to decline following the Fed meeting last week. Thus, with volatilities unlikely to move higher in the coming weeks, selling short term volatility is a compelling trade.

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CHART 10: **G10 volatility remains subdued**

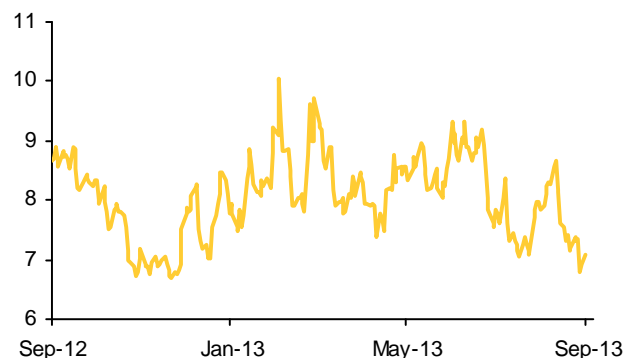
G10 3 Month implied volatilities in % vol



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **EUR-USD volatility comes lower post FOMC**

EUR-USD 1 Month ATM 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%	-0.10%	1.00%	Open
08.07.2013	Sell GBP-USD risk reversal 1.51 / 1.46	08.10.2013	1m x 1m	0.01%	-6.90%	-6.91%	Open
14.09.2013	EUR-GBP seagull 0.86 / 0.845 / 0.825	14.10.2013	1m x 1m x 1m	0.25%	+0.66	0.41%	Open
24.09.2013	EUR-USD strangle 1.38 / 1.25	23.12.2013	1m x 1m	0.61%	-0.68	-0.07%	Open

Sources: Bloomberg L.P., Commerzbank Research

Technical Analysis

GBP-USD's recent sharp advance looks to be on its last up leg

Over the past few weeks GBP-USD has been accelerating higher and made its current September high at 1.6105.

We are of the opinion that the currency pair may already have peaked at 1.6105 or that it will do so ahead of its four year resistance line at 1.6331 and the 2012 peak at 1.6369. Together with the April and September 2012 highs at 1.6302/07 these levels should stall any advance.

Since we can see a 13 count on the daily TD Sequential and a perfected sell setup on the weekly chart it looks likely that recent upside momentum should soon be on the wane.

A retracement back towards the June high at 1.5752 is thus expected to be seen in the weeks to come while resistance at 1.6302/69 caps on a weekly closing basis.

Should the 1.6302/69 resistance zone unexpectedly be exceeded, we would have to allow for the 2011 peak at 1.6745 to be reached. This we do not expect to happen, however.

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CHART 12: GBP-USD Weekly Chart

The July-to-September rally is to fail in the 1.6105/1.6369 region within the next couple of months



Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior	
24 September	13:00	HUF	Interest rate decision	%	SEP 24	3,60	3,80	
	14:00	USA	Case-Shiller house price index	yoy	JUL	12,4	12,1	
	14:00	USA	OFHEO House Price Index	yoy	JUL	0,8	0,7	
25 September	15:00	USA	Consumer confidence CB		SEP	80,0	81,5	
	07:00	GER	GfK Consumer Confidence		OCT	7,0	6,9	
	11:00	ZAR	Consumer confidence		3Q	-	1	
	12:00	USA	MBA Mortgage Applications	%	SEP 20	-	11,20	
	13:00	RUB	CPI weekly year to date	%	SEP 23	-	4,6	
	13:30	USA	Durable Goods New Orders ex Transportation	mom mom	AUG AUG	-0,1 1,0	-7,4 -0,8	
	15:00	USA	New home sales	K	AUG	420	394	
	26 September		EUR	M3 money supply 3 month av.	yoy	AUG	2,3	2,5
09:30		GBP	GDP	qoq yoy	2Q F 2Q F	0,7 1,5	0,7 1,5	
12:00		CZK	CNB interest rate decision	%	SEP 26	0,05	0,05	
12:00		RUB	FX and gold reserves	USD bn	SEP 20	-	504,0	
13:30		USA	Initial jobless claims	K	SEP 21	325	309	
13:30		USA	GDP annualized	qoq	2Q T	2,6	2,5	
27 September	15:00	USA	Pending home sales	mom	AUG	-1,0	-1,3	
	00:05	GBP	GfK Consumer Confidence ex fresh food and energy	mom	SEP SEP	-11 -0,3	-13 -0,4	
	00:30	JPY	CPI ex fresh food	yoy yoy	SEP SEP	0,5 0,3	0,5 0,4	
	07:00	GBP	Nationwide House Price Index	mom yoy	SEP SEP	0,5 4,4	0,6 3,5	
	07:30	HUF	Current account balance	€ mn	2Q	520	549	
	08:00	CHF	KOF leading indicator		SEP	1,45	1,36	
	08:30	SEK	Retail sales	mom yoy	AUG AUG	0,4 2,7	-0,7 2,1	
		EUR	Consumer confidence Industrial confidence Business confidence		SEP F SEP SEP	-14,5 -7,0 96,0	-14,9 -7,9 95,2	
	13:00	GER	Consumer prices	mom yoy	SEP P SEP P	0,0 1,5	0,0 1,5	
	13:30	USA	Personal income Personal spending PCE-deflator PCE core rate	mom mom yoy mom yoy	AUG AUG AUG AUG	0,4 0,3 1,2 0,1 1,3	0,1 0,1 1,4 0,1 1,2	
	14:55	USA	Michigan consumer confidence		SEP F	78,0	76,8	
	30 September	00:50	JPY	Retail trade	mom yoy	AUG AUG	- -	-1,7 -0,3
		00:50	JPY	Industrial production	mom yoy	AUG P AUG P	- -	3,4 1,8
		08:00	TRY	Trade balance	USD bn	AUG	-	-9,81
		08:00	HUF	Producer price index	mom yoy	AUG AUG	- 2,1	0,2 1,3
09:30		GBP	Mortgage approval	K	AUG	-	61	
10:00		EUR	Consumer price index core rate	yoy yoy	SEP SEP A	- 1,1	1,3 1,1	
-		RON	Interest rate decision	%	SEP 30	-	4,50	

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