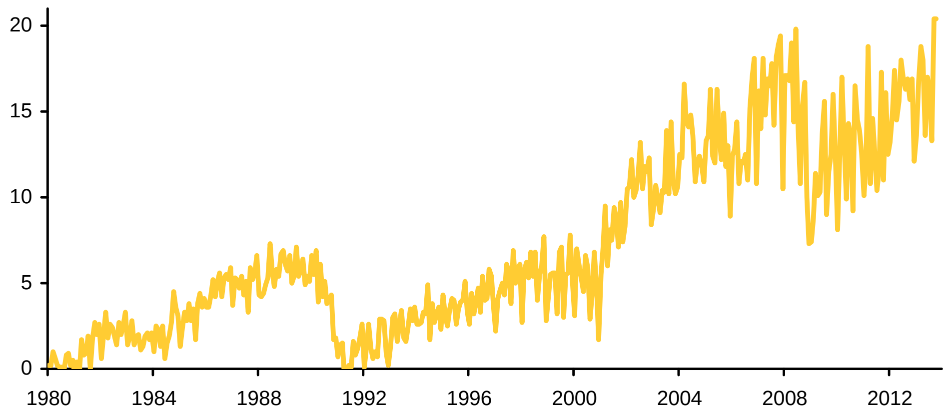
FX Alpha

The fairy tale of German superiority

12 November 2013

The fairy tale of German superiority. Time and again Germany's trade surplus is mentioned as the main reason behind other countries external imbalances. If the ECB would start verbal interventions to avoid the periphery being strangled by a strong euro German exporters would benefit unintended. Concerns that this would increase the cause of the periphery weakness are not justified.

CHART 1: **The German trade surplus on record high …**
Trade balance, EUR bn



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. EUR bulls bear up. GBP – Inflation Report is key. Inflation data weighs on SEK. NOK collapsing.

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

EM Highlights. RUB – Lower growth looms. Credible CNB interventions? Risk of Polish inflation surprise. Economic data should point to a slowdown in Brazil's economy.

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

Technical Analysis. GBP-USD – a potential top is developing.

Event calendar. The week of growth data: many countries will see the release of Q3 GDP data during the next days.

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The fairy tale of German superiority

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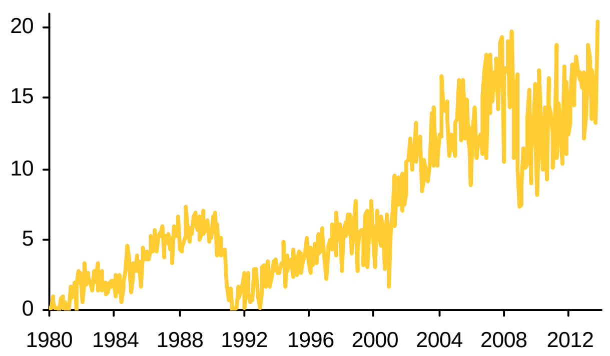
Time and again Germany's trade surplus is mentioned as the main reason behind other countries external imbalances. If the ECB would start verbal interventions to avoid the periphery being strangled by a strong euro German exporters would benefit unintended. Concerns that this would increase the cause of the periphery weakness are not justified.

Certainly since EUR-USD rose above 1.38 recently, verbal interventions on the part of the ECB could no longer be excluded. Some analysts even put the ECB's surprise rate cut down to its intention to weaken the euro. Even though the ECB justified the rate cut with falling inflation and underlined that the strong euro was not discussed, it makes sense not to allow a strong euro to put additional pressure on the countries of the periphery. The German trade balance surplus on the other hand will be seen in a different light by many. The German office of statistics recently published the highest monthly surplus since the data was first recorded. The strong euro not only does not seem to pose a problem for German companies, but this economic imbalance is now even being seen as the cause for the crisis in the periphery. Even the International Monetary Fund recently criticised Germany for the high surplus. Would a lower German trade surplus be the solution for the various European problems? Critics might say that I consider this view to be completely absurd because I am biased. However, there are two factors that are impossible to ignore. The first reason illustrates why the IMF's analysis is incorrect. The second reason illustrates the now worrying approach on the part of the IMF.

Re. 1: The reason for Germany's high external trade surplus is the high exports. However, it is not just Germany that benefits from the exports, but above all the importing countries. Theoretically there are three reasons for a foreign country to be purchasing goods in Germany. Either it gets the same goods of equal quality more cheaply in Germany or it receives higher quality at the same price (or a combination of the two). The third possibility is that the goods are not available anywhere else. In all three cases the importing country would be worse off without German exports. Either the importer would have had to pay more, would receive inferior quality or had to do without the goods completely. So it is completely obvious that the importing country would have suffered a loss of welfare. So German exports are not damaging for the recipient countries, but helpful!

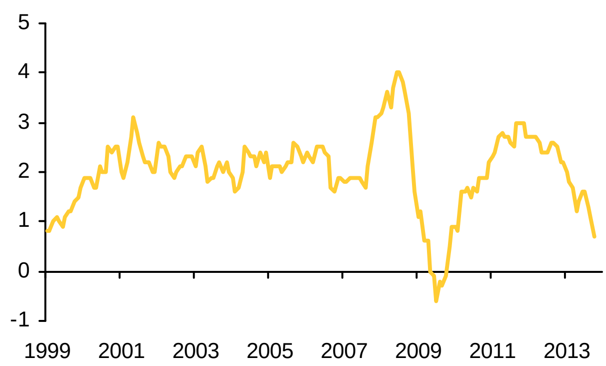
Re 2: Even if a reduction of German exports would also be negative for the importing countries, let us assume here that this was not the case. How exactly does the IMF imagine would exports be reduced? So as to reduce the German surplus German exports would have to be reduced by approx. EUR 15bn per month. But who would decide which of the currently EUR 90bn. per month will have to be banned in the future and for what reason? At closer inspection the IMF seems to indirectly demand a totalitarian economic order. At least with the existing economic setup the discussion about the German trade surplus is nothing but a chimera preventing euro zone leaders from getting in touch with the real problems.

CHART 2: **The German trade surplus on record high …**
Trade balance, EUR bn



Source: Commerzbank Research, Bloomberg

CHART 3: **Decreasing inflation sets ECB under pressure**
Consumer price index, percentage change year ago



Source:Commerzbank Research, Bloomberg

G10 Highlights

EUR bulls bear up. GBP – Inflation Report is key. Inflation data weighs on SEK. NOK collapsing.

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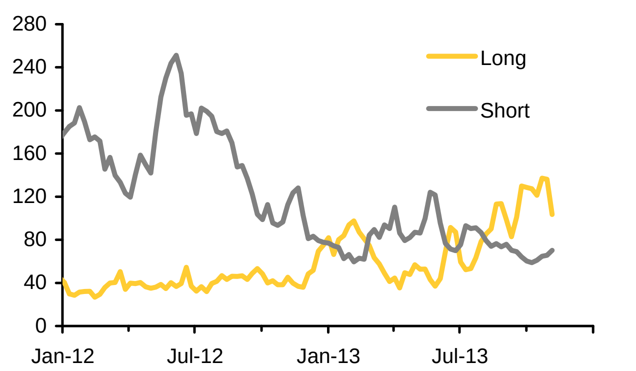
EUR-USD: The EUR bulls bear up, as can be noted by looking at the CFTC data. EUR longs were reduced well ahead of the ECB meeting, but continue to outweigh shorts. Short-term players who had held on to their EUR long positions after the ECB meeting seem to have been unimpressed by the strong US NFP data, firmly sticking to their longs. This means that this week's euro zone data is unlikely to weigh heavily on the euro in case of negative surprises. The better strategy currently seems not to play too strongly against the euro.

GBP: The key data release for the pound will come with tomorrow's Inflation Report. It is expected that growth forecasts may be upgraded to show that the 7% unemployment threshold might be reached sooner than the BoE expected. Rates markets have already priced in rate moves earlier than the MPC expects, so the main focus will be upon the tone of the statement and subsequent press conference. One thing that we can state with some degree of certainty is that irrespective of the Inflation Report, the case for a weakening pound is becoming thinner and thinner.

SEK: Swedish October CPI disappointed to the downside, falling back into negative territory (-0.1% yoy). The main reason behind October's decline was the drop in food and fuel prices. Since the Riksbank in October revised down its inflation forecast to 0.0% for 2013, this is not dramatic yet although below the Bank's projections. In any case inflation figures for November and December should better be positive again in order not to deviate too strongly from Riksbank's forecasts. There is no immediate need for the Riksbank to act on the rather disappointing October figures, but it will keep a close eye on the future development of prices. After all, the key rate is low because inflation is low, as Riksbank noted in its last statements. Since the market is sensitive after recent weak industrial production data, the reaction in EUR-SEK to push higher is understandable. However, in our view it is overstretched and we are sellers above 8.90.

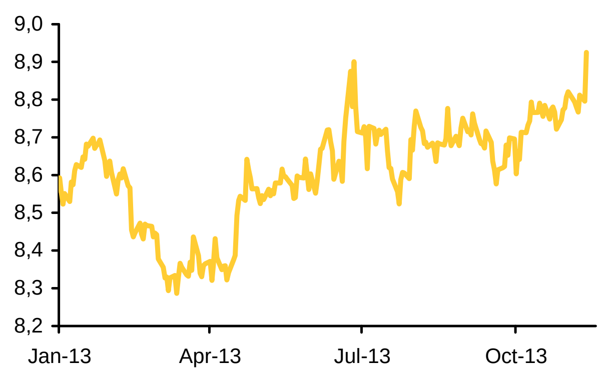
NOK: The NOK took a bad hit, falling sharply since the end of last week. EUR-NOK touched new highs at 8.3250. The trigger was weak industrial production data last Thursday. The move was fuelled further on Friday by a strong US NFP report and statements from Prime Minister Erna Solberg to cut back the budget if the exchange rate was too strong in order to enhance competitiveness in the export sector. Now talk about an equity transaction weigh on the NOK. We stick to our view that fundamentally the move is not justified and prefer EUR-NOK falling back towards 8.00, but it is hard to go against the trend. Nevertheless, we think current levels are good selling levels in EUR-NOK. The next important domestic event is the release of Q3 GDP data next Tuesday. If the data disappoints, we may have to revise our view.

CHART 4: **Speculative EUR longs were reduced, but remain significant**
EUR positioning of non-commercial IMM trades, in thds contracts



Source: CFTC, Commerzbank Research

CHART 5: **EUR-SEK reaching new yearly highs**
EUR-SEK spot rate, daily data



Source:Commerzbank Research

FX Metrics

G10 carry trade indices

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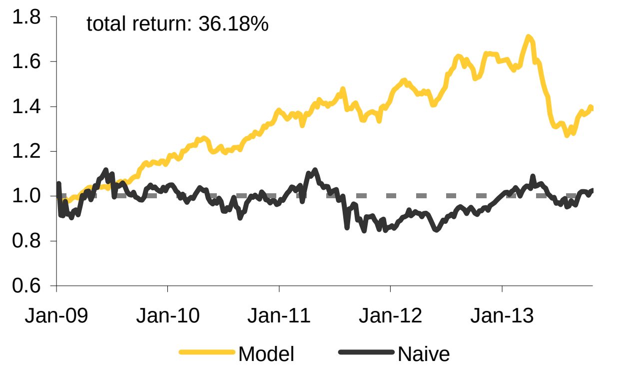
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

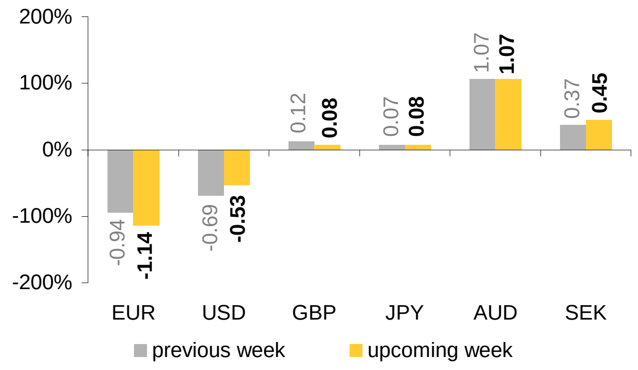
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 12 Nov to 19 Nov**
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

RUB – Lower growth looms. Credible CNB interventions? Risk of Polish inflation surprise. Economic data should point to a slowdown in Brazil's economy.

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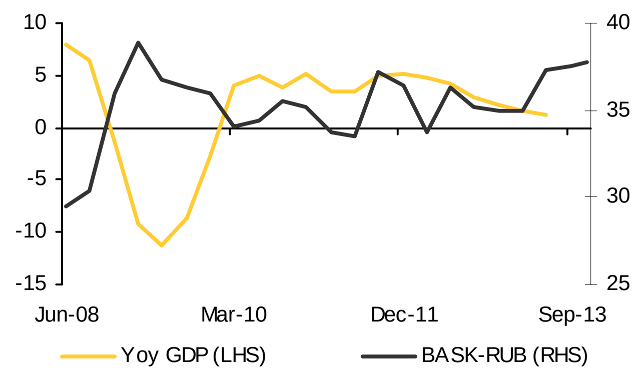
RUB: Last week the Russian government downgraded its growth forecasts through 2030 from 4.3% to an average of 2-2.5% per annum. Whilst these are longer term concerns, in the short term slowing growth will likely prove a burden for RUB. Already the ruble basket is trading towards the upper end of its recent range albeit that this is mainly to do with the upmove in US treasury yields. Nonetheless should growth print poorly in Q3 and Q4 of 2013, the chances of further rate cuts and more band widening should not be discounted. All told we remain of the view that the RUB basket will trade at higher levels in the coming quarters.

CZK: Due to the CNB's interventions the CZK was the clear underperformer over the past week among EM currencies. In our view its interventions are similarly credible to the SNB's as both central banks are able to print as much of their home currency as they want. However, there is one big difference. The SNB intervened against an overvalued CHF while the CZK is fairly valued. This means that the CNB will have to counter downward pressure on EUR-CZK much more frequently, particularly as the Czech economy starts to recover. The risk that EUR-CZK would collapse as soon as the CNB were to give up its interventions is thus extremely high. This is also reflected in the sharp decline of long term EUR-CZK Risk Reversals, i.e. while markets saw a much greater risk of a strong depreciation of the CZK before the CNB's interventions, they now see a broadly balanced risk between depreciation and appreciation. Clearly, the market does not believe the CNB will be able to keep the CZK weak long term.

PLN: Following the weak CPI figures from the euro zone as well as Eastern European peers, there is now a high risk of a downside surprise of Polish CPI due on Thursday. However, the figure would have to surprise massively in order for rate cut speculation to flare up again. After all, the Polish central bank has made clear that it intends to keep its interest rates unchanged until the middle of next year. Moreover, we expect Q3 GDP growth, also due on Thursday, to pick up, leaving no doubt that the economy is recovering. The upside in EUR-PLN remains thus limited in our view.

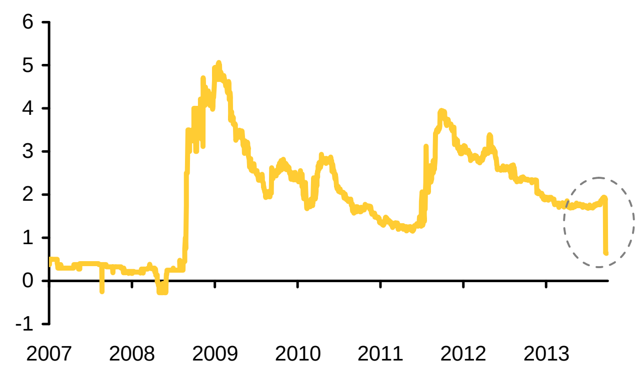
BRL: With the release of retail sales data and the economic activity indicator this week we will probably get some more evidence that the economy is slowing down after the strong upside surprise in Q2. For tomorrow's retail sales release for September we expect growth of 4.7% yoy after a strong reading of 6.2% in August. The economic activity indicator for September which is due on Thursday should show a stronger reading compared to the previous month. We expect 2.9% yoy after 1.32%. However, this should be due to base effects after the indicator showed a negative reading in last September. Should the data surprise to the downside this will weigh on the BRL. However, we would be cautious to bet on a significant weaker BRL since the central bank might step up its intervention efforts to mitigate the downside pressure.

CHART 8: **Lower growth looms in Russia**
GDP growth yoy in %, BASK-RUB spot



Sources: Bloomberg LP., Commerzbank Research

CHART 9: **EUR-CZK Risk Reversals free falling**
EUR-CZK 1 year 25 Delta Risk Reversals, % annualized volatility



Source: Bloomberg

FX portfolio recommendation

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Core trading views:

- Sell volatility in selective G10 crosses (EUR-CHF, EUR-USD and EUR-GBP)
- We retain low delta downside in USD-JPY as a tail hedge
- Short AUD via downside put spread

Tactical trading views:

- Enter GBP longs ahead of the BoE's Inflation Report on Wednesday

Last week we cut our long positions in low beta EMFX and this has turned out to be a prescient move. The combination of the ECB's rate cut along with further improvements in US economic data manifested in a broadly stronger USD and an increase in US yields, with 10 yr yields moving towards 2.75%. The subsequent weakening in EMFX was indiscriminating as low and high beta EMFX sold off.

The move lower in EUR-USD also contributed to an impressive performance in both short strangle positions with spot rates coming to the middle of recent ranges which more than offset the slight pickup in volatility. Even this slight pick up in volatility didn't last long as EUR-USD shorter dated at-the-money volatilities gave back half of their gains. As such we are content to hold the short volatility positions for the time being and will look to establish further short volatility positions when the timing is appropriate.

The put spread in AUD-USD suggested last week has already contributed to net portfolio performance as risky currencies underperformed both within the G10 and EM complex. Our downside put in USD-JPY at 94.00 underperformed given the up move in USD-JPY, however we retain this position as a tail hedge against a turn for the worse in equity market sentiment.

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	-1.2%	1.6480	Stopped
29.10.2013	Long EUR-USD	1	1.3780	1.3680	-0.70%	1.3920	Stopped

Source: Bloomberg L.P., Commerzbank Research

TAB. 1: **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%	-0.13%	0.48%	Open
15.10.2013	Short EUR-GBP strangle 0.81 / 0.87	15.01.2013	1 x 1	+0.46%	-0.32%	0.14%	Open
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1	-0.42%	0.18%	-0.24%	Open
05.11.2013	Long AUD-USD put spread 0.92 / 0.88	04.02.2013	1 x 1	-0.50%	0.58%	0.08%	Open

Source: Bloomberg L.P., Commerzbank Research

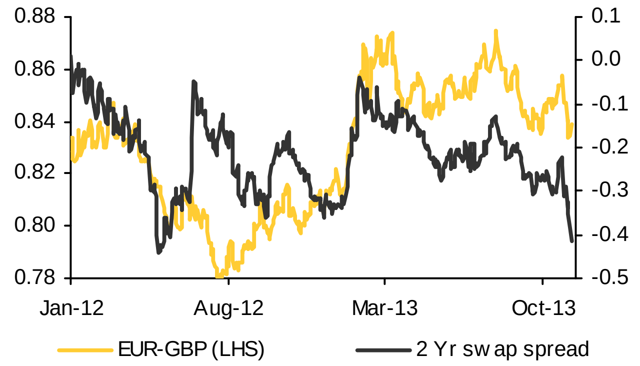
Tactical trading views:

- We recommend initiating long GBP positions ahead of the BoE's Inflation Report this Wednesday, where we expect the BoE to upgrade growth forecasts, which may essentially show that the 7% unemployment threshold will be reached sooner rather than later. Rates markets will likely move in favour of the pound and as such further upside in GBP-CHF is a distinct possibility. We would buy a dip with a view to taking profit around 1.4860. We maintain a tight stop at 1.4490.

Portfolio Risk:

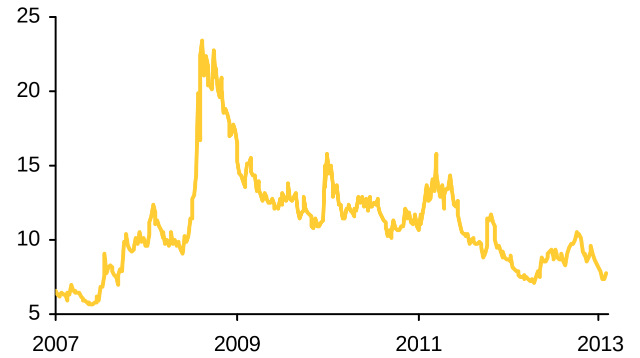
- The portfolio is negatively correlated with volatility
- The portfolio is negatively correlated with the USD

CHART 10: **Swaps moving in favour of GBP**
EUR-GBP spot, 2 yr swap spread in %



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **G10 volatility remains muted**
Aggregate G10 implied 3 month volatility in % vol



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

GBP-USD – a potential top is developing

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We believe the pattern developing on the GBP-USD chart is a potential top. The market has failed twice recently at the 1.6255/60 region. The rally last week stopped dead at the 1.6122 61.8% retracement of the recent move down and focus this week is on the 1.5894 mid October low. A close below here is required in order to complete the potential top and offer a downside measured target to 1.5533.

This is a minimum downside target, however given the close proximity of the 200 day ma at 1.5495 this is likely to provoke some profit taking.

In addition to the potential top, the market has also recently backed away from its 2009-2013 downtrend, this is located at 1.6308 and reinforces overhead resistance. Our longer term bias is therefore negative and this suggests that longer term we should in fact see a slide sub 1.50 once more.

The euro has underperformed Sterling all year, but last week sold off into 10 month lows and towards the 0.8285 50% retracement of the move 2012-2013. We would expect to see some consolidation around here, but given that EUR-GBP has been contained in a down channel for the past 4 years, the longer term risk remains for euro to continue to underperform Sterling. Loss of 0.8285 on a closing basis will trigger another leg lower to 0.8160 then 0.7983, the 61.8% and 78.6% retracements of the same move.

CHART 12: **GBP-USD – Weekly Chart**
Market has failed at the 2009-2013 downtrend

Source: CQG, Commerzbank Research

CHART 13: **GBP-USD – Daily Chart**
Potential double top will complete on a close below 1.5894.

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
13 November	08:00	TRY	Current account balance	USD bn	SEP	-2,7	-2,0
	09:30	GBP	Unemployment rate	%	SEP	7,6	7,7
	10:00	EUR	Industrial production	mom	SEP	-0,3	1,0
				yoy	SEP	0,0	-2,1
	12:00	RUB	CPI weekly year to date	%	NOV 11	-	5,4
	12:00	USA	MBA Mortgage Applications	%	NOV 8	-	-7,00
	23:50	JPY	GDP	qoq	3Q P	1,7	3,8
14 November	04:30	JPY	Industrial production	mom	SEP F	-	1,5
				yoy	SEP F	-	5,4
	08:00	CZK	GDP	yoy	3Q A	-0,5	-1,3
	08:00	HUF	GDP	yoy	3Q P	0,8	0,5
	08:00	RON	GDP	yoy	3Q A	3,5	1,5
		CHF	Producer and import prices	mom	OCT	-0,2	0,1
				yoy	OCT	-0,2	0,0
	08:30	SEK	Unemployment rate		OCT	7,4	7,5
	09:00	PLN	GDP	yoy	3Q P	1,6	0,8
	09:30	GBP	Retail sales	mom	OCT	0,0	0,6
				yoy	OCT	3,1	2,2
	10:00	EUR	GDP	qoq	3Q A	0,1	0,3
				yoy	3Q A	-0,3	-0,6
	11:00	RUB	FX and gold reserves	USD bn	NOV 8	-	513,9
	13:00	PLN	Consumer prices	mom	OCT	0,3	0,1
				yoy	OCT	1,0	1,0
	13:30	USA	Initial jobless claims	K	NOV 9	330	336
	13:30	USA	Trade balance	USD bn	SEP	-39,0	-38,8
15 November	08:00	HUF	Industrial production	mom	SEP F	-	1,8
				yoy	SEP F	-	3,1
	08:00	CZK	Producer price index	mom	OCT	0,0	0,1
				yoy	OCT	0,4	0,6
	10:00	EUR	Consumer prices	mom	OCT	-0,1	-0,1
				yoy	OCT F	0,7	0,7
			core rate	yoy	OCT F	0,8	0,8
		PLN	Core rate	mom	OCT	0,3	-0,1
				yoy	OCT	1,3	1,3
	13:30	USA	Import Prices	mom	OCT	-0,5	0,2
				yoy	OCT	-1,7	-1,0
	13:30	USA	Empire State Index		NOV	5,00	1,52
	14:15	USA	Industrial production	mom	OCT	0,2	0,6
	14:15	USA	Capacity utilization	%	OCT	78,3	78,3
18 November	00:01	GBP	Rightmove House Prices	mom	NOV	-	2,8
				yoy	NOV	-	3,8

Commerzbank Corporates & Markets

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