FX Alpha

15 October 2013

Will the US exorbitant privilege destroy itself?

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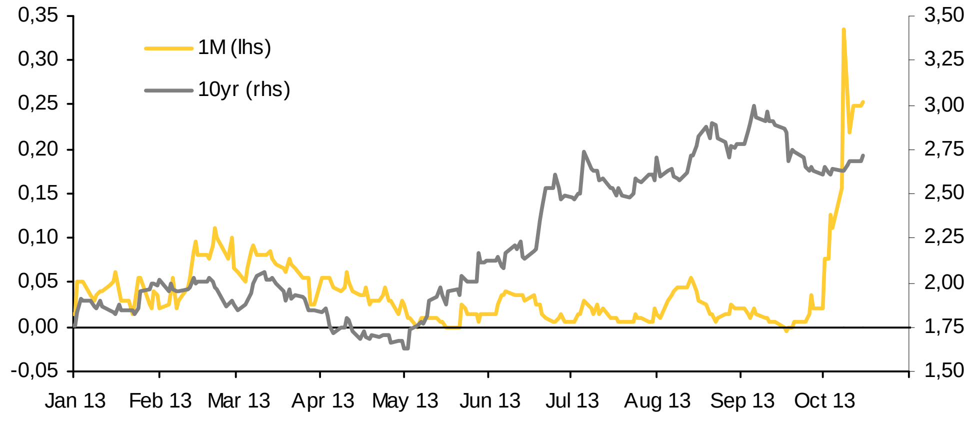
Will the US exorbitant privilege destroy itself? The FX market still is relaxed about the US budget crisis, given that a last-minute solu-tion seems to be likely again. We argue, however, that the developments so far pose a long-term risk for the dollar. US politicians one day might damage the US dollar's status as the world's dominant currency, whatever they will do to solve the current crisis.

CHART 1: **Only 1M T-bills suffer**
Yields on US obligations, percent



Source: Bloomberg, Commerzbank Research

G10 Highlights. USD: The major questions are still before us. GBP – Unemployment data next in line. Nothing new from the RBA minutes.

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

EM Highlights. NBP minutes to remain neutral. FX mortgage conversion plan postponed in Hungary. RUB – Rates on hold.

Tactical trade recommendations. Sell EUR-PLN.

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Event calendar. The data calendar remains meagre due to the government shutdown in the US, so the market will have to wait a couple of more days for important fundamental momen-tum.

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Will the US exorbitant privilege destroy itself?

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The FX market still is relaxed about the US budget crisis, given that a last-minute solution seems to be likely again. We argue, however, that the developments so far pose a long-term risk for the dollar. US politicians one day might damage the US dollar's status as the world's dominant currency, whatever they will do to solve the current crisis.

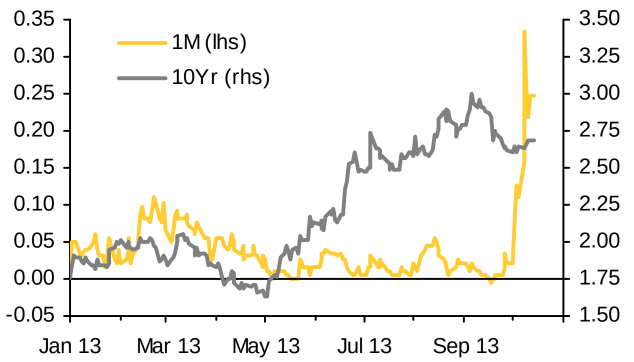
The rating agencies so far have been very complacent with the US budget crisis. None of the big ones is considering a change of the US sovereign debt rating. And the markets share the rating agencies' attitude. Apart from 1-month T-bills, no other US debt obligation suffered significantly (chart 2). This is quite astonishing, given the fact that US Congress actually is considering if the US should or should not service its obligations. I cannot think of any country in the world except the US which would receive such a benign treatment from the rating agencies and the markets. In fact this special treatment seems to be another facet of the US "exorbitant privilege" that had been bemoaned since Charles de Gaulle's times.

Isn't this exorbitant privilege a strong argument for the dollar? Maybe in the short run. In the medium to long run, however, the US is not functioning differently than other western democracies like Greece, Italy or Germany. Without market pressure, politicians find it hard to generate required discipline. In the case of the US this implies that the fight over debt ceilings and obligations imposed by former Congresses will go on as long as the US political system does not have to face dire consequences of such political battles. Even worse, in every new round of similar struggles politicians might feel the incentive to take it one step further than the previous time – to signal their determination. Even if a default on parts of the Treasury's obligations can be avoided this time, next time it will get significantly more difficult. I can easily envisage a scenario where in some future budget crisis the Treasury cannot service its obligations for hours, next time for days, and in the end will service them only when the prevailing political climate permits it. In such an environment the USD-centric global "system" would be at risk.

Such a development would likely be a crisis instead of a smooth process. Changing from the dollar-centric global setup to something different requires – among others – an important condition: To offset the loss in efficiency, which is unavoidable for the early dissidents from the dollar-centric system, the dollar-centric system must be in a deep crisis. But the likelihood of such a crisis will increase if market discipline does not stop brinkmanship on Capitol Hill. The exorbitant privilege at some point in the future might destroy itself.

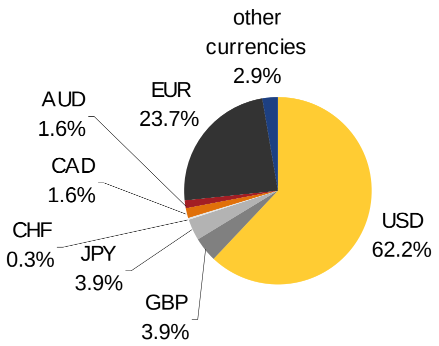
The consequence for the dollar would be severe. Not only would the demand as trading and and reserve currency fall dramatically. The US would also find it very difficult to finance its current account deficit. It might take years before such a scenario will materialize. In retrospect however, the current budget crisis might be regarded as the beginning of the end. This fresh risk for the dollar is only creating marginal USD weakness right now. But it should definitely be kept in mind for medium- to long-term strategies involving USD positions.

CHART 2: **Only 1M T-bills suffer**
Yields on US obligations, percent



Source: Bloomberg, Commerzbank Research

CHART 3: **Allocation of FX reserves**
Percent of allocated reserves



Source: IMF, Commerzbank Research

G10 Highlights

USD: The major questions are still before us. GBP – Unemployment data next in line. Nothing new from the RBA minutes.

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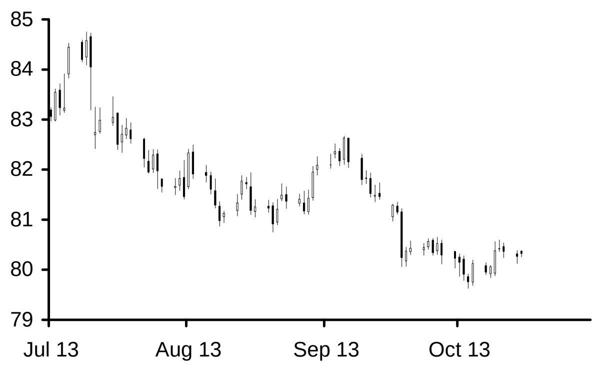
USD: The deadline for a potential default of the US is coming closer. At the same time, though, there are increasing signs that an agreement can be reached until Thursday – although it may only be an interim solution. Markets remain quite relaxed and in a wait and see mode. In case we see an agreement in the next days, the dollar will react moderately positively. Thereafter, the main point will be: what are the damages on the economy of the shutdown? What will the economic data bring that hasn't been published throughout the shutdown? And what will the Fed finally do out of all this? Will it revise its outlook and start tapering even later? It is clear that the major questions are still before us, which in turn means that we could experience stronger USD moves until year-end, depending on incoming data and the Fed's assessment. Get ready for the roller-coaster ride, whenever it may start. The timing is difficult, since political markets such as now are hard to assess and hard to trade.

GBP: Following last week's BoE meeting (which was a non event as expected) the focus for sterling investors will shift towards unemployment data later this week. At current rates of 7.7% we estimate it will take until 2016 before rates hit the 7% threshold applied by the BoE as part of its forward guidance mandate. What this means for investors is that they should not get too excited in the short term. In any case we doubt whether UK economic data will retain the positive momentum that they have recently enjoyed. Markets seem to have acknowledged this with consequent sterling weakness. However against the EUR we think it unlikely that significantly higher levels will manifest in the coming weeks given the confluence of technical resistance levels around 0.8520 (200 day moving average).

AUD: The minutes of the RBA rate meeting on 1st October did not bring any real news as the tone was similar to that of the minutes for the meeting on 3rd September. The RBA confirmed its neutral approach and wants to gauge the effects of the substantial degree of policy stimulus, i.e. the rate cuts of the past months as well as low interest rates. The RBA stated that the exchange rate of the AUD had appreciated and confidence had picked up, but remains cautious as to whether these developments would be sustained, and as a result the effects are difficult to gauge. As was the case in September the RBA maintains that it should neither close off the possibility of reducing rates further nor signal an imminent intention to reduce them. In my view the minutes are not a convincing reason to buy AUD now – September would have been just as good a time then, as the tone of the minutes remained unchanged. However, some investors might be realising only now that the rate cut cycle in Australia has definitely ended – as long as the Australian economy does not suffer a shock. In view of the budget crisis in the US we continue to expect moderate support for AUD, but remain cautious.

CHART 4: **Budget crisis remains a burden for the USD**
Dollar index DXY, candle stick chart, daily data



Source: Commerzbank Research

CHART 5: **AUD has recovered from its summer lows**
AUD-USD spot, daily data

Source:Commerzbank Research

FX Metrics

G10 carry trade indices

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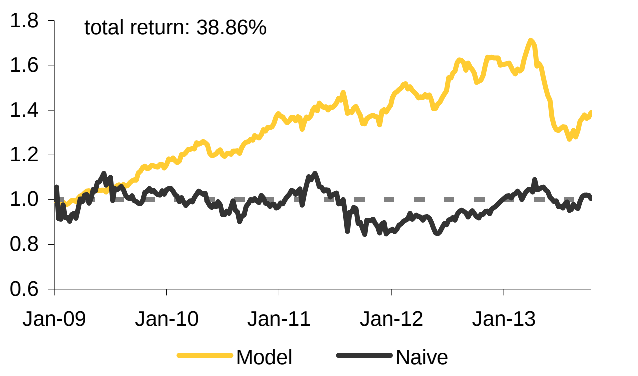
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

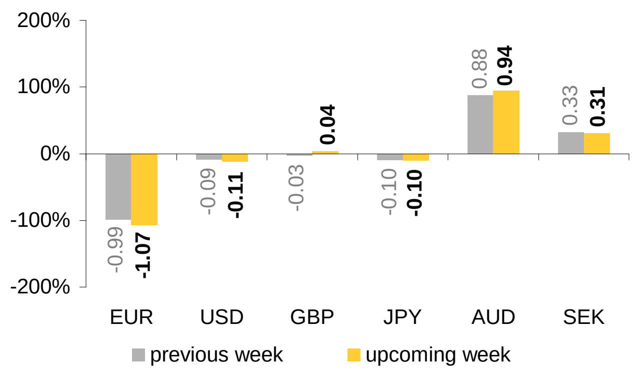
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 15 Oct to 22 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

NBP minutes to remain neutral. FX mortgage conversion plan postponed in Hungary. RUB – Rates on hold.

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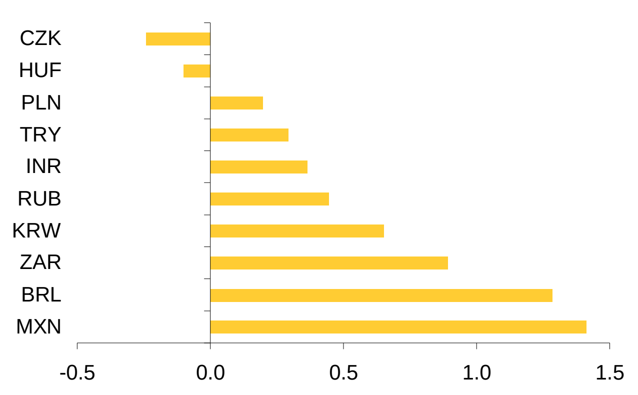
PLN: The minutes of the last MPC meeting due on Thursday are unlikely to bring any breaking news. It is clear by now that the Polish central bank will remain in its neutral stance until year end. If it was up to central bank governor Marek Belka, interest rates will even be kept unchanged throughout the first half of 2014. His chances of enforcing his stance have recently increased as one of the hawks in the MPC, Zyta Gilowska, has resigned from her position in the council. There is a high probability that Polish president Bronislaw Komorowski will take the opportunity to chose a more dovish rate setter to replace Gilowska. Nonetheless, we remain optimistic with regards the outlook for the PLN as there is no question that the Polish economy is on the rebound and the NBP might have to turn hawkish faster than it is currently expecting.

HUF: The threat of the Hungarian government to force upon banks a plan to convert problematic FX mortgage loans into HUF, unless they come up with a plan themselves until Nov 1st, has backfired. According to Austrian central bank governor Ewald Nowotny, ECB's Mario Draghi, in his role as head of the European Systemic Risk Board (ERSB), has warned Prime Minister Viktor Orbán not to proceed with the FX conversion plan without coordination. According to Nowotny, Orbán has agreed to discuss his plan with his European partners, thus postponing the implementation of the conversion plan for the time being. Chances have certainly increased for a more market friendly solution to the problem which is positive for the HUF. However, the risk remains high that the Hungarian government will push for a quick solution at the cost of the banks as well as the HUF.

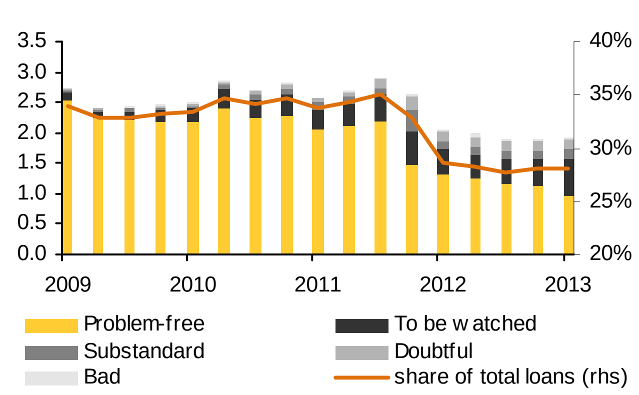
RUB: Yesterday CBR left key rates on hold at 5.5%, though in an interesting development the central bank indicated a willingness to tolerate a loss of output in order to lower inflation. This is surprising in the respect that investors generally view CBR as having a relaxed view about inflationary developments. What that means for investors is that marginal rate cut expectations should be priced out. However it would be a mistake to read this as being beneficial for RUB. CBR have made it clear that there is no case for RUB appreciation in Q4 this year, irrespective of oil price developments. We are still of the view that RUB will gradually weaken somewhat in line with the RUB becoming a more freely floating currency in 2015.

CHART 8: **EM currencies broadly stronger**
% Gain / Loss vs. USD since 8th October 2013



Source: Bloomberg

CHART 9: **FX housing loans still a problem in Hungary**
FX based housing loans in HUF bn (left axis), in % of total loans (right axis)



Source: MNB

Tactical trade recommendation

Sell EUR-PLN.

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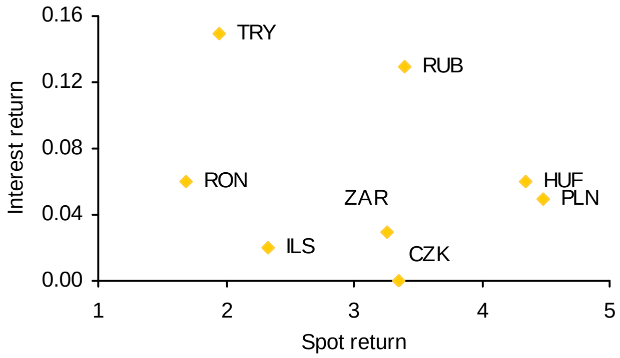
We recommend investors to establish short EUR-PLN positions at current levels with a view to taking profit around 4.10. We maintain a tight stop at 4.22.

Since the beginning of September PLN has been the best performer within the EMEA complex and we think there is still room to appreciate further against the EUR. Domestic data continue to print robustly, with retail sales and PMI data both showing signs of economic expansion. This points towards strong domestic economic growth in 2014. At the same time, exports to the euro zone should pick up given the improvement in economic data there, which means that the Polish trade balance should improve. In the context of current account deficit currencies within the EMEA complex this makes PLN stand out for all the right reasons.

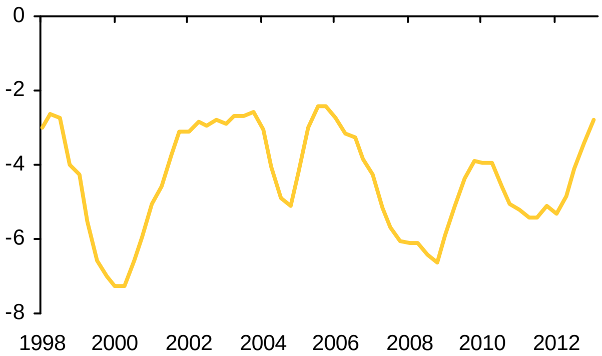
PLN should also benefit from improved financial market sentiment in the coming days and weeks in light of an agreement regarding US fiscal issues (we assume that politicians can avoid a US default). At the same time, given the US shutdown so far there is every possibility that monetary conditions will remain accommodative. All told, there is decent potential for PLN to rally further.

CHART 10: **PLN top fo the class**
% gain / loss vs. USD since 2nd September 2013



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **Current account deficit improving notably**
Current account as a % of GDP



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%	-0.02%	1.08%	Open
24.09.2013	EUR-USD strangle 1.38 / 1.25	23.12.2013	1m x 1m	0.61%	-0.63	-0.02%	Open

Sources: Bloomberg L.P., Commerzbank Research

Technical Analysis

Make or break time for the US Dollar

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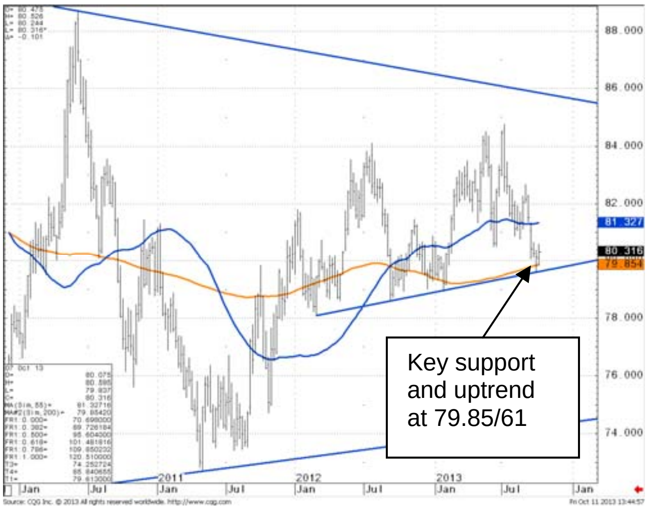
The US Dollar has come under a considerable amount of downside pressure over the past 2 months, which has seen the US Dollar Index drop from a peak of 84.75 to a low of 79.63, an approximate 6% fall.

The sell off has seen the US Dollar Index tumble all the way back to the 200 week moving average and the 2012-2013 uptrend at 79.85/61 currently. This is key support and it has so far held the downside to produce a decent rebound. Note we also find the 200 month moving average here at 79.59. Ideally we would like to see the index now strengthen further and close above the 81.35 2 month downtrend in order to confirm that the intermediate low is in and the US Dollar is well placed for further strength. This remains our favoured scenario.

Once the close above the downtrend has been seen this would introduce scope to 82.67/79. This is the 5th September peak and also the 61.8% retracement en route to the 84.75 peak.

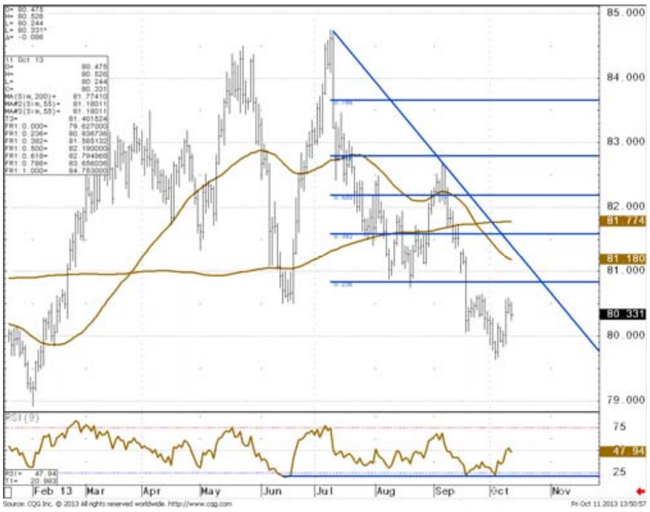
A weekly close below 79.50 would on the other hand negate the foregoing and imply losses to the 78.09/19 1992 low and the 2012 low and then to 77.30, the 61.8% retracement of the move up from 2011.

CHART 12: **US Dollar Index - Weekly chart**
Holding the 200 week ma



Source: CQG, Commerzbank Research

CHART 13: **US Dollar Index – Daily chart**
Needs to close above downtrend to confirm that it has based



Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
15 October	22:45	NZD	Consumer prices	qoq	3Q	0,8	0,2
				yoy	3Q	1,2	0,7
16 October	09:30	GBP	Unemployment rate	%	AUG	7,7	7,7
	10:00	EUR	Consumer prices	mom	SEP	0,5	0,5
				yoy	SEP F	1,1	1,1
			core rate	yoy	SEP F	1,0	1,0
	10:00	CHF	ZEW business expectations		OCT	-	16,3
	12:00	USA	MBA Mortgage Applications	%	OCT 11	-	1,30
	13:00	PLN	Wages	mom	SEP	-0,2	-1,8
				yoy	SEP	3,1	2,0
	13:00	RUB	CPI weekly year to date	%	OCT 14	-	4,9
	13:00	PLN	Core rate	mom	SEP	0,0	-0,1
				yoy	SEP	1,3	1,4
	15:00	USA	NAHB Housing Market Index		OCT	57	58
17 October	08:30	SEK	Unemployment rate		SEP	7,5	7,3
	09:30	GBP	Retail sales	mom	SEP	0,4	-0,9
				yoy	SEP	2,0	2,1
	12:00	RUB	FX and gold reserves	USD bn	OCT 11	-	512,7
	13:00	PLN	Producer price index	mom	SEP	0,2	-0,3
				yoy	SEP	-1,4	-1,1
	13:00	PLN	Sold Industrial Output	mom	SEP	10,4	-4,5
				yoy	SEP	7,0	2,2
	13:30	USA	Initial jobless claims	K	OCT 12	335	374
	15:00	USA	Philadelphia Fed Index		OCT	15,0	22,3
18 October	12:59	USA	Leading indicator CB		SEP	0,6	0,7
	13:30	CAD	Consumer prices	mom	SEP	0,1	0,0
				yoy	SEP	1,0	1,1
21 October	00:01	GBP	Rightmove House Prices	mom	OCT	-	-1,5
				yoy	OCT	-	4,5
	06:00	JPY	Leading Index CI		AUG F	-	106,5
			Coincident Index CI		AUG F	-	107,6
	07:00	GER	Producer price index	mom	SEP	-	-0,1
				yoy	SEP	-	-0,5
	15:00	USA	Existing Home Sales	mn	SEP	5,35	5,48
				mom	SEP	-2,4	1,7

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