FX Alpha

19 November 2013

Why isn't CHF weaker?

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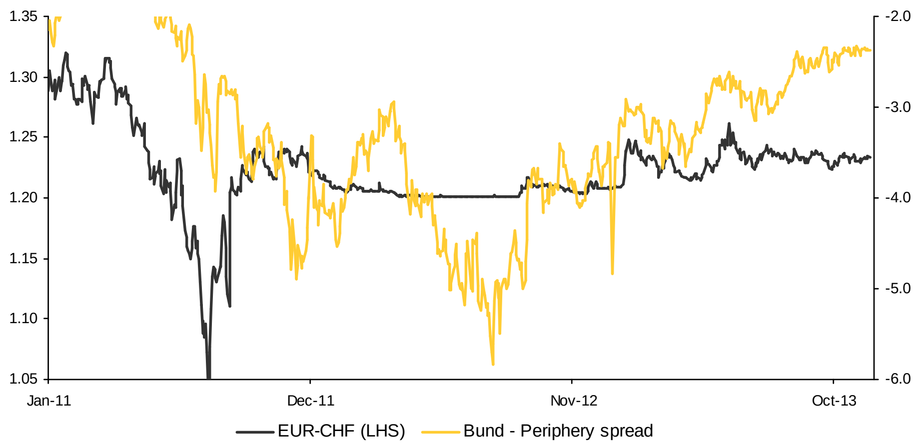
Why isn't CHF weaker? Since the amelioration of the euro zone crisis analysts have consistently argued for weaker CHF exchange rates, yet they have never manifested. We argue that CHF is now the last remaining safe haven and as such tends to lag moves in G10 FX.

CHART 1: **EUR-CHF not impressed by peripheral spread development**
EUR-CHF spot, 10 Yr Bund – Periphery spread in %



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. BoE Minutes will be non event. RBA not considering rate cuts. Back to square one for the EUR. CPI data key for USD this week.

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's meeting minutes highlight neutral stance. No positive impetus for MXN from the data front. CBR raises RUB trading band.

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

Technical Analysis. USD/JPY – continuation triangle breakout is bullish.

Event calendar. Key euro zone data releases will be German Q3 GDP release and French PMI data. In the US the focus will move to retail sales and CPI data.

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Why isn't CHF weaker?

Since the amelioration of the euro zone crisis analysts have consistently argued for weaker CHF exchange rates, yet they have not manifested. We argue that CHF is now the last remaining safe haven and as such tends to lag moves in G10 FX.

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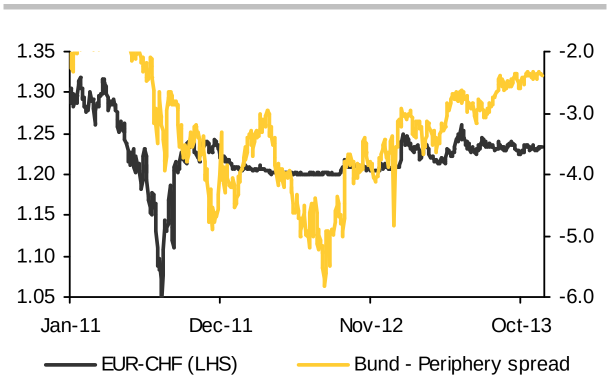
At the height of the euro zone debt crisis moves in EUR-CHF typically tracked changes in peripheral yield spreads. Analysts argued that as the euro zone crisis subsided and in particular as peripheral spreads tightened EUR-CHF would automatically trade at higher levels. The three key indicators of the euro zone crisis that we follow; yield developments, Target2 balances and EUR-USD shorter dated volatilities all clearly illustrate an easing of the situation. Yet EUR-CHF remains glued to levels around 1.23. It is abundantly clear that something else is going on and therefore that it requires an explanation.

With EUR-CHF price action consistently disappointing the predictions of many analysts a variety of explanations have been offered for sustained CHF strength. The first being that EUR-CHF is' fairly valued' at levels around 1.20. Frankly, such an argument is absurd and reminds me of similar arguments being made when USD-JPY was trading close to 130 before the onset of the financial crisis. This argument also ignores a plethora of indicators from PPP data to REER data which consistently show that CHF remains an expensive currency. More to the point if EUR-CHF was fairly valued around 1.20 the SNB would not have implemented the lower bound to begin with. Other arguments point towards the deleveraging cycle in the Swiss banking system where the argument goes that Swiss banks have been repatriating capital and as such CHF has remained well bid. An examination of loan to deposit ratios of the largest Swiss banks dispels this line of reasoning as these ratios print consistently below their euro zone equivalents. Likewise the lofty current account does not point towards excessive CHF strength, indeed CHF traded at significantly weaker levels when the current account was even higher in the pre–crisis period 2004 – 2006.

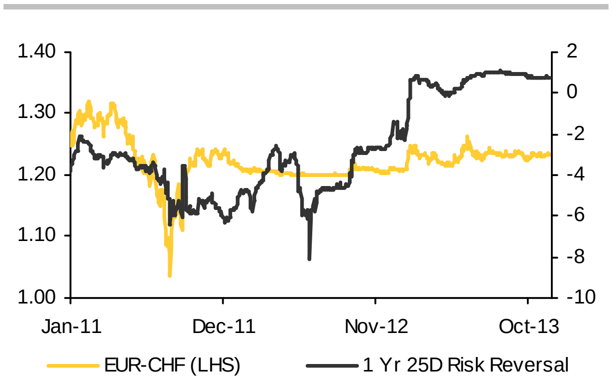
A more nuanced explanation lies with the development of safe haven currencies more generally. Although JPY benefits marginally during periods of increasing risk aversion it is hard to argue that investors purchase JPY denominated assets[1] to the same extent that they buy CHF denominated assets. As Abenomics slowly dims the appeal of JPY as a safe haven that means when it comes to safe haven currencies CHF is the only show in town, even more so when markets treat the USD with benign neglect. Thus, moves in EUR-CHF will tend to lag moves in risky assets because of the natural bid towards CHF. What this means is that further upside in EUR-CHF will be a grind.

CHART 2: **EUR-CHF not impressed by peripheral spreads**
EUR-CHF spot, 10 Yr Bund-Periphery spread in %



Source: Commerzbank Research, Bloomberg LP

CHART 3: **Spot underperforms risk reversals**
EUR-CHF spot, 1 Yr 25D Risk Reversal in % vol



Source:Commerzbank Research, Bloomberg LP

[1] http://www.imf.org/external/pubs/cat/longres.aspx?sk=41039.0

G10 Highlights

BoE Minutes will be non event. RBA not considering rate cuts. Back to square one for the EUR. CPI data key for USD this week.

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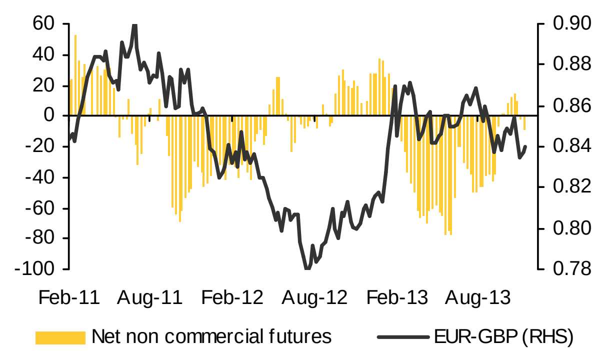
GBP: This week's BoE minutes are likely to be a non event as far as the market is concerned in large part because last week's Inflation Report has already covered all the bases. Growth forecasts have been revised higher whilst inflation forecasts have been revised lower. All in all, this is the perfect combination for currency appreciation and indeed this has been the case since last week's Inflation Report. Positioning data now show a slight short GBP position so it is difficult to argue that sterling is overbought at current levels. More to the point swap spreads continue to show more pronounced downside in EUR-GBP so we remain of the view that selling rallies in EUR-GBP should remain a favoured strategy.

AUD: Last night's Minutes from the RBA's November meeting illustrated that the central bank remain some distance from even contemplating further rate cuts. Forward looking indicators such as business surveys and housing market indicators pointed to a more benign environment in the coming quarters. The Minutes noted AUD's appreciation since August but did not state that this was an onerous development. The markets immediately responded by buying AUD-USD towards 0.9440, whilst markets moved to price out the probability of any rate cuts at the next rate meeting. The key levels to watch on the upside will be the 200 day moving average at 0.9656.

EUR: Investors can be forgiven for feeling a sense of Déjà-vu considering that EUR-USD now trades above levels that preceded the ECB's surprise rate cut two weeks ago. In the period since the rate cut various ECB speakers have been at pains to stress their unanimity when it comes to monetary policy, a clear sign of a split on the governing council! What is clear however is that forward guidance policies are having a limited effect (if any) upon EUR exchange rates, so for the moment investors are better off focussing on data rather than the vagaries of ECB speeches. In terms of data, the key releases to focus upon will be PMI data from France and German Q3 GDP releases.

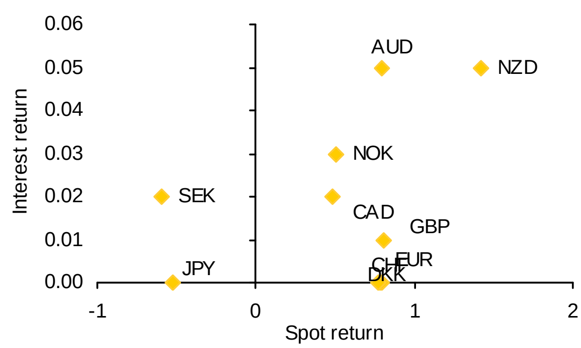
USD: Over the course of the last week the USD has traded rather weakly, in particular since the FOMC's Yellen testified in front of Congress. Quite why market participants were surprised by Yellen's dovish testimony is a mystery, but nonetheless one has to respect price action; the USD and US yields came lower. The key data release this week will be tomorrow's US CPI print which is expected to print at flat levels (0.0%) MoM. Should the data print below expectations one can expect the USD to sell of further as expectations of QE infinity come back to the market.

CHART 4: **IMM data now show small GBP short position**
EUR-GBP spot, IMM net non commercial futures



Source: CFTC, Commerzbank Research, Bloomberg LP

CHART 5: **Week on week high yielders appreciate**
% Gain / Loss Vs. USD since 12th November 2013



Source:Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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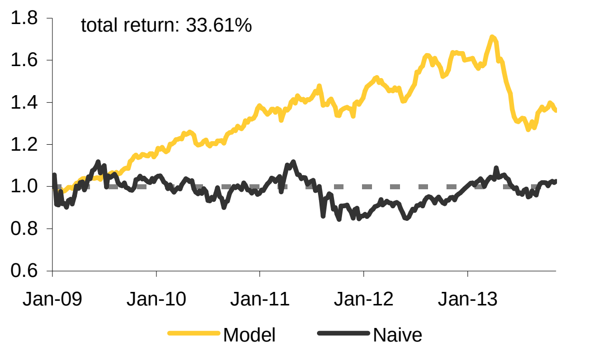
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

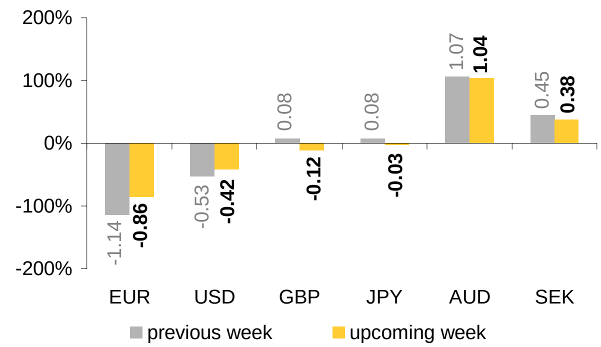
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

CHART 6: **Historic performance of optimized Carry Trade Portfolio**
Cumulative return[2] 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 19 Nov to 26 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.

[2] Returns are based on Tuesdays’ London opening

EM Highlights

NBP's meeting minutes highlight neutral stance. No positive impetus for MXN from the data front. CBR raises RUB trading band.

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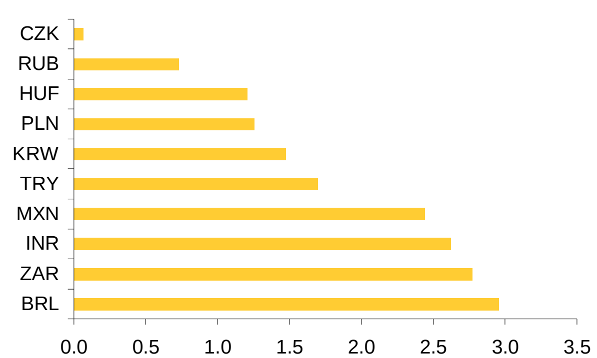
PLN: The NBP's meeting minutes due on Thursday are again going to highlight the central bank's neutral stance. While there is no doubt that the Polish economy is showing strong signs of a recovery and there are no fears of deflation as core inflation is slowly creeping up, the NBP is still trying to keep the market's interest rate expectations stable. NBP chief Marek Belka has made very clear that the central bank does not intend to change its key rate in the foreseeable future as this will ensure that the recovery proceeds as currently projected. While the NBP clearly signalled that it will not rush any key rate hikes, it also excluded any rate cuts which in the current environment of easy monetary policy across the region is certainly a plus for the PLN. We continue to forecast a gradual appreciation of the PLN towards 4.15 in the weeks ahead.

MXN: After the peso made rapid gains against the USD in the past days, this move might be dampened this week with major data up for release: retail sales on Wednesday and more important GDP for the third quarter on Thursday. Retail sales in September have probably fallen again on a year-on-year basis. GDP should have been able to grow slightly compared to the previous quarter, with the forecast risk higher than usual, though, as the fallout of September's hurricane is hard to assess. We believe, however, that the economy should be past its trough following the decline in GDP in the second quarter so that the Mexican economy should recover, particularly in the quarters ahead. This has yet to be reflected in data, though. While the third quarter should signal a trend reversal, this is unlikely to trigger waves of euphoria on the market. Consequently, we are unlikely to see further positive impetus from the data front for the peso to continue its recent rally. A breather thus appears likely, in our view.

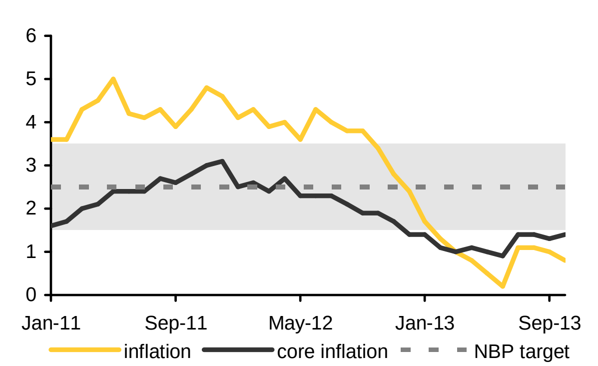
RUB: CBR yesterday raised the BASK-RUB trading corridor to 32.55 – 39.55. The move higher comes after CBR had intervened throughout the course of last week by some 200 mln RUB each trading session. Given the slow growth environment and continued capital outflows investors can expect more of the same over the remainder of the year. We continue to forecast BASK-RUB trading above 38.00 by the end of 2013.

CHART 8: **EM currencies recovering**
% Gain / Loss Vs. USD since 12th November 2013



Source: Commerzbank Research, Bloomberg LP

CHART 9 **Poland: Inflation running below target, but core rate picking up**
inflation in % yoy



Source: Commerzbank Research, BloombergLP

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
- Position for mild GBP outperformance

Tactical trading views

- We maintain a neutral stance over the coming week

Over the week our short volatility positions continued to perform well as improved equity market sentiment brought volatilities lower. In terms of spot developments, EUR-USD edged slightly higher over the week and is now trading at pre ECB rate cut levels. EUR-GBP remains in the middle of our strangle range, so all told we are content to hold short volatility positions for the immediate future. The downside put spread in AUD-USD underperformed slightly as news of Chinese reforms led to an appreciation of AUD, however given that the reforms will likely depress Chinese growth over the longer term, we are content to hold the position for the moment.

The downside put in USD-JPY underperformed over the week but again we are content to hold the position. More and more, USD-JPY trades in line with equity market sentiment and any correction here combined with completely one sided short JPY positioning could lead to a squeeze lower. Thus, the position represents a clever hedge for our portfolio.

Finally, last week our long GBP-CHF recommendation performed relatively well with the BoE upgrading its growth forecasts for 2014. Combined with falling inflation these are the perfect ingredients for currency appreciation. Thus positioning for mild GBP outperformance from current levels should prove to be a decent trade.

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	-1.20%	1.6480	Stopped
29.10.2013	Long EUR-USD	1	1.3780	1.3680	-0.70%	1.3920	Stopped
12.11.2013	Long GBP-CHF	1	1.4620	1.4490	**0.60%**	1.4860	Open

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
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%	-0.15%	0.46%	Open
15.10.2013	Short EUR-GBP strangle 0.81 / 0.87	15.01.2013	1 x 1	+0.46%	-0.20%	0.26%	Open
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1	-0.42%	0.10%	-0.32%	Open
05.11.2013	Long AUD-USD put spread 0.92 / 0.88	04.02.2013	1 x 1	-0.50%	0.46%	-0.04%	Open

Source: Commerzbank Research, Bloomberg LP

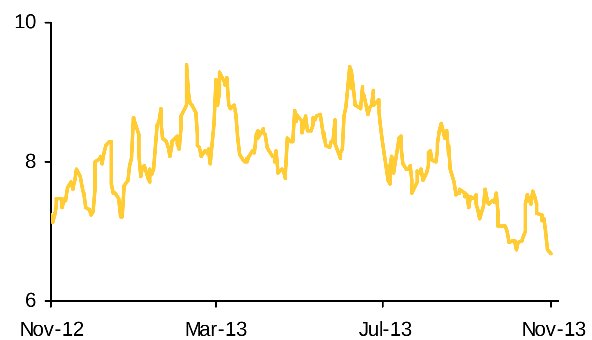
Tactical trading views

- We maintain a neutral stance over the coming week given the lack of risk events and / or data releases. In terms of spot positions we maintain the long GBP-CHF position and look to take profit towards 1.4860.

Portfolio Risk

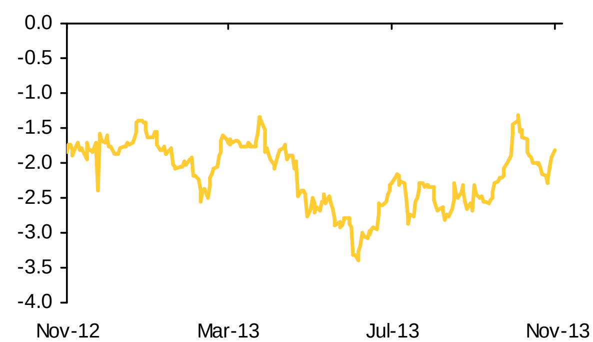
- The portfolio is negatively correlated with volatility
- The portfolio is negatively correlated with the USD

CHART 10: : **Volatility remains subdued**
EUR-USD 3 month at-the money-volatility in % vol



Sources: Commerzbank Research, Bloomberg LP

CHART 11 **AUD riskies move higher**
AUD-USD 3 month 25D Risk Reversal in % vol



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

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USD/JPY – continuation triangle breakout is bullish

USD/JPY has broken out of its 2013 continuation triangle and is currently getting ever closer to the September high at 100.62. Once overcome, the 101.54/60 July high and 78.6% Fibonacci retracement of the May-to-June decline will be in focus.

A rise above the 101.54/60 resistance area will push the May peak at 103.74 and the 105.00 region back to the fore.

Minor support is seen between the 99.10 November 12 low and the 99.01 October peak.

Still more support comes in between the 55- and 200-day moving averages and the six month support line at 98.61/97.47.

We will remain bullish while USD/JPY stays above the 96.55 October low.

CHART 12: : **USD/JPY – Daily Chart**
Bounced off the 200 day moving average and is accelerating higher

Source: CQG, Commerzbank Research

CHART 13: **USD/JPY – Weekly Chart**
Triangle breakout is bullish; targets the 105.00 region

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
20 November	07:00	GER	Producer price index	mom	OCT	-	00
				yoy	OCT	-	-01
	08:00	ZAR	Consumer prices	mom	OCT	01	01
				yoy	OCT	06	06
	10:00	CHF	ZEW business expectations		NOV	-	25
	12:00	RUB	CPI weekly year to date	%	NOV 18	-	06
	12:00	USA	MBA Mortgage Applications	%	NOV 15	-	-002
	13:30	USA	Retail sales	mom	OCT	00	00
			less vehicles	mom	OCT	00	00
	13:30	USA	Consumer prices	mom	OCT	00	00
				yoy	OCT	00	01
			core rate	mom	OCT	00	00
				yoy	OCT	00	02
	15:00	USA	Existing Home Sales	mn	OCT	-	005
				mom	OCT	-	-02
21 November	08:30	GER	PMI (Markit)		NOV A	50	52
	08:30	GER	PMI Services (Markit)		NOV A	53	53
	09:00	EUR	PMI (Markit)		NOV A	50	51
	09:00	EUR	PMI Services (Markit)		NOV A	50	52
	11:00	RUB	FX and gold reserves	USD bn	NOV 15	-	511
		ZAR	Interest rate decision	%	NOV 21	-	005
	-	JPY	BoJ Target Rate	%	NOV 21	-	000
	13:00	PLN	Producer price index	mom	OCT	-	00
				yoy	OCT	-	-01
	13:00	PLN	Sold Industrial Output	mom	OCT	-	10
				yoy	OCT	-	06
	13:30	USA	Initial jobless claims	K	NOV 16	336	339
	13:30	USA	Producer price index	mom	OCT	00	00
				yoy	OCT	00	00
			core rate	mom	OCT	00	00
				yoy	OCT	-	01
	15:00	EUR	Consumer confidence		NOV A	-17	-15
		USA	Philadelphia Fed Index		NOV	15	20
22 November	09:00	GER	ifo business climate		NOV	106	107
			Current assessment		NOV	110	111
			Business expectation		NOV	-	104
	13:30	CAD	Consumer prices	mom	OCT	-	00
				yoy	OCT	-	01
24 November	-	GER	Import Prices	mom	OCT	-	00
				yoy	OCT	-	-03
25 November	08:00	CZK	Composite confidence indicator		NOV	-	03

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