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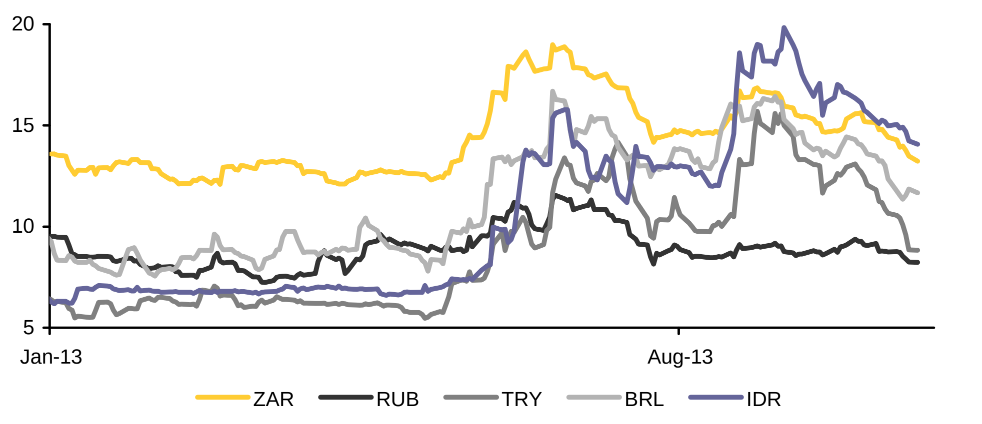
FX Alpha

22 October 2013

EMFX – Sell volatility, buy diamonds

EMFX – Sell volatility, buy diamonds. A variety of idiosyncratic changes and an easing in external financing conditions have improved the landscape for EMFX in recent weeks. The short term environment will likely remain conducive to further muted gains for selective EMFX.

CHART 1: **Volatilities come lower**
3 month ATM volatilities Vs. USD in % vol



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. USD continues to struggle. GDP data in focus in the UK. Profit taking in AUD on CPI data possible. BoC to remain on hold. Norges Bank unlikely to back pedal.

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

EM Highlights. CBT meeting likely to be a non event. Banxico to cut, Banrep to stay on hold. CPI data – still no case for ZAR appreciation.

FX portfolio recommendations. We provide a series of thematic and tactical trade suggestions across G10 and EM.

Technical Analysis. EUR-NOK – far enough?

Event calendar. Market focusing on the release of the delayed US employment report for September.

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EMFX – Sell volatility, buy diamonds

A variety of idiosyncratic changes and an easing in external financing conditions have improved the landscape for EMFX in recent weeks. The short term environment will likely remain conducive to further muted gains for selective EMFX.

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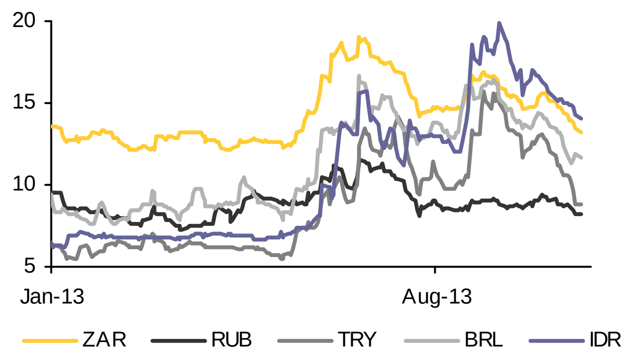
By any standard EMFX enjoyed a turbulent summer, experiencing significant losses after the Fed indicated its intention to taper its QE3 programme. After the generic sell off, central banks engaged in a variety of policy responses including rate hikes, capital controls and currency interventions. These actions have been successful in alleviating depreciation pressure. Chart 3 illustrates the development of 3 month carry against currency performance. It is clear that those currencies which experienced rate hikes have also seen the benefits in currency appreciation. Indeed in some cases rate hikes have been so significant that it is now prohibitively expensive for speculators to initiate short positions in EMFX (BRL especially).

At the same time the above dynamic benefitted from an improvement in external financing conditions, namely US treasury yields. Following the immediate see - saw reaction of EMFX to the Fed's September meeting, volatilities have steadily decreased across most of the EM complex (and across most asset classes more generally speaking). This dynamic as always is conducive towards gains in carry trades which have performed well since September such that high beta EMFX carry trades have been able to recoup nearly 50% of their losses since May. Lower beta EMFX carry trades recouped all of their losses. The question is whether this dynamic will be maintained? On the external side market participants now expect Fed tapering to take place no earlier than March 2014 meaning volatility should remain subdued in the short term. Hence further outperformance of EMFX is entirely possible.

However investors should be careful not to over-egg the pudding as EM currencies continue to be burdened by longer term structural issues. Real rate profiles remain low by absolute and historical standards and likewise the rate hike measures stated above will likely have a deleterious effect upon growth, which is already adjusting towards a structurally lower profile. Local central banks will likely be vigilant against any significant appreciation of their currencies. Remember, it was only 6 months ago that central banks were complaining about the challenges posed by too strong currencies. However we are some way away from this being an issue.

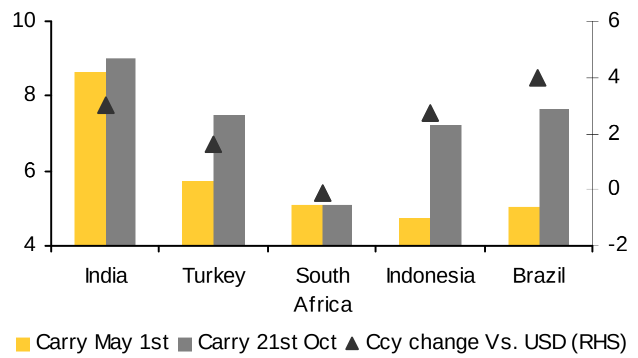
At the same time, developments in current accounts will continue to be an issue as far as the market is concerned. That being the case investors would do well to take a selective approach towards EM currencies and avoid excessive exposure towards higher beta currencies that exhibit large current account deficits. In this respect getting selective exposure towards the likes of PLN, MXN and MYR could prove to be a beneficial trade in the coming months.

CHART 2: **Volatilities come lower**
3 month ATM volatilities Vs. USD in % vol



Source: Commerzbank Research, Bloomberg LP

CHART 3: **The early bird catches the morning worm**
3 month deposit interest in %, Currency change Vs. USD in %



Source: Commerzbank Research, Bloomberg LP

G10 Highlights

USD continues to struggle. GDP data in focus in the UK. Profit taking in AUD on CPI data possible. BoC to remain on hold. Norges Bank unlikely to back pedal.

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USD: September US NFP might be of low informative value, with markets already focusing on the next NFP report for October at the beginning of November. The USD is likely to continue to struggle, considering the fact that QE3 tapering is postponed until Q1 next year. Although 1.3711 (February high) still remains a hurdle the risks in EUR-USD are tilted to the upside. Stop losses above this level could increase upside dynamics in case of a break on disappoining US data.

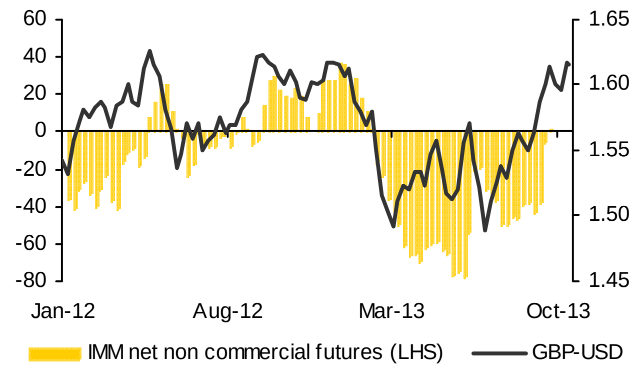
GBP: The pound is likely to tread water over much of the coming week ahead of the Q3 GDP data release on Friday. Even the release of the BoE's minutes from its last rate meeting on Wednesday are not all that likely to move markets. MPC members have been at pains to state that recent data developments by no means indicate an early tightening of monetary policy. Regarding the GDP data expectations are for an increase of +0.8% qoq, with yoy data printing at +1.5% yoy. EUR-GBP remains in the middle of its recent trading range whilst GBP-USD continues to flirt with the 1.62 level. Given the pronounced environment of USD weakness it is entirely possible that GBP-USD could trade higher, particularly in light of the dearth of significantly large long sterling positioning.

AUD: Since September the RBA has been taking a neutral stance and has not given any indication of its future approach. It is questionable whether an inflation rate that eases back below the RBA's inflation target of 2-3% in Q3 (expected 1.8% yoy) would shock the RBA sufficiently for it to take a more cautious stance again. As long as the weighted mean and the trimmed mean do not ease below 2% the RBA is unlikely to be seriously alarmed, but it will raise an eyebrow. Weak inflation data will cause profit taking in AUD-USD, in particular as the aussie was able to appreciate against the USD in recent weeks and might add to that in case of a weak US labour market report today. The 0.9680-0.9720 area is a good selling area for profit taking. The market is not going to trust surprisingly high inflation rates so that the reaction is likely to be asymmetrical and will leave less scope to the upside in AUD-USD.

CAD: The BoC is likely to remain on hold tomorrow. In its last MPR in July, the BoC expected GDP in Q3 around 3.8%, now it exepcts only 2.0-2.5%. Inflation continues to linger at the lower end of the 1-3% inflation target. Recent economic data has been mixed but rather friendly, confirming the BoC's view of moderate growth. Hence, the USD will be the driving force in USD-CAD for the time being, meaning 1.0425 should cap, the weak side being the downside.

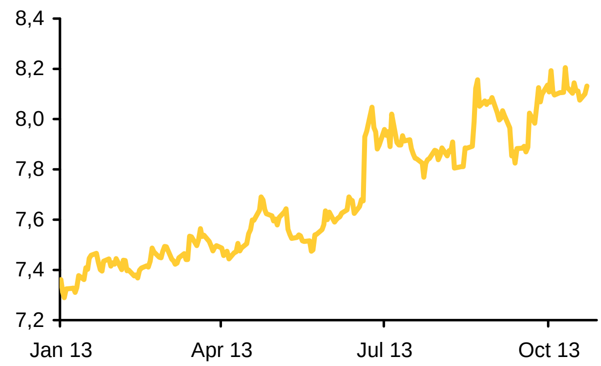
NOK: Having raised the rate path in September on rising inflation rates, it looks as if Norges Bank might have to back pedal somewhat on Thursday after CPI has come down again. However, the NOK has depreciated since then, meaning Norges Bank shouldn't change its assessment. We think the NOK is undervalued, but it is yet too early for substanial NOK gains.

CHART 4: **GBP by no means over bought**
GBP-USD spot, IMM net non commercial futures



Source: Commerzbank Research, CFTC, Bloomberg LP

CHART 5: **Too early for sustainable NOK gains**
EUR-NOK spot, daily data



Source:Commerzbank Research

FX Metrics

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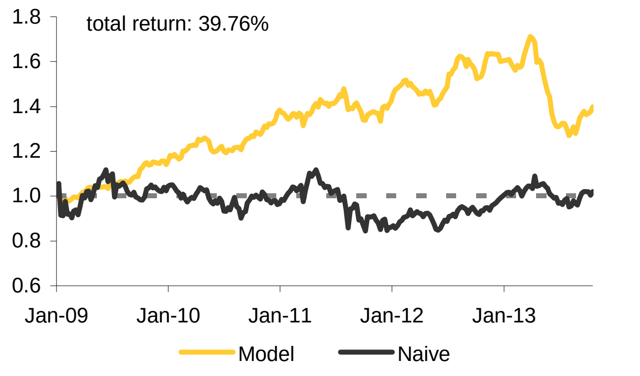
G10 carry trade indices

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.

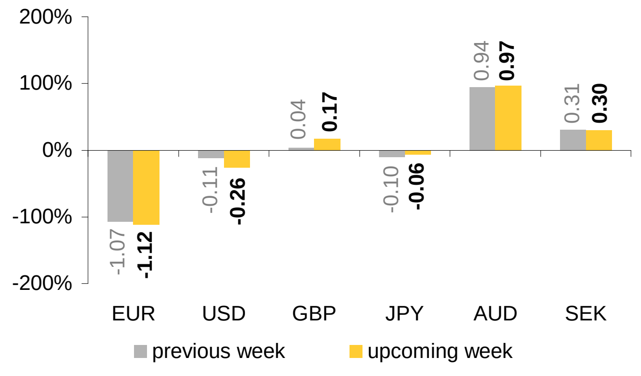
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 22 Oct to 29 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

CBT meeting likely to be a non event. Banxico to cut, Banrep to stay on hold. CPI data – still no case for ZAR appreciation.

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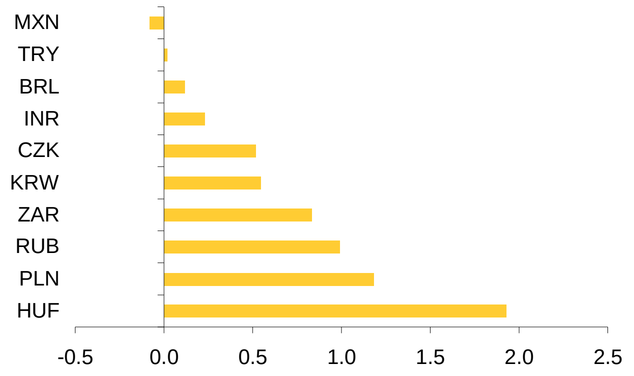
TRY: Tomorrow's CBT rate meeting is likely to be a non event for the market. Now that the TRY exchange rates have more or less stabilized, the CBT is no longer under pressure to hike key rates in order to defend its currency. While this strategy might work during the currently benign risk environment, the TRY remains highly vulnerable to setbacks in sentiment as Turkey is one of the few countries with a high current account deficit but a low (even negative) real interest rate - a highly unattractive combination. As QE tapering as well as the US debt debate are postponed to the beginning of next year, at least the TRY might be spared until the end of this year though.

MXN: With yesterday's disappointing retail sales data for August the probability of another rate cut on Friday has increased. On its last meeting in September Banxico surprised the market with a rate cut by 25 bp. Since then leading indicators have signalled that the Mexican economy might take longer to recover from recent weakness. There is uncertainty how much the two hurricanes will affect the Mexican economy. The government shutdown in the US is not helping either. On the other hand inflation eased further in September and since the US central bank is probably not going to taper in the next months Banxico might feel comfortable to cut rates again. Although we think that Banxico will stay on hold afterwards the communiqué should give more clarity regarding future steps. While ahead of the central bank decision on Friday the Mexican peso will probably take a breather this week downside pressure on the peso should be limited since dollar weakness is probably going to persist.

COP: Although industrial production continues to show weakness the strong demand side leaves little room for rate cuts by the central bank. The overall economy has improved in the second quarter and the last meeting minutes suggest that Banrep has turned to neutral. Therefore we expect the central bank to stay on hold on its rate meeting this Friday. In the case the US data calendar delivers no massive positive surprise we see no reason for USD-COP to move above the level of 1900.

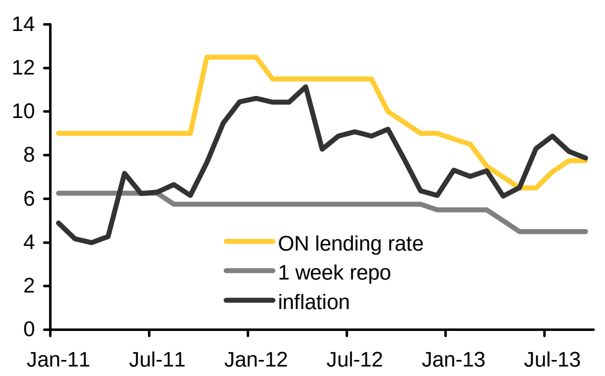
ZAR: Good news from South Africa has been scarce this year. Data publications have been overtoned by the dichotomy of reasonable cyclical data but weak structural data. All the more, attention will be drawn to CPI data due for publication tomorrow. Inflation is expected to print at +6% yoy, +0.5% mom. Although just within SARB's target we doubt whether this will give SARB any room for rate cuts in the near term. Although EM currencies in general have traded more robustly lately, ZAR has been notable in that it has not rallied to any large extent. The bottom line for investors is that it remains difficult to construct a strong case for ZAR appreciation whilst the current account deficit continues to deteriorate.

CHART 8: **Benign sentiment giving EM currencies a push**
% Gain / Loss Vs. USD since 15th October 2013



Source: Bloomberg

CHART 9: **Turkey: interest rates lower than inflation**
interest rates in %, inflation in % yoy



Source: CBT

FX portfolio recommendations

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Core trading views:

- Long low beta EMFX versus EUR and USD
- Sell volatility in selective G10 crosses (EUR-CHF, EUR-USD and EUR-GBP)
- USD to trade weakly in the coming weeks and months
- We establish low delta downside in USD-JPY as a tail hedge

Tactical trading views:

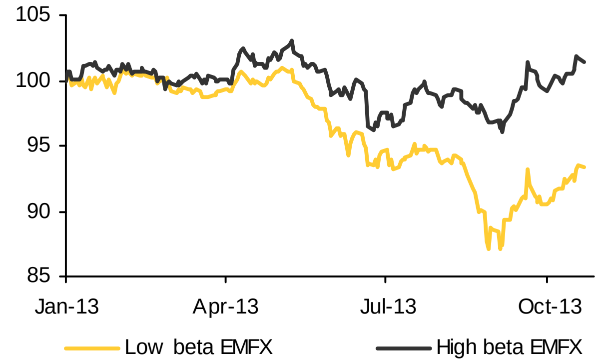
- Establish long GBP-USD positions ahead of Q3 GDP data on Friday

As discussed on page 2 our view is that the general risk environment is conducive to further gains for selective EM currencies and for carry trades more generally speaking. In this case our focus is more so upon lower beta EMFX rather than higher beta currencies within the EM complex. This is admittedly a conservative view, however current account dynamics should continue to be a burden hence we are more comfortable in getting exposure to those EM currencies which illustrate a noted improvement in this respect. As such we are content to maintain the short EUR-PLN position which we suggested last week. In our view EUR-PLN can easily move towards 4.10 in the coming weeks.

Regarding the volatility profile we find it difficult to envisage volatility increasing significantly in the coming weeks and months. On the data side, markets will treat US economic data releases with an asymmetric reaction function; discounting good US data whilst poor data should result in assumptions of continuing loose monetary conditions on the part of central banks, notably the Fed. In this sense we are happy to hold short volatility positions in EUR-GBP where we are short a 0.81 – 0.87 strangle. With EUR-GBP currently in the middle of its recent range at 0.845, this is the perfect way of gaining premium in the short term. We also maintain the short put position in EUR-CHF which we have held for sometime. In EUR-USD we maintain the short strangle position which we suggested a number of weeks ago (1.25 – 1.38).

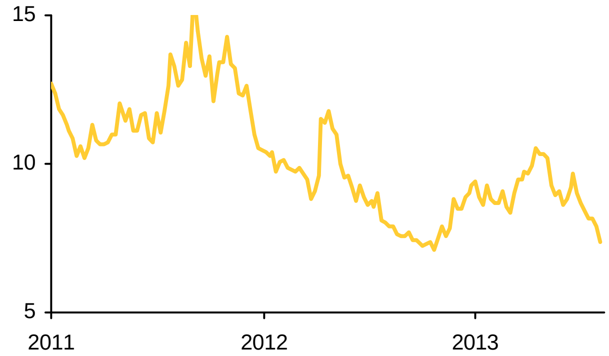
Given the asymmetric reaction function described above we think it reasonable that the USD should continue to trade rather weakly. Tapering at this stage is increasingly tilted towards being a Q1 2014 event. Hence with a generally accommodative monetary framework the USD should continue to trade with a benign neglect in the coming weeks and months. As a tail hedge, we establish a 3 month downside put in USD-JPY with a 94.00 strike for a cost of 0.55% of notional, just in case we see more pronounced USD weakness in tandem with an increase in risk aversion.

CHART 10: **Low beta EMFX performs well since July**
% gain / loss Vs. USD since 2nd September 2013



Sources: Commerzbank Research, Bloomberg LP

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



Sources: Commerzbank Research, Bloomberg LP

Tactical trading views:

- Investors should consider establishing long GBP-USD positons ahead of the Q3 GDP release in the UK on Friday. Positioning is still rather light coming into the release and as such it is difficult to argue that sterling is overbought. At the same time our feeling is that upside in GBP-USD is not owned to any large degree in the options market, hence we may well see a move towards 1.6480 quite easily. From a technical perspective the risk reward is also compelling with the downtrend since early January at risk of being eroded with a break of 1.6250. We would go long with a tight stop around 1.5960.

Portfolio Risk:

- The portfolio is negatively correlated with volatility
- The portfolio is negatively correlated with the USD. The risk here is that we see a more aggressive weakening / strengthening of the USD in the near term. For EUR-USD market participants are now starting to fret about moves towards 1.40, in line with seasonal factors. However valuation measures argue that this is something of a stretch for EUR-USD at this point in time. As such we are content for the moment to maintain the short strangle in EUR-USD within the portfolio.

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	0.10%	4.10	Open
21.10.2013	Long GBP-USD	1	1.6150	1.5960	0.00%	1.6480	Open

Source: Bloomberg L.P., Commerzbank Research

TAB. 2: **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%	-0.73%	-0.12%	Open
15.10.2013	EUR-GBP strangle 0.81 / 0.87	15.01.2013	1m x 1m	+0.46%	-0.42%	0.04%	Open
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1m	0.42%	-0.39%	-0.03%	Open

Sources: Bloomberg L.P., Commerzbank Research

Technical Analysis

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EUR-NOK – far enough?

EUR-NOK has seen a stunning rally throughout 2013, rising from a low circa 7.30 at the beginning of the year to a recent peak circa 8.20, a move of over 12%. We suspect that the market will now struggle to make further gains.

For starters both the daily and weekly RSI's are showing signs of significant divergence (this reveals a loss of upside momentum). Secondly the up move is approaching some very tough resistance offered by the 8.2575 October 2010 high and lastly the move looks to be executing a 'return to point of break down' from the previous 1975-2010 uptrend. This now offers resistance at 8.2860.

With such a dense band of resistance in the mid to late 8.20's and given the divergences, we suspect that the market may have already topped. We note that the daily chart is indicating that the recent move higher was also the 5th leg of an Elliot wave count. As a consequence we would allow for the upmove to grind to a halt (it is possible that we will see another minor new high, which we suspect will not be sustained) and look for a slide back to the 7.80/7.7660 region, where we find the lows charted since July.

CHART 12: **EUR-NOK - Weekly chart**
Weekly RSI has diverged

Source: CQG, Commerzbank Research

CHART 13: **EUR-NOK – Quarterly Chart**
Previous uptrend now offers resistance at 8.2860

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
22 October	13:30	USA	Nonfarm Payrolls	K	SEP	180	169
			Unemployment rate	%	SEP	7.3	7.3
	14:00	USA	Tic data	USD bn	AUG	31.0	31.1
23 October	01:30	AUD	Consumer prices	qoq	3Q	0.8	0.4
				yoy	3Q	1.8	2.4
	09:00	ZAR	Consumer prices	mom	SEP	0.5	0.3
				yoy	SEP	6.0	6.4
	12:00	TRY	Interest rate decision	%	OCT 23	4.50	4.50
	12:00	USA	MBA Mortgage Applications	%	OCT 18	-	0.30
	13:00	RUB	CPI weekly year to date	%	OCT 21	-	5.0
	13:30	USA	Import Prices	mom	SEP	0.2	0.0
				yoy	SEP	-1.0	-0.4
		USA	OFHEO House Price Index	yoy	AUG	0.8	1.0
	15:00	EUR	Consumer confidence		OCT A	-14.5	-14.9
	15:00	CAD	Interest rate decision	%	OCT 23	1.00	1.00
24 October	08:00	CZK	Composite confidence indicator		OCT	-	1.2
	08:30	GER	PMI (Markit)		OCT A	51.4	51.1
	08:30	GER	PMI Services (Markit)		OCT A	53.7	53.7
	08:30	SEK	Interest rate decision	%	OCT 24	1.00	1.00
	09:00	EUR	PMI (Markit)		OCT A	51.4	51.1
	09:00	EUR	PMI Services (Markit)		OCT A	52.2	52.2
	09:00	NOK	Interest rate decision	%	OCT 24	1.50	1.50
	12:00	RUB	FX and gold reserves	USD bn	OCT 18	-	509.8
	13:30	USA	Initial jobless claims	K	OCT 19	340	358
	13:30	USA	Trade balance	USD bn	AUG	-39.5	-39.1
25 October			ex fresh food and energy	mom	OCT	-0.3	-0.3
	00:30	JPY	CPI	yoy	OCT	0.5	0.5
			ex fresh food	yoy	OCT	0.3	0.2
	09:00	EUR	M3 money supply 3 month av.	yoy	SEP	2.3	2.3
	09:00	GER	ifo business climate		OCT	108.0	107.7
			Current assessment		OCT	111.4	111.4
			Business expectation		OCT	104.5	104.2
		GBP	GDP	qoq	3Q A	0.8	0.7
				yoy	3Q A	1.5	1.3
	13:30	USA	Durable Goods New Orders	mom	SEP	2.2	0.1
			ex Transportation	mom	SEP	0.5	-0.1
	14:55	USA	Michigan consumer confidence		OCT F	75.0	75.2
27 October	10:59	GER	Retail sales	mom	SEP	-	-0.2
				yoy	SEP	-	0.3
28 October	08:30	SEK	Retail sales	mom	SEP	-	0.3
				yoy	SEP	-	2.4
	-	GBP	Nationwide House Price Index	mom	OCT	-	0.9
				yoy	OCT	-	5.0
	-	GER	Import Prices	mom	SEP	0.2	0.1
				yoy	SEP	-3.1	-3.4
	13:15	USA	Industrial production	mom	SEP	0.4	0.4
	13:15	USA	Capacity utilization	%	SEP	78.0	77.8
	14:00	USA	Pending home sales	mom	SEP	0.0	-1.6

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