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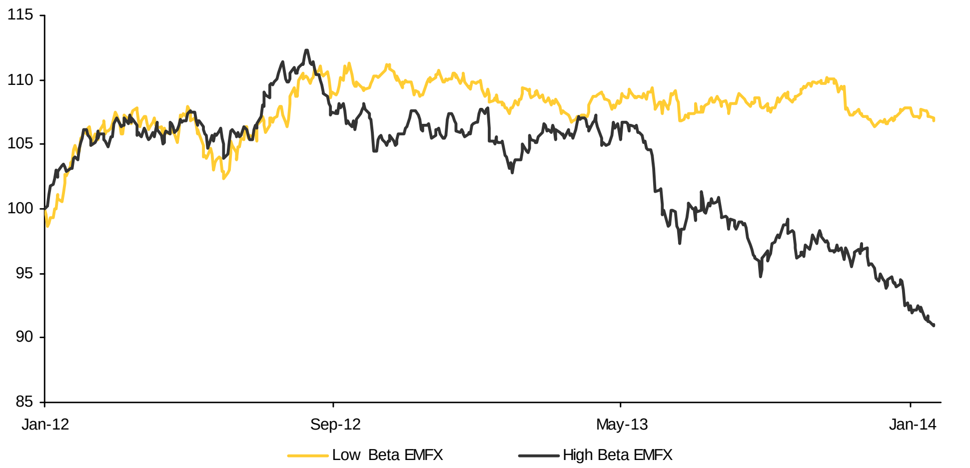
FX Alpha

21 January 2014

High Beta EM currencies hitting a BRIC wall?

High Beta EM currencies hitting a BRIC wall? Markets will now focus on idiosyncratic policy responses by national central banks.

CHART 1: **High Beta EMFX underperforms**
Low Beta (PLN, HUF, CZK) High Beta (TRY, ZAR, RUB) Vs. EUR



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. The downside remains the vulnerable side in EUR-USD. GBP should continue to benefit from disinflationary growth. Be prepared to a quickly acting RBNZ. The BoC could sound more cautious tomorrow.

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

EM Highlights. UAH embarks on a gradual depreciation path. MXN to take a breather. Minutes should give more clarity about the next rate decision by the Banco central do Brasil.

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

Technical Analysis. Canadian Dollar weakness this year is expected to be pronounced.

Event calendar. No first tier data due, and the FOMC meeting next week already casts shadows.

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High beta EM currencies hitting a BRIC wall?

Markets will now focus on idiosyncratic policy responses by national central banks.

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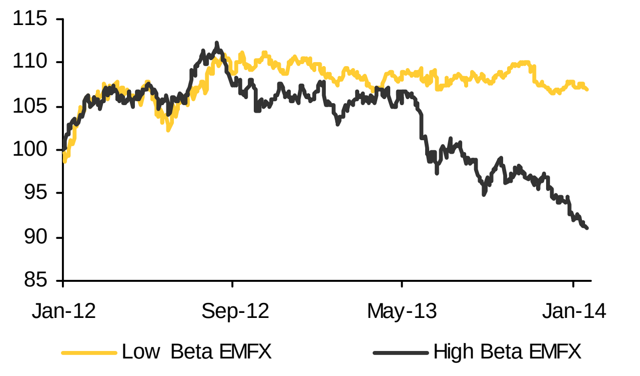
Since the beginning of the year markets have treated higher beta EM currencies, in particular TRY and ZAR, with a high degree of suspicion. In part this is merely a continuation of a trend from last summer, but nonetheless the weakness seen so far this year is disconcerting. Further weakness comes despite modest falls in US yields following Fed tapering in December. Thus far it is clear that markets are not following previous patterns of announcement effect vs. implementation effect of QE policies (where asset prices moved before QE programmes were actually implemented). Lower beta EM currencies however have fared reasonably well during this period; therefore we cannot consider current price action as being part of generic EM weakness but rather weakness that is specific to the higher beta complex. To improve the situation, it requires either i) a significant fall in US yields or ii) idiosyncratic policy responses by national central banks.

So far this year national central banks have been conspicuous by their absence in terms of verbal interventions aimed at stemming currency weakness, particularly TRY and ZAR. Although markets have moved to price in rate hikes, in South Africa the lack of any pick up in inflation from the weakening ZAR gives SARB some scope for waiting to act, though markets currently price in a 50 basis point hike. Likewise in Turkey, although markets have moved to price in rate hikes, politicians continue to paint a rather disjointed picture with some calling TRY weakness temporary and others calling for rate hikes. This confusion has done TRY no favours with the TRY basket now trading at all time highs.

The question then becomes to what extent rates will have to increase in order to meaningfully stem currency weakness? In the case of TRY we will need to see the overnight lending rate rise to levels around 10% and even for the repo rate itself to rise by 50 bps before we see the trend revert. For SARB such levels are out of reach given the unemployment situation hence we are likely to see more ZAR weakness in the coming weeks. That said; ZAR now trades 15% below its 5 year average in REER terms, so we are getting to a point where ZAR will become excessively cheap. It is worthwhile considering the steps that the Brazilian authorities have taken over the past 6 months in order to stem their inflation problems. Successive selic rate hikes towards current levels of 10.5% have stemmed BRL weakness but at the same time have not meaningfully led to BRL appreciation.

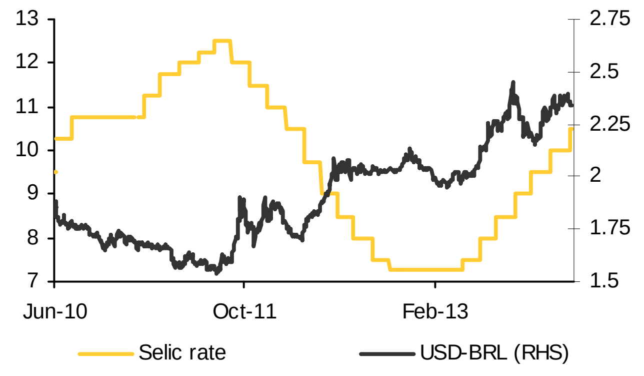
The trick for central banks is to make the cost of carry prohibitively expensive such that any pause in weakening momentum will lead to investors and speculators reducing short positions. However this is not a costless policy as it will reduce growth significantly. The bottom line is that Q1 is likely to be a difficult period for high beta EM currencies.

CHART 2: **High Beta EMFX underperforms**
Low Beta (PLN, HUF, CZK) High Beta (TRY, ZAR, RUB) Vs. EUR



Source: Commerzbank Research, Bloomberg LP

CHART 3: **BCB shows how it's done**
USD-BRL spot, Selic rate in %



Source:Commerzbank Research, Bloomberg LP

G10 Highlights

The downside remains the vulnerable side in EUR-USD. GBP should continue to benefit from disinflationary growth. Be prepared to a quickly acting RBNZ. The BoC could sound more cautious tomorrow.

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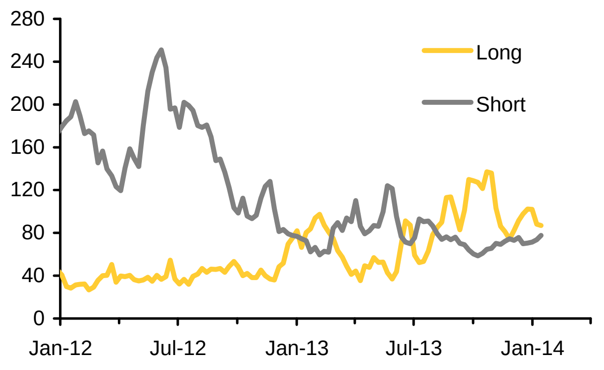
EUR: Unfortunately, EUR-USD currently isn't a really interesting story. Ahead of the FOMC meeting, there are no Fed speakers, and recent euro zone economic data doesn't give any further hints to the ECB's policy. Market consensus goes for a further reduction in QE3 next week at the FOMC. At the same time, speculative EUR positioning is almost balanced after speculative traders reduced their EUR longs since their performance hasn't been systematically positive any longer. The event calendar is slim, which means that slow trading is likely to prevail until the weekend. Nevertheless, the weak side remains the downside in EUR-USD since the monetary policies of the Fed and the ECB continue to move into different directions.

GBP: The pound continues to trade robustly in line with better than expected UK economic data. In particular last week's CPI and retail sales illustrate that the pound should continue to benefit from disinflationary growth. This week the key release will be UK unemployment data to be released on Wednesday. Expectations are for a print of 7.3%, meaning that the BoE are getting closer to one of their forward guidance thresholds being breached. That said, already various BoE speakers have been quick to point out that the 7% unemployment level is a threshold and not a trigger. Therefore investors should expect the BoE to engage in more verbal intervention aimed at calming rate hike expectations.

NZD: Be prepared that the RBNZ acts quite quickly on the key rate. Inflation has been rising since last summer despite the strong NZD, momentum in the construction and housing sector is more and more spreading over to the entire economy. Among the G10 central banks, the RBNZ will be the first to start a hiking cycle. The timing remains the only open question. Having signalled a first rate hike in summer at its last meeting, we think the RBNZ will stay on hold next week but sharpen its language and verbally bring forward the first rate step to March. This means further support for the NZD. The downside in NZD-USD should be limited to 0.81, since even more tapering by the Fed can't compete with a classical hiking cycle.

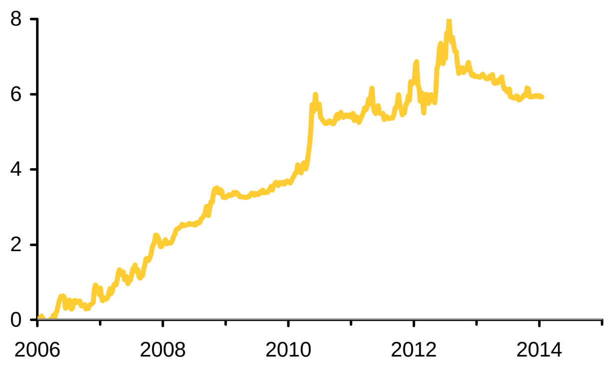
CAD: The BoC will remain on hold tomorrow. No big surprises are expected. Central Bank Governor Stephen Poloz, who is more on the dovish side compared to his predecessor Mark Carney, might sound a bit more cautious than in December, having voiced concerns at the beginning of January on low inflation levels. This means that USD-CAD can climb a bit higher on a dovish BoC tomorrow afternoon after having tested the upside at 1.1020 this morning.

CHART 4: **Speculative EUR positions almost balanced**
EUR positions of non-commercial IMM traders, in '000 contracts



Source: CFTC, Commerzbank Research

CHART 5: **Performance of net EUR positions held by speculative IMM traders**
In USD billion since early 2005



Source: Commerzbank Research

FX Metrics

G10 carry trade indices

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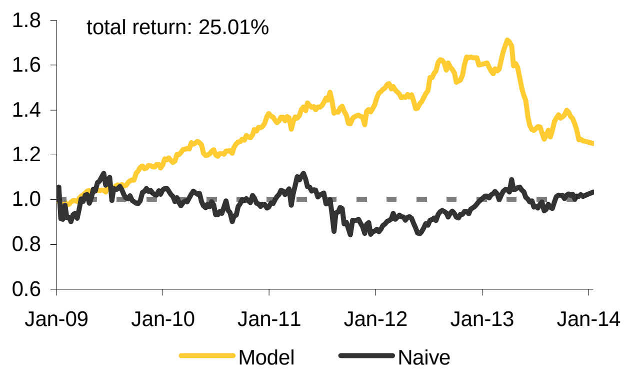
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

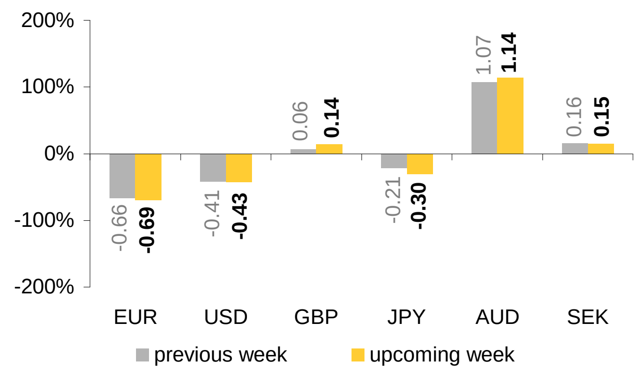
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 21 Jan to 28 Jan**
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

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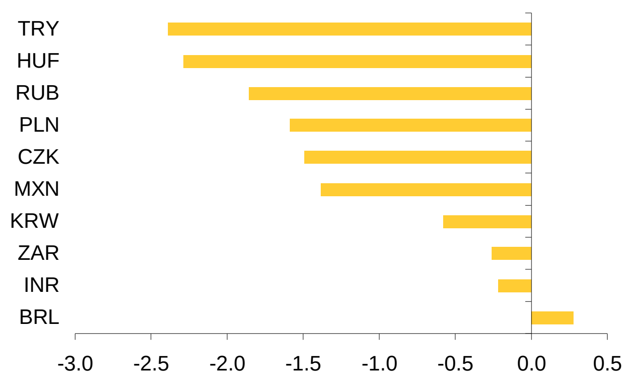
UAH embarks on a gradual depreciation path. MXN to take a breather. Minutes should give more clarity about the next rate decision by the Banco central do Brasil.

UAH: Despite securing substantial financial support from Russia, the Ukraine government is facing strong headwinds. Pro-EU protests renewed and are putting pressure on UAH. USD-UAH temporarily rose to as much as 8.39. Pressure is likely to persist as the fundamental situation remains weak and political infighting continues. In our view the central bank is going to tolerate a gradual depreciation trend as it is by now in no position to defend the currency any longer. Reserves have melted away significantly over the past year and a weak currency could alleviate pressure from the staggering high current account deficit. We see USD-UAH rising further to 8.50.

MXN: Last week the Mexican peso was one of the worse performers amongst the EM currencies. It seems unjustified that the peso of all currencies should have suffered like that. Compared with many other countries of the segment Mexico is in a better position fundamentally. As the US economy is on a solid recovery path Mexico is likely to benefit from the strong economic dependence on its neighbour. Admittedly that is not yet obvious in the economic data. The monthly economic indicators as well as industrial production in particular have been disappointing recently. This week the peso might be allowed a breather. There is no important data due for publication in the US and as a result there is a lack of negative momentum. After the strong upwards move in USD-MXN we see good chances for a short-term correction. However, on Friday Mexico will release retail sales for November. A disappointing release should weigh on the peso. Additionally the Fed meeting next Wednesday already casts shadows.

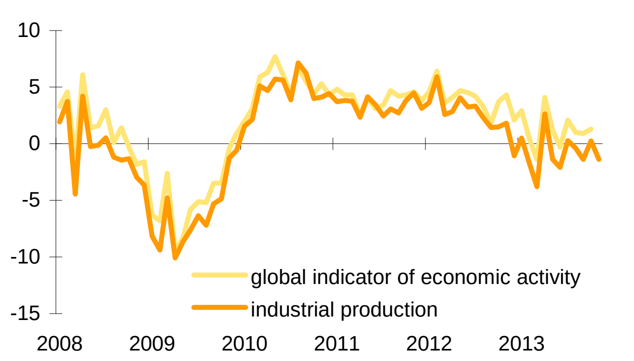
BRL: This Thursday the Brazilian central bank will release the minutes of its last week's monetary policy decision where it hiked its target rate by another 50 bps to 10.50%. A small majority had expected that the central bank will reduce the pace to 25 bps. Many market participants adjusted their forecasts after the decision expecting the Selic to end the year at 10.75% (before: 10.5%). The accompanying statement did not provide a clear signal about the next step by the central bank. On the one hand inflation remains stubbornly high, on the other hand the central bank has increased the Selic by 325 bps since April 2013 and the effect on inflation and the economy has still to be seen. Therefore the central bank might prefer to take a pause. The minutes could give more clarity. A hawkish central bank might lend some support, however only temporary. We don't expect that the BRL can continue its good performance seen in the last days. The fundamental problems persist and speculations that the US Fed will taper its asset purchases again next week should increase and weigh on the BRL.

CHART 8: **BRL outperforms**
gains/losses against USD since 14th January 2014



Source: Bloomberg L.P., Commerzbank Research

CHART 9: **Recovery in Mexico expected, but not visible in the data yet**
Mexico's global indicator of economic activity and industrial production, yoy change in percent



Source: Commerzbank Research, INEGI

FX portfolio recommendation

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Core trading views:

- Close short volatility positions in EUR-CHF & EUR-GBP
- Establish long USD positions via basket trades
- Position for sterling outperformance in Q1

Tactical trading views:

- We initiate long GBP positioning versus AUD

Over the week the short strangle position in EUR-GBP (0.87 / 0.81) expired out of the money as expected with a profit of 0.47% of notional. The short volatility position in EUR-CHF continued to perform well, however we have decided to close the position mainly as a result of EUR based risks. We now think it likely that the ECB will cut its refi rate in Q1 and also impose negative deposit rates. As this combination of measures is not a consensus view from the market it offers considerable downside risks for the EUR and as such we have closed the EUR-CHF position to show a profit of 0.52% of notional.

The long USD basket trade performed reasonably well over the week and now shows an aggregated profit of 0.8%. IMM positioning shows an increase in long USD positioning week on week which illustrates that the long USD trade is starting to gain legs. That said, short term 2 Yr US rates were a touch lower over the week, but we still expect the rate profile to move in the USD's favour over the coming weeks.

The downside position in USD-JPY will expire this week so we will begin to think about potential low delta downside positions in EUR-JPY as a tail hedge to possible ECB actions and any disappointments stemming from Japanese data.

TAB. 1: **Global FX Strategy Spot Portfolio**

Trade date	Strategy	Size (€ mln)	Entry level	Stop	% Gain / Loss	Take Profit	Open/ Closed
14.01.2014	Short EUR-USD	1	1.3680	1.4090	**0.92%**	1.2610	Open
14.01.2014	Long USD-CHF	1	0.9015	0.8745	**0.87%**	**0.9730**	Open
14.01.2014	Long USD-CAD	1	1.0900	1.0560	**0.45%**	**1.1760**	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
15.10.2013	Short EUR-GBP strangle 0.81 / 0.87	15.01.2013	1 x 1	+0.47%	0.00%	0.47%	Closed
22.10.2013	Long USD-JPY 94.00 put	21.01.2013	1	-0.42%	0.00%	-0.42%	Open
26.11.2013	Short EUR-CHF 1.22 put	25.02.2013	1	+0.60%	0.08%	0.52%	Closed

Source: Commerzbank Research, Bloomberg LP

Tactical trading views:

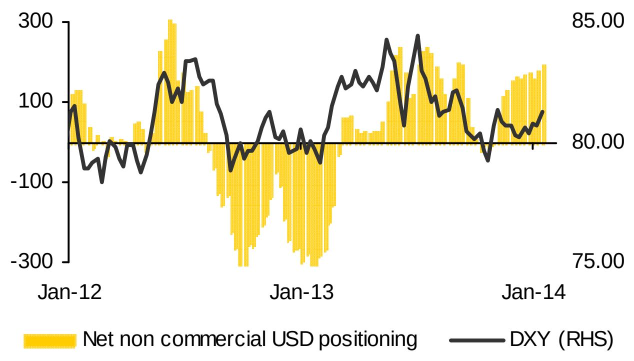
- We recommend investors to position for further GBP-AUD outperformance over the remainder of the year. One of our key themes coming into Q1 has been that sterling would outperform due to the increase in UK real yields and buoyant economic growth.

At the same time, the RBA display a rather neutral bias and explicitly favor a weaker exchange rate. Seasoned investors know that you should not stand in the way of a central bank that wants a weaker exchange rate and as such we are content to position for more upside in this cross. As such we recommend to buy a dip around 1.8520 with a view to taking profit towards 1.90. We maintain a stop loss at 1.8355.

Portfolio Risk:

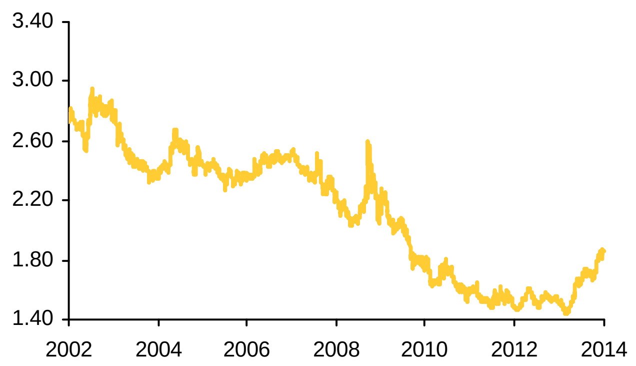
- The portfolio is positively correlated with the USD

CHART 10: **Long USD positioning increases**
DXY, IMM net non commercial futures



Sources: Commerzbank Research, Bloomberg LP, CFTC, ICE

CHART 11: **GBP-AUD to correct higher**
GBP-AUD spot



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

Canadian Dollar weakness this year is expected to be pronounced

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The Canadian Dollar is set to see weakness throughout 2014. At the end of last year we saw the Bank of England Trade weighted index (TWI) complete a 3 year top pattern, which suggests that the market is likely to come under increasing downside pressure in 2014.

We would allow for losses towards the 12 year support line, this is currently located at 99.08, and this is regarded as a minimum downside target.

One of our favourite trades is long USD-CAD, which recently completed a 4 year base by registering a close above the 1.0857 May 2010 peak. Initial upside target is 1.1187/1.1235, the 1991 low and the 50% retracement of the move down from the 2009 peak. While we acknowledge that this is likely to hold the initial test, we then look for further gains to 1.1668/1.1782 band, the 61.8% retracement of the same move and the 38.2% retracement of the move down from the 2002 peak. Dips lower should remain well supported on pullbacks into the 1.0857/ 1.0736 band (May 2010 high and the December 2013 high). While above here, the market will remain well placed for further gains.

We note the potential head and shoulders pattern on the CAD-MXN cross but await a weekly close below 11.84 to confirm. The top completes on a weekly close below 11.84, and the initial downside target would be 10.61, the 20 year support line. The top offers a minimum downside measurement to 9.64; this coincides well with 9.67, which is the 2008 low.

CHART 12: **BOE CAD TWI – weekly chart**
Has completed a sizeable 3 year top

Source: CQG, Commerzbank Research

CHART 13: **USD-CAD – Monthly chart**
Has eroded its 10 year resistance line

Source: CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
22 January	00:30	AUD	Consumer prices	qoq	4Q	0,4	1,2
				yoy	4Q	2,4	2,2
	05:00	JPY	Leading Index CI		NOV F	-	110,8
			Coincident Index CI		NOV F	-	110,5
	08:00	ZAR	Consumer prices	mom	DEC	0,4	0,1
				yoy	DEC	5,6	5,3
	09:30	GBP	Unemployment rate	%	NOV	7,3	7,4
	10:00	CHF	ZEW business expectations		JAN	-	39,4
	12:00	RUB	CPI weekly year to date	%	JAN 20	-	0,3
	12:00	USA	MBA Mortgage Applications	%	JAN 17	-	11,90
	15:00	CAD	Interest rate decision	%	JAN 22	1,00	1,00
23 January	08:30	GER	PMI (Markit)		JAN A	54,6	54,3
		GER	PMI Services (Markit)		JAN A	54,0	53,5
	08:30	SEK	Unemployment rate		DEC	7,5	7,5
	09:00	EUR	PMI (Markit)		JAN A	53,0	52,7
	09:00	EUR	PMI Services (Markit)		JAN A	51,4	51,0
	11:00	RUB	FX and gold reserves	USD bn	JAN 17	-	499,1
	13:30	USA	Initial jobless claims	K	JAN 18	330	326
	14:00	USA	OFHEO House Price Index	yoy	NOV	0,3	0,5
	15:00	EUR	Consumer confidence		JAN A	-13,0	-13,6
	15:00	USA	Leading indicator CB		DEC	0,2	0,8
	15:00	USA	Existing Home Sales	mn	DEC	4,95	4,90
				mom	DEC	1,0	-4,3
24 January	08:00	CZK	Composite confidence indicator		JAN	-	5,5
	13:30	CAD	Consumer prices	mom	DEC	-0,2	0,0
				yoy	DEC	1,3	0,9
27 January	09:00	GER	ifo business climate		JAN	-	109,5
			Current assessment		JAN	-	111,6
			Business expectation		JAN	-	107,4
	-	GER	Retail sales	mom	DEC	-	0,8
				yoy	DEC	-	1,1
	-	GER	Import Prices	mom	DEC	0,2	0,1
				yoy	DEC	-2,1	-2,9

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