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FX Alpha

28 January 2014

Will JPY pause for breath?

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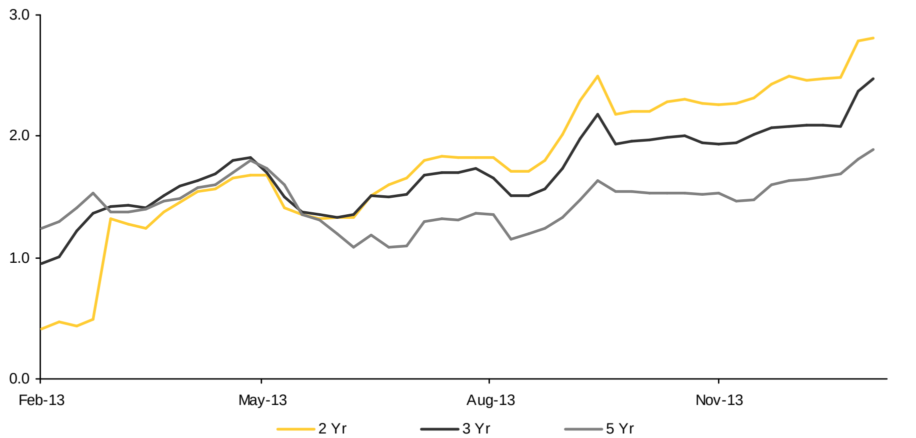
Will JPY pause for breath? Markets now fully price in the BoJ's inflation target. Is there scope for disappointment?

CHART 1: **Japanese inflation expectations move higher**
Japanese breakevens in %



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. Decent UK GDP data. Fed in focus for the USD. G10 volatility remains subdued.

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

EM Highlights. Make or break for CBT. No rate hike from SARB. Political risks abound in UAH.

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

Technical Analysis. GBP-USD at tough resistance should provoke failure.

Event calendar. Fed rate meeting and Turkish Central Bank meeting the highlights before the data calendar focuses on PMI's next week.

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Will JPY pause for breath?

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Markets now fully price in the BoJ's inflation target. Is there scope for disappointment?

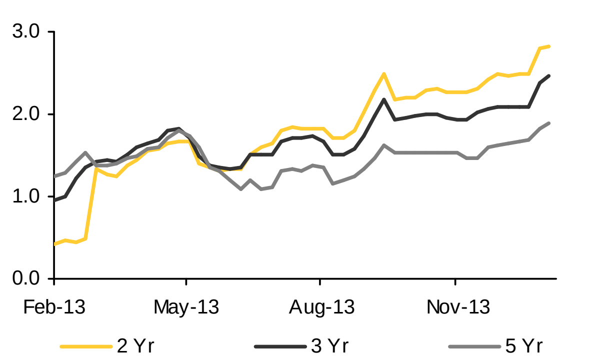
Although markets are currently fixated with woes in emerging markets and the general under-performance of carry trades, it is timely to ask whether the funding leg of carry trades, namely JPY, will weaken further.

A cursory look at inflation expectations illustrates that so far, both markets and consumers largely buy into the BoJ's inflation targeting regime. Within only 2 years, markets have gone from pricing in a deflationary scenario to pricing in sustainable increases in inflation. As a result JPY has weakened significantly with USD-JPY trading upwards from 75 towards current levels around 103. That this has been largely idiosyncratic JPY weakening can be seen in that the USD has not materially strengthened during this time frame and likewise shorter dated swap spreads have not increased markedly in favour of the USD. However one has to ask whether JPY can weaken further in the absence of any upward movement in inflation expectations. Indeed, 2 year breakevens take into account the VAT increase, but thereafter we see a declining profile.

So far, markets have largely bought in to the JPY weakening story as can be seen by the massive increase in short JPY positioning by the speculative community and commercial hedgers. Indeed it is worth asking who, if anyone, actually has long JPY positioning. At the same time one has also to question the relative risk reward of increasing JPY short positions at current levels in light of events within the higher yielding G10 and EM currency universe. Shorter dated volatilities also remain at relatively low levels; all told the ingredients for a short squeeze (however modest) are there, the only question is what could be the catalyst. Increasingly USD-JPY seems to be trading as an equity trade. Indeed the correlation between USD-JPY and the Nikkei is an impressive one. Hence any shock to equity market sentiment could well lead to position covering and subsequent JPY strength.

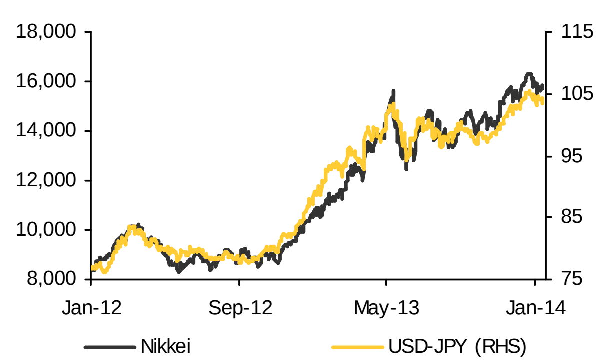
Over the longer term of course there are fundamental reasons for continued JPY weakness. Rapid balance sheet expansion by the BoJ will be a burden, even more so in the context of balance sheet contraction by the other major central banks. The most recent current account data show that Japan is running a small deficit, which implies that Japan may well have to import capital over the longer term, which of course will be a task worthy of Sisyphus given current JGB yields. All told there are good reasons to expect further longer term JPY weakness, albeit that increasing inflation expectations are not going to be one of them. On this basis, investors have to expect that the next short term driver of USD-JPY's up move is likely to come from the USD leg of the trade rather than for idiosyncratic Japanese reasons. With US rates not likely to move meaningfully higher before the end of the first quarter, this means we may well see a pause in USD-JPY's up move.

CHART 2: **Japanese inflation expectations move higher**
Japanese breakevens in %



Source: Commerzbank Research, Bloomberg LP

CHART 3: **USD-JPY increasingly an equity trade**
USD-JPY spot, Nikkei



Source: Commerzbank Research, CFTC. Bloomberg LP

G10 Highlights

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Fed in focus for USD. Decent Q4 UK GDP data. G10 volatility remains subdued.

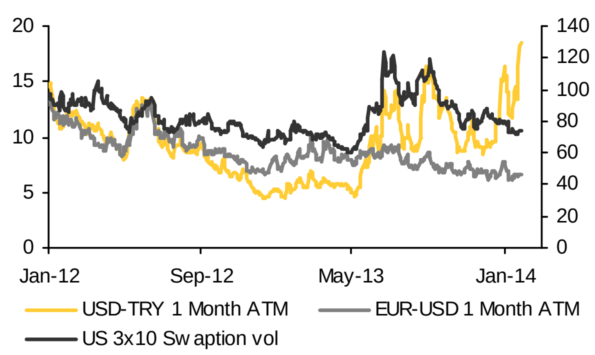
GBP: Q4 GDP printed at +0.7% qoq, +2.8% yoy, confirming the broad recovery of the UK economy. Indeed the data mean that the UK is now among the fastest growing economies amongst developed markets. The pound appreciated slightly following the data and our view is that GBP will continue to appreciate over the first quarter as it benefits from better inflation and growth dynamics than its peers. Perhaps the best way to express the long sterling view is against the EUR, where we feel the EUR is potentially subject to considerable short term downside risk from potential ECB cuts to refi rates and the imposition of negative deposit rates.

USD: This week's highlight as far as the USD is concerned will be the Fed meeting on Wednesday night where consensus expectations are for tapering to continue at USD 10 bln, bringing total monthly purchases to USD 65 bln. Although the tapering debate gets most of the attention what has been more interesting is how the USD has traded in recent days. The USD trades with a closer correlation to risky assets, appreciating in line with increasing risk sentiment and losing ground as risk aversion increases and US treasury yields fall. Whether this dynamic will continue as short term rates begin to rise is another matter however. As such investors would do well to pay more attention to rate developments and 2 year rate differentials rather than relative central bank balance sheet dynamics.

G10 volatility: Investors may well question what it will take for G10 volatility to trade at higher levels. Despite significant increases in EMFX volatility in recent days, particularly within current account deficit currencies, there has been comparatively little spill over into developed market currency volatility. This points towards markets taking a view that issues with respect to TRY and other current account deficit currencies are purely idiosyncratic rather than being caused by the tapering debate. So far, market instruments seem to bear this out in that both US yields and swaption volatilities have fallen considerably, whilst EMFX volatility has increased notably in recent days (Chart 4). Therefore once we see central bank reaction functions in the coming days, one can argue that volatilities should resume their slumber. This however, would be far too crude an expectation, especially if policy reactions disappoint already lofty expectations.

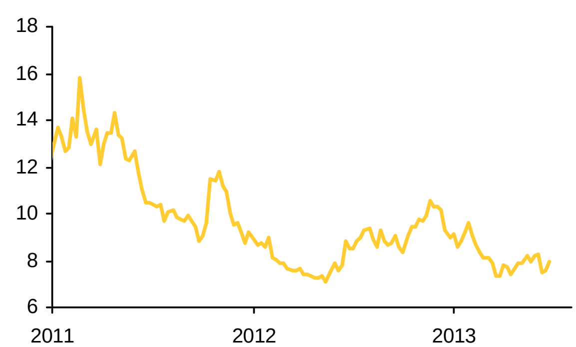
It is worthwhile noting that EUR-USD volatilities have traded at higher levels than at present nearly 90% of the time since the EUR's inception in 1999, so to an extent one might well view current volatility levels as being too cheap. The problem from an investor's point of view is that buying volatility that does not perform is effectively bleeding premia whilst the risk reward from selling volatility at current levels has to be uncompelling. The best position therefore is to stay long lower delta options that can benefit from any shocks to G10 growth, which is where most consensus expectations lie at the moment. We suggest just such a strategy below.

CHART 4: **EMFX vol increases purely idiosyncratic**
USD-TRY & EUR-USD 1 Month ATM vol in % vol, US 3 month x 10 Yr swaption in % vol



Source: Commerzbank Research, Bloomberg LP

CHART 5: **G10 vol remains subdued**
G10 3 Month implied aggregate volatility in % vol



Source:Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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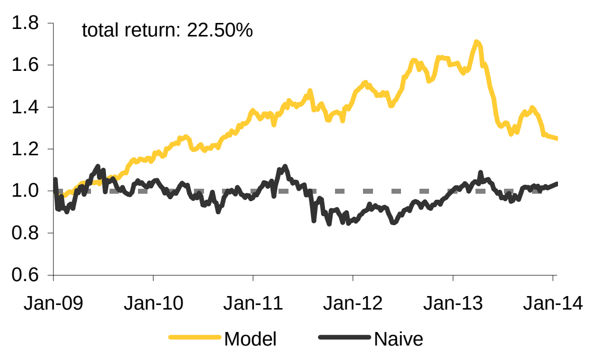
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

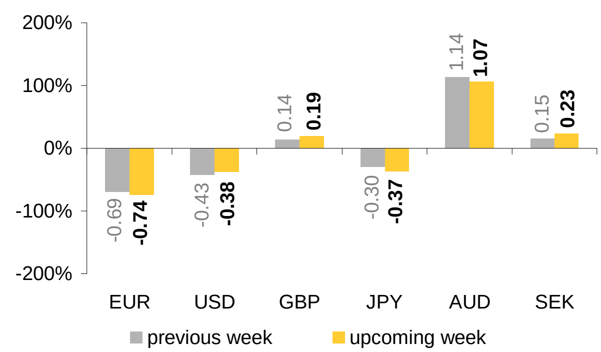
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

CHART 6: **Historic performance of optimized Carry Trade Portfolio**
Cumulative return[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 28 Jan to 4 Feb**
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

Turkish central bank: make or break. Ukraine Prime Minister resigns. No rate moves from SARB tomorrow.

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ZAR: Tomorrow's SARB rate meeting will be an interesting affair, not so much for what SARB do, but rather for what they don't. Despite widespread concerns regarding the sustainability of current account financing within emerging markets, market expectations are for SARB to remain on hold at 5.0%. The main reason being that despite the weakening ZAR, inflation levels have experienced remarkably little pick up. As such this gives SARB some room in the short term. However the longer that USD-ZAR remains above 10.50 the more likely another rate hike becomes. The question is whether a hike of merely 50 basis points will be enough to curtail the weakening ZAR, especially given that other central banks are (belatedly) moving towards a hiking bias.

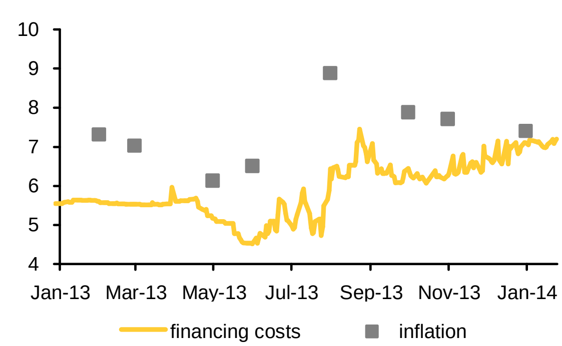
TRY: Make or break. The CBT's extraordinary meeting tonight might be one of the last chances for the central bank to regain investors' confidence. After it had kept key rates unchanged last week, despite the sharp depreciation of the TRY and elevated inflation, the TRY embarked on a depreciation spiral. Considering the positive reaction following the CBT's announcement of today's meeting, market expectations are high. The question is whether the CBT will be able to deliver or if it will yet again disappoint. In today's press conference following the presentation of the inflation report, central bank governor Basci already signalled that the CBT is considering permanent hikes of the key rates. In our view only determined and aggressive monetary tightening, e.g. a hike of the 1-week-repo rate along with the rate corridor will be able to sustain the TRY's recovery. In particular, the CBT needs to hike real rates, i.e. interest rates will have to rise significantly above inflation. Anything considered to be too hesitant (e.g. modest rate hikes of less than 100bps) will however spark the next wave of TRY weakness with USD-TRY likely to break the 2.40 resistance in no time.

UAH: Ukraine Prime Minister Azarov today submitted his resignation amid the popular protests which clears the way for a new cabinet. President Yanukovych will appoint a new Prime Minister which in turn will form a new government. The opposition is however unlikely to approve of this after recently already having rejected the offer by Yanukovych to take the Prime Minister's post. It is rather going to continue to push for early presidential elections. While Azarov's resignation is the first step towards calming political tensions, there is still a long way to go until a new government will be in place. The depreciation pressure on UAH is thus likely to persist.

CHART 8: **Next wave of EM weakness?**
% Gain / Loss Vs. USD since 21st January 2014

Sources: Bloomberg LP, Commerzbank Research

CHART 9: **Ukraine reserves melting away**
USD bn



Source: IMF, Commerzbank Research

FX portfolio recommendation

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Core trading views:

- Position for sterling outperformance in Q1
- Establish long USD positions via basket trades

Tactical trading views:

- We take profit on the GBP-AUD position
- We establish low delta downside options in EUR-JPY

Over the week our portfolio had a generally decent performance. The GBP-AUD trade recommendation performed admirably and we took profit close to the highs above 1.90. The pair has since retraced and we will look to re-establish the position at more attractive levels in the coming weeks.

The long USD basket trade had a mixed performance with the USD-CAD position outperforming whilst the USD-CHF and EUR-USD positions showed slight losses. The USD-CHF position is somewhat more nuanced in the sense that with CHF being the only real safe haven within the G10 complex, the position tends to lose ground in times of increasing risk aversion, as was the case last week. In general the USD traded on the weaker side as US yields declined in line with increases in risk aversion. However we are content to hold the long USD basket view in that US real yields should continue to appreciate in tandem with short term US 2 year rates in the coming months.

As the portfolio balance is somewhat skewed towards positive growth dynamics within G10, we are adding some protection via downside optionality in EUR-JPY, which will benefit in case of any negative developments or potential spillovers from emerging market sentiment.

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	0.23%	1.2610	Open
14.01.2014	Long USD-CHF	1	0.9015	0.8745	0.19%	0.9730	Open
14.01.2014	Long USD-CAD	1	1.0900	1.0560	2.23%	1.1760	Open
22.01.2014	Long GBP-AUD	1	1.8520	1.8355	2.65%	1.90	T/P

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
28.01.2014	Long EUR-JPY 127.00 put	24.03.2014	1	-0.15%	0.05%	0.10%	Open

Source: Commerzbank Research, Bloomberg LP

Tactical trading views:

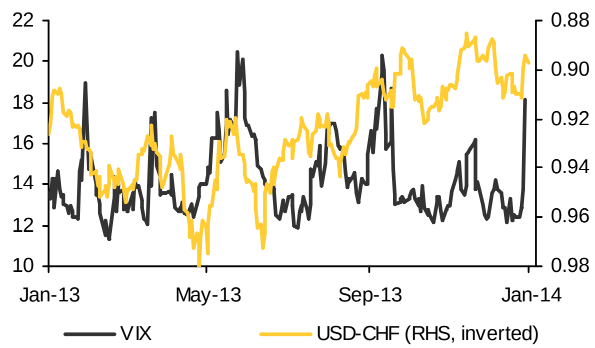
- We took profit on the long GBP-AUD trade which we recommended last week to show a profit of 2.65%. GBP benefitted in particular following the release of the UK's unemployment data which to us illustrates that GBP should continue to trade robustly. We will seek to re-enter the position at more attractive entry levels.

- We also add a downside EUR-JPY put, strike 127.00, 8 week tenor to the portfolio. The rationale behind the position is to take advantage of any negative developments coming from emerging markets and at the same time take advantage of any surprise rate moves from the ECB. Regarding the ECB, our non consensus view is that the ECB will cut the refi rate and also impose negative deposit rates. These developments imply that EUR crosses could trade abruptly lower, even for a short period, and as such the position will benefit. At a cost of only 0.15% of notional, the risk reward from the position is a compelling one.

Portfolio Risk:

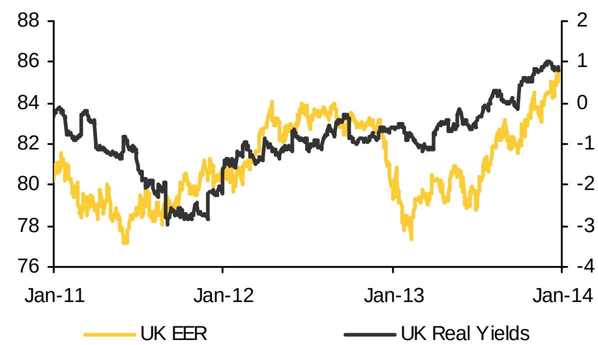
- The portfolio is positively correlated with the USD

CHART 10: **CHF benefits with increase in risk aversion**
USD-CHF spot, VIX index



Sources: Commerzbank Research, Bloomberg LP, CBOE

CHART 11: **GBP appreciation continues**
GBP EER, UK Real Yields in %



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

GBP-USD at tough resistance and the signs are it should fail.

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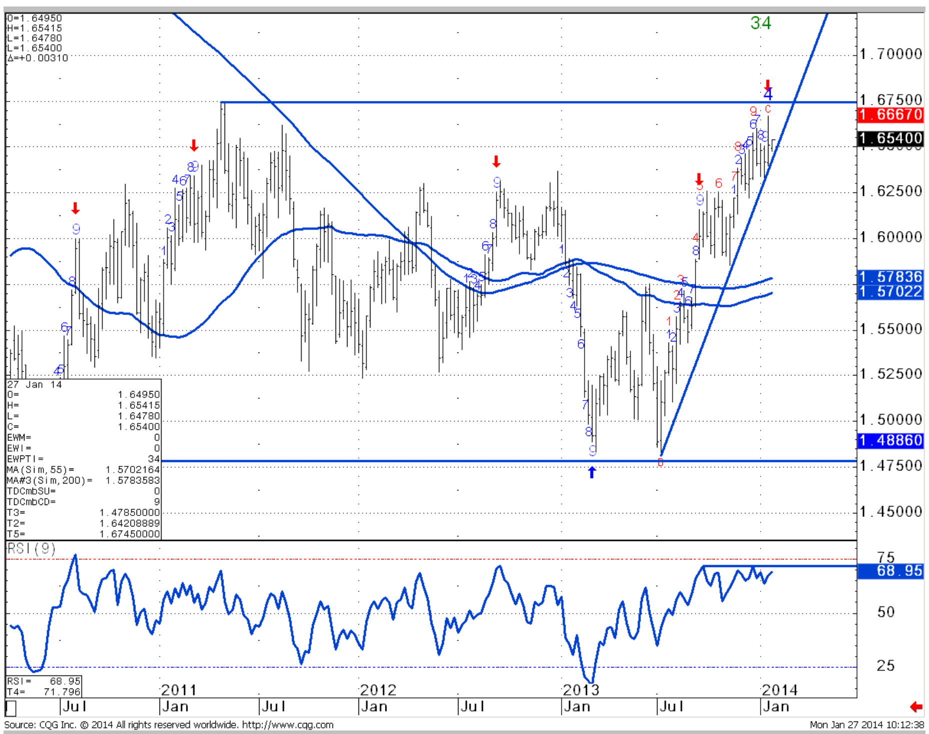
GBP-USD has strengthened over the past 6 months and rallied from a low of 1.4813 to a peak of 1.6667, we suspect that the market will now struggle to make further gains and we are alert to failure here.

Directly overhead the market is approaching much tougher resistance namely, the 1.6745 May 2011 peak. The 200 month ma at 1.6635 and the inter-year pivot line at 1.6657 are also found here. We also find here the 1.6713 55 quarter moving average.

The convergence of resistance at this juncture together with the TD perfected set up on the weekly chart all suggests that we should see initial failure here and possibly more significant failure.

A close below the 1.6259 October high will negate upside pressure and concentrate attention on the November low at 1.5855. The market should eventually return to the 1.5220/1.5176 2013 lows. Only a weekly close above 1.6745 would cause us to re-evaluate this view.

CHART 82: **GBP/USD Weekly chart**
Rally is approaching the 1.6745 2011 high



Source: CQG, Commerzbank Research

Event Calendar

Date	Time (GMT)	Region	Release	Unit	Period	Survey	Prior
29 January		ZAR	Interest rate decision	%	JAN 29	5.00	5.00
	12:00	RUB	CPI weekly year to date	%	JAN 27	-	0.4
	12:00	USA	MBA Mortgage Applications	%	JAN 24	-	4.70
	19:00	USA	Interest rate decision	%	JAN 29	0.25	0.25
	20:00	NZD	Interest rate decision	%	JAN 30	2.50	2.50
	23:50	JPY	Retail trade	mom	DEC	0.3	2.0
				yoy	DEC	3.9	4.1
30 January	08:00	CHF	KOF leading indicator		JAN	2.00	1.95
	09:30	GBP	Mortgage approval	K	DEC	73	71
	10:00	EUR	Consumer confidence		JAN F	-11.7	-11.7
			Industrial confidence		JAN	-2.9	-3.4
			Business confidence		JAN	101.0	100.0
	11:00	RUB	FX and gold reserves	USD bn	JAN 24	-	498.8
	13:00	GER	Consumer prices	mom	JAN P	-0.4	0.4
				yoy	JAN P	1.5	1.4
	13:30	USA	Initial jobless claims	K	JAN 25	330	326
	13:30	USA	GDP annualized	qoq	4Q A	3.2	4.1
	15:00	USA	Pending home sales	mom	DEC	-0.3	0.2
	23:30	JPY	Natl. CPI	yoy	DEC	1.5	1.5
			ex fresh food	yoy	DEC	1.2	1.2
			ex fresh food, energy	yoy	DEC	0.7	0.6
	23:30	JPY	Tokyo CPI	yoy	JAN	0.8	0.9
			ex fresh food	yoy	JAN	0.7	0.7
			ex fresh food, energy	yoy	JAN	0.4	0.3
	23:30	JPY	Unemployment rate	%	DEC	3.9	4.0
	23:50	JPY	Industrial production	mom	DEC P	1.3	-0.1
				yoy	DEC P	7.3	4.8
31 January	00:05	GBP	GfK Consumer Confidence		JAN	-12	-13
	07:00	GER	Retail sales	mom	DEC	0.2	0.8
				yoy	DEC	1.9	1.1
	08:00	TRY	Trade balance	USD bn	DEC	-7.10	-7.15
	08:00	HUF	Producer price index	mom	DEC	-	-0.3
				yoy	DEC	0.7	0.6
	10:00	EUR	Consumer price index	yoy	JAN	0.9	0.8
			core rate	yoy	JAN A	0.9	0.7
	12:00	ZAR	Trade balance	ZAR bn	DEC	3.0	0.8
	13:30	USA	Personal income	mom	DEC	0.2	0.2
			Personal spending	mom	DEC	0.2	0.5
			PCE-deflator	yoy	DEC	1.1	0.9
			PCE core rate	mom	DEC	0.1	0.1
				yoy	DEC	1.2	1.1
	13:30	CAD	GDP	mom	NOV	0.2	0.3
	14:45	USA	Chicago PMI		JAN	59.0	60.8
	14:55	USA	Michigan consumer confidence		JAN F	81.0	80.4
03 February	07:30	SEK	Swedbank PMI Survey		JAN	-	52.2
	08:00	NOK	Puchasing Manager Index		JAN	-	51.6
	08:00	TRY	Consumer prices	mom	JAN	-	0.5
				yoy	JAN	-	7.4
			Producer price index	mom	JAN	-	1.1
				yoy	JAN	-	7.0
	08:00	RON	Retail sales	mom	DEC	-	-0.2
				yoy	DEC	-	0.1
	08:30	CHF	SVME- PMI		JAN	-	53.9
	08:55	GER	PMI (Markit)		JAN F	54.6	56.3
	09:00	EUR	PMI (Markit)		JAN F	53.0	53.9
	09:00	ZAR	Investec PMI		JAN	-	49.9
	09:30	GBP	PMI (Markit)		JAN	58.4	57.3
		ZAR	SACOB business confidence		JAN	-	91.9

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