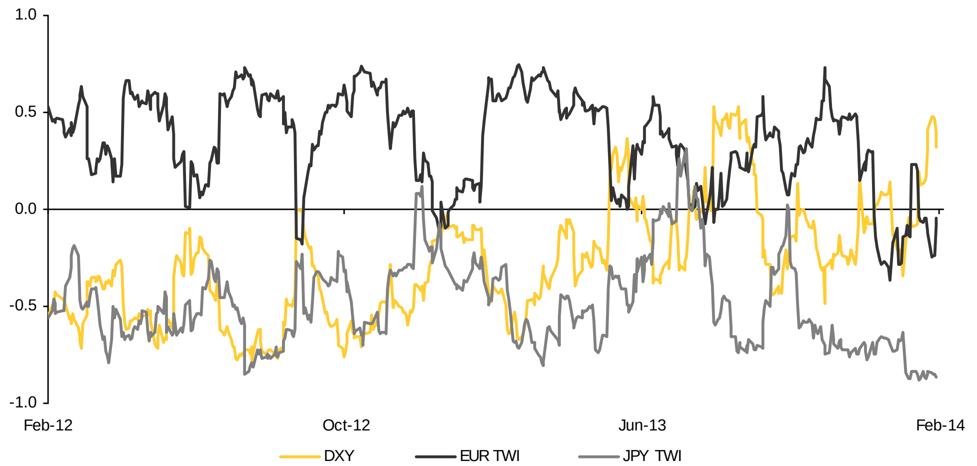
FX Alpha

What's the best funding currency?

11 February 2014

What's the best funding currency? Increasing real interest rates could lead to a resurgence in carry trade performance. We ask what is the best funding currency?

CHART 1: **JPY the clear funder thus far**
21 Day correlation with S&P Index



Source: Commerzbank Research, Bloomberg LP

G10 Highlights. Inflation Report the key event for GBP. Japanese current account data go unnoticed by investors. Riksbank to stay on hold tomorrow. Be aware of rising inflation in Norway.

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

EM Highlights. Central Bank of Russia to refrain from rate increases and isse a rather cautious statement. CEE CPI week.

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

Technical Analysis. USD weaker but looking for key supports to hold.

Event calendar. First appearance of new Fed Chairwoman Janet Yellen today. Otherwise, Riksbank rate decision as well as CEE CPIs and GDP data in focus.

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What's the best funding currency?

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Increasing real interest rates could lead to a resurgence in carry trade performance. We ask what is the best funding currency?

Year to date carry trades have been conspicuous by their underperformance on both a relative and an absolute basis. However, recent rate increases by emerging market central banks have had two distinct effects; idiosyncratic volatilities have fallen and carry has improved considerably. From this perspective the seeds for an improvement in carry trade performance have been sewn. Current account deficits should also improve somewhat in the coming months due to the combination of rate hikes which encourage foreign investment and the lagged effects of significant currency weakness. The question from here then is what or which currencies provide the best opportunities for use as funding currencies?

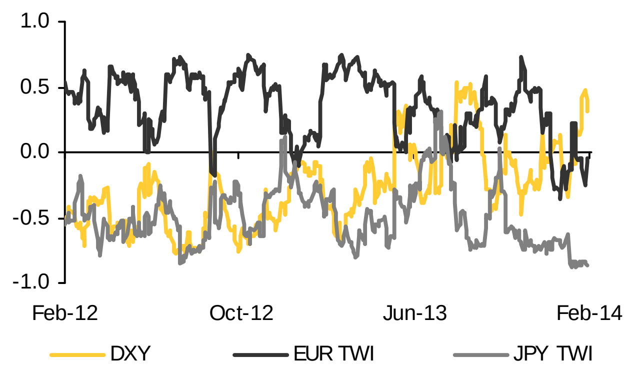
Amongst the majors, JPY shows the best prospects for use as a funding currency. It has the strongest negative correlation with risk indices (Chart 2) and unlike the other majors it boasts a worsening real yield profile. However the latter point is already widely priced in by markets as any cursory glance at shorter and longer dated breakevens will show. At the same time, the BoJ are aggressively expanding their balance sheet in contrast to the other majors, which again is a strong argument for considering JPY as a funding currency. Market participants have decreased JPY short positioning by nearly half since late December, so it is difficult to argue that JPY is oversold. All told these are good reasons to consider JPY a strong candidate as the preeminent funder.

The USD on the other hand displays a more nuanced profile. Shorter and longer dated correlations show that the USD is trading less and less like a funding currency, with most USD moves following changes in rate expectations. Likewise one should be careful in shorting the USD at what are relatively cheap levels, especially in the context of Fed tapering continuing over the course of 2014 along with shorter dated US 2 yr rates set to increase. Positioning is also noteworthy in that despite recent wobbles investors still continue to increase USD longs. Put simply the risk reward from engaging in aggressive USD shorts is not a compelling one in our view.

Which brings us to the EUR. As amazing as it sounds the EUR actually displays the characteristics of a safe haven currency, with increasing real yields, strong balance of payments dynamics and continuing portfolio inflows. Indeed the manner in which it trades is reminiscent of how JPY traded over the course of 2009-12. This presupposes that the ECB refrains from aggressive easing in their forthcoming meetings, but thus far the EUR seems too robust to short aggressively.

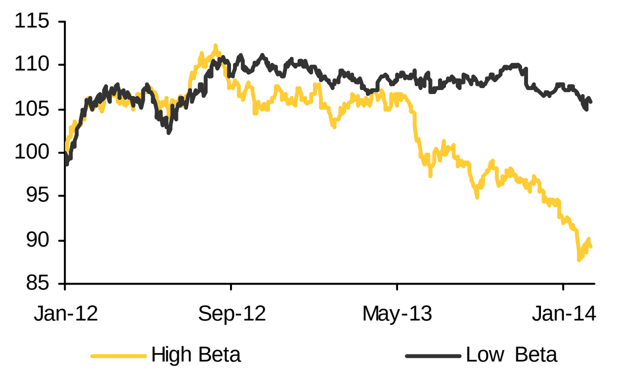
Of course there are risks to this broad scenario. Although both G10 and EM volatility remains exceptionally low, from here it can only move higher on a structural basis, which is an argument against allocating significant resources towards carry strategies.

CHART 2: **JPY the clear funder thus far**
21 Day correlation with S&P index



Source: Commerzbank Research, Bloomberg LP

CHART 3: **Carry to outperform from here?**
Low Beta (CZK, PLN, HUF) High Beta (TRY, ZAR, RUB) Vs. EUR



Source: Commerzbank Research, Bloomberg LP

G10 Highlights

Inflation Report the key event for GBP. Japanese current account data go unnoticed by investors. Riksbank to stay on hold tomorrow. Be aware of rising inflation in Norway.

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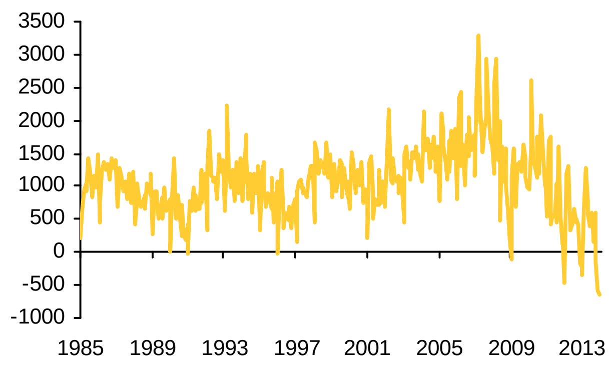
GBP: This week's Inflation Report is the key event risk for GBP investors. Coming into the release the pound has weakened as investors have reduced their long GBP positions marginally. Regarding the inflation outlook the BoE are likely to be rather sanguine, arguing that falling inflation levels give no reason to increase base rates anytime soon. The key question that investors face is whether the BoE will change their unemployment threshold from 7% towards lower levels. This has been hinted at by Governor Carney in recent statements, so this is a strong possibility. All told the BoE should make a more aggressive move towards calming market expectations of early rate increases. As such, investors would do well to tighten stops on long GBP positions.

JPY: Sunday's balance of payments data show in stark relief the challenges facing the Japanese authorities. The data show that in December Japan recorded the largest current account deficit in years. Far from being an exporter of capital according to the so called 'wall of money' theory, the data show that Japan more and more is having to import capital. What is even more surprising is that the market totally ignored the data. Again we have to highlight the risks what increasing capital imports mean for Japan. In a world of increasing interest rates it means that Japan will have to pay higher rates to entice foreign investors, therefore making control of fiscal matters significantly more difficult. That said, the market is not currently trading on this dynamic. The next key release for JPY investors will be Monday's release of Q4 GDP.

SEK: After the unanimous rate cut decision in December, Riksbank will likely stay on hold tomorrow. There is even the risk that due to recent price data, Riksbank might increase again its inflation forecast which it lowered in December. In any case the hurdle in the Executive Board for another cut is high, even among the doves. The latter are inclined to further cut the key rate in case the economy doesn't gain speed. However, recent surveys signal a pick up in momentum. Hard data have rather disappointed, though. As in many other countries, hard data and sentiment indicators have been diverging for some time now. Anyhow, the long-term risks of low rates, especially high and rising private debt levels, will prevent the Riksbank from cutting further, in particular on the backdrop of a possible increase in the inflation forecast. Overall, the rate decision should be supportive for the SEK, pushing EUR-SEK below 8.80.

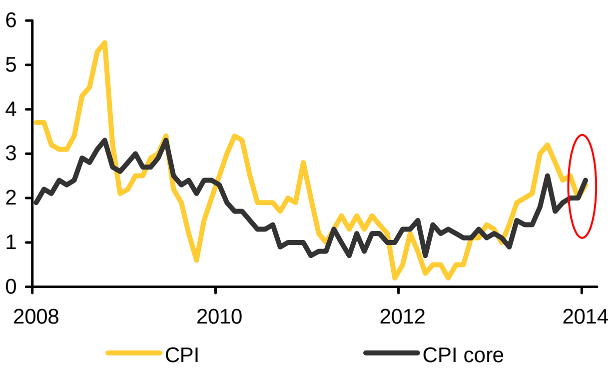
NOK: Eventually, the market is realising what we have been writing for the last months: be aware of rising inflation in Norway, pushing Norges Bank to hike rates earlier than many expect and leading to an appreciation of the NOK. At 2.3% (total) resp. 2.4% (core), inflation in January is above Norges Bank's 2014 projection of 2% and close to the 2.5% target. We have to wait for further information, but if the economy gains speed, Norges might backpedal and signal a first rate hike in summer. We are happy to see EUR-NOK approaching the 8.30-area again.

CHART 4: **Current account shows a worsening profile**
Japan current account in JPY bln



Source: Commerzbank Research, Bloomberg LP

CHART 5: **Inflation in Norway rising**
CPI and Core CPI yoy, in percent



Source: Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

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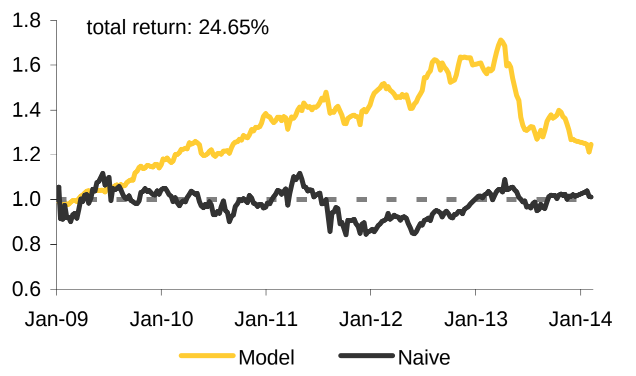
The portfolio weighting of a common carry trade strategy often simply corresponds to the ranking of the interest rate levels. Moreover the number of investment positions is usually fixed at the outset. However, such a strategy does not effectively exploit the benefits of diversifying across different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

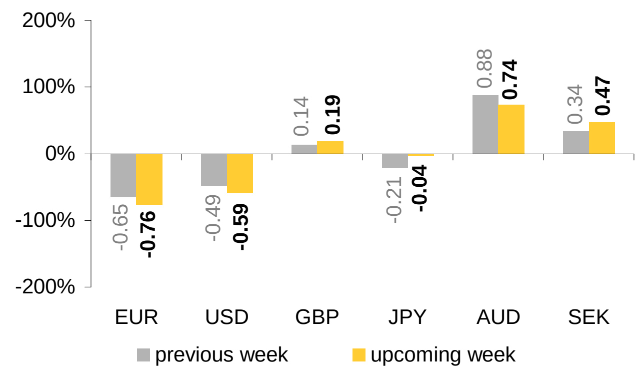
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 11 Feb to 18 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

Central Bank of Russia to refrain from rate increases and isse a rather cautious statement. CEE CPI week.

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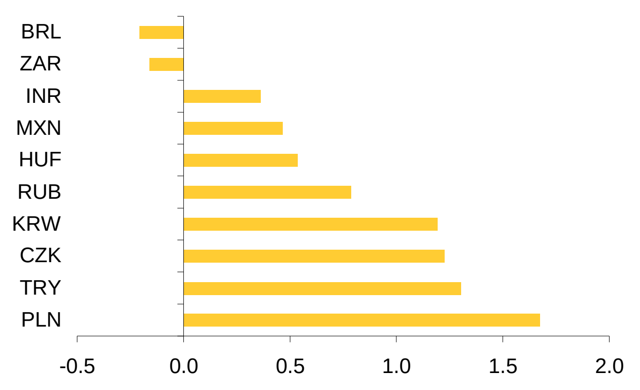
RUB: The key event risk for RUB investors over the coming week will be CBR's rate meeting on Friday. Markets will be looking to see whether CBR will follow the lead of other EM central banks and increase base rates from 5.5%. With projected capital outflows for Q1 in the region of 35 bln USD (on top of a 2013 outflow of 62 bln USD) one can see why this is an issue. Over the last number of quarters CBR has preferred to weaken the RUB as a means of loosening financial conditions, however now that CBR are moving towards a more freely floating currency regime, this essentially means that overall monetary policy will require an anchor in the form of potentially higher interest rates. For now we expect CBR to refrain from rate increases and issue a rather cautious statement. So for the moment investors can expect more detail from CBR, but not detailled action.

CZK: January CPI data due tomorrow will be key for the CNB as well as the market as they will be prove of the success of the central bank's interventions. The CNB had projected that inflation would fall to zero at the beginning of this year if it were not to ease monetary policy further. In order to avert the threat of deflation it had thus decided to weaken the koruna back in November. The consensus is now expecting inflation to have fallen to just above zero, i.e. from 1.4% down to 0.4% yoy. This would also be in line with the CNB's new projections. Any upside surprise would only confirm the CNB's stance and in this case we would not expect any significant market reaction as it should be clear that the central bank will still hold on to its exchange rate target. On the other hand, a surprise to the downside could spark speculations of a further weakening of the koruna which could well push EUR-CZK back towards the 27.65 area.

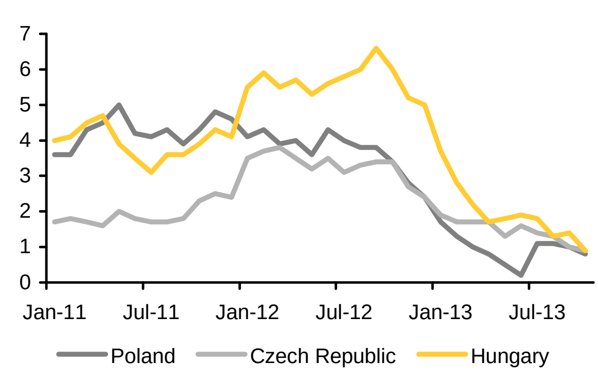
HUF: According to consensus inflation in Hungary has fallen to a low of 0.2% in January which would give the central bank plenty of reason to cut interest rates further. Only a significantly positive surprise could dampen rate cut expectations by now and provide the HUF with a positive lift. For the time being though expansionary monetary policy remains a burden on the currency. This is despite the fact that Hungarian real interest rates are at one of the highest levels within the region. The crucial point is that this is mainly due to the rapid drop in inflation and as inflation bottoms out, real rates are set to deteriorate.

CHART 8: **EM recovery**
% Gain / Loss Vs. USD since 4th February 2014



Sources: Bloomberg LP, Commerzbank Research

CHART 9: **CEE inflation falling further**
CPI, yoy change in percent



Source: National Statistics Offices, Commerzbank Research

FX portfolio recommendation

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Core trading views:

- Position for sterling outperformance in Q1
- Tighten stops on long USD positions via basket trades
- Maintain low delta downside in EUR-JPY as a tail hedge

Tactical trading views:

- We maintain a neutral position for the coming week

Over the course of the week our long USD basket position underperformed slightly. The catalyst for this underperformance lies with the mixed US labour market report on Friday. As a consequence US rates came lower and the USD weakened. However all is not lost. In our view US 2 Yr rates should start to move meaningfully in favour of the USD by the end of the first quarter meaning that the long USD trade should begin to gain more traction (Chart 11).

However, the coming week does offer some event risk, especially with Fed Chairwoman Yellen's inaugural speech. Therefore we think it prudent to tighten stops on the EUR-USD leg of the basket from 1.4090 to 1.3780.

Elsewhere the short EUR-GBP position we suggested last week did not perform although the losses were rather limited given that we implemented a tight stop. This week the BoE's Inflation Report will be the main event risk for GBP and as such we are content to re-enter sterling long positions once it becomes clear how the BoE intend to proceed.

The EUR-JPY 127 put shows a slight underperformance over the course of the week but this is rather insignificant given that it is a low delta hedge to the overall portfolio.

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	1.3780	0.33%	1.2610	Open
14.01.2014	Long USD-CHF	1	0.9015	0.8745	0.47%	0.9730	Open
14.01.2014	Long USD-CAD	1	1.0900	1.0560	1.15%	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
28.01.2014	Long EUR-JPY 127.00 put	24.03.2014	1	-0.15%	0.03%	0.12%	Open

Source: Commerzbank Research, Bloomberg LP

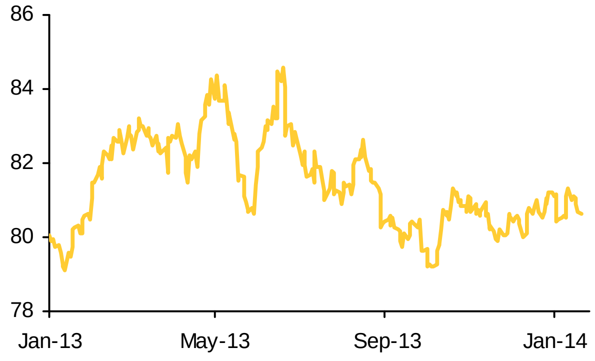
Tactical trading views:

- We maintain a neutral position for the coming week

Portfolio Risk:

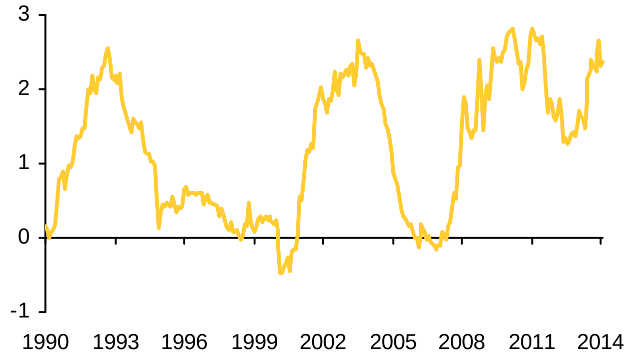
- The portfolio is positively correlated with the USD

CHART 10: **USD loses ground following NFP**
DXY Index, daily data



Sources: Commerzbank Research, Bloomberg LP, ICE

CHART 11: **US yield curve still remarkably steep**
2-10 US yield curve in %



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

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US Dollar weaker but looking for key support to hold.

Essentially the US Dollar Index is sidelined within its 55 and 200 week moving averages, but is under pressure in its range. The topside for the index has been capped by its 55 week moving average (currently at 81.49) since September and this is reinforced by the 200 day moving average at 81.38.

Last week we saw the dollar index once again back away from these twin resistances and currently we remain unable to rule out further near term weakness. However directly below we find the 200 week moving average (currently at 79.94) and this is reinforced by the 2011-2014 uptrend, which offers support at 79.78. The definition of a bull trend is higher reaction highs and higher reaction lows and this remains the case for the US Dollar Index – the last reaction low was at 79.00 and while above here our longer term bullish view is intact.

The break above the 55 week moving average at 81.49 is expected to act as the catalyst for a rally to the 2005-2014 down trend currently at 85.57. However the market appears to be in no hurry to take this out and meanwhile is likely to ease lower to test the support offered just below 80.00, which we continue to look to hold.

CHART 82: **US Dollar Index Weekly chart**
Topside capped by the 55 week ma

Source: CQG, Commerzbank Research

Event Calendar

Date	Time (GMT)	Region	Release	Unit	Period	Survey	Prior
12 February	08:00	HUF	Industrial production	mom	DEC F	-	-1.9
				yoy	DEC F	6.2	4.4
	08:00	CZK	Consumer prices	mom	JAN	0.4	0.4
				yoy	JAN	0.4	1.4
	08:00	RON	Consumer prices	mom	JAN	0.7	0.3
				yoy	JAN	0.8	1.6
	08:15	CHF	Consumer prices	mom	JAN	-0.3	-0.2
				yoy	JAN	0.1	0.1
	10:00	EUR	Industrial production	mom	DEC	-0.3	1.8
				yoy	DEC	1.8	3.0
	-	RON	Current account balance	EUR mn	DEC	-	-1326
	12:00	RUB	CPI weekly year to date	%	FEB 10	-	0.7
	12:00	USA	MBA Mortgage Applications	%	FEB 7	-	0.40
	13:00	PLN	Current account balance	yoy	DEC	-1325	-984
13 February	00:01	GBP	RICS housing market index		JAN	57.5	56.0
	00:30	AUD	Employment change	K	JAN	15.0	-22.6
			Unemployment rate	%	JAN	5.9	5.8
	07:00	GER	Consumer prices	mom	JAN F	-0.6	-0.6
				yoy	JAN F	1.3	1.3
	08:00	TRY	Current account balance	USD bn	DEC	-7.4	-3.9
	08:15	CHF	Producer and import prices	mom	JAN	-0.1	0.0
				yoy	JAN	-0.4	-0.4
	08:30	SEK	Unemployment rate		JAN	8.3	7.5
	08:30	SEK	Interest rate decision	%	FEB 13	0.75	0.75
	11:00	RUB	FX and gold reserves	USD bn	FEB 7	-	498.9
	13:30	USA	Initial jobless claims	K	FEB 8	330	331
	13:30	USA	Retail sales	mom	JAN	0.0	0.2
			less vehicles	mom	JAN	0.1	0.7
14 February	08:00	HUF	Consumer prices	mom	JAN	0.5	-0.5
				yoy	JAN	0.2	0.4
	08:00	CZK	GDP	yoy	4Q A	-0.2	-1.2
	08:00	HUF	GDP	yoy	4Q P	2.5	1.8
	08:00	RON	GDP	yoy	4Q A	2.8	4.1
	09:00	PLN	GDP	yoy	4Q P	2.9	1.9
	10:00	EUR	GDP	qoq	4Q A	0.2	0.1
				yoy	4Q A	0.4	-0.3
	13:00	PLN	Consumer prices	mom	JAN	0.3	0.1
				yoy	JAN	0.9	0.7
	13:30	USA	Import Prices	mom	JAN	-0.1	0.0
				yoy	JAN	-1.8	-1.3
	14:15	USA	Industrial production	mom	JAN	0.2	0.3
	14:15	USA	Capacity utilization	%	JAN	79.3	79.2
	14:55	USA	Michigan consumer confidence		FEB P	80.3	81.2
16 February	23:50	JPY	GDP	qoq	4Q P	2.8	1.1
17 February	00:01	GBP	Rightmove House Prices	mom	FEB	-	1.0
				yoy	FEB	-	6.3
	04:30	JPY	Industrial production	mom	DEC F	-	1.1
				yoy	DEC F	-	7.3

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