

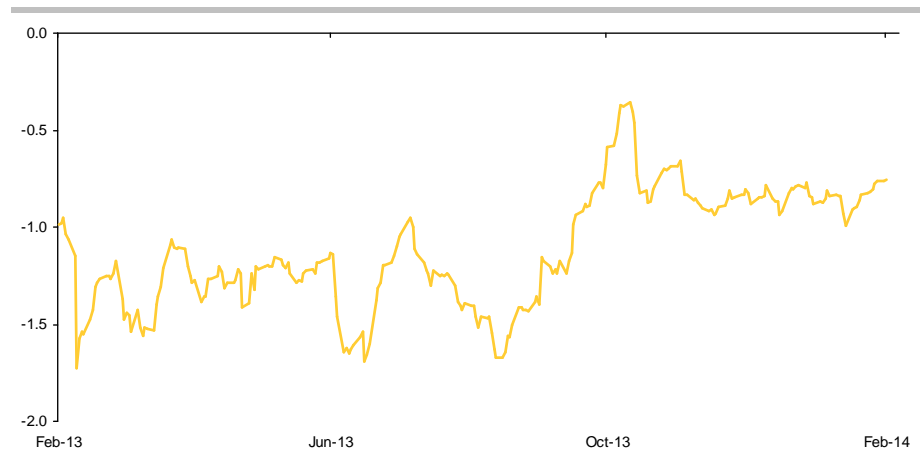
FX Alpha

18 February 2014

Taking Stock

Taking Stock. The German Constitutional Court’s referral of the ECB’s OMT programme to the ECJ means that the ECB have to ensure that OMT is never used. They can only do this via further expansionary measures.

CHART 1: **EUR-USD riskies to correct?**
EUR-USD 3 Month 25 delta risk reversal in % vol



Source: Commerzbank Research, Bloomberg LP

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G10 Highlights. BoE minutes a non event. RBA move to a neutral bias. Negative CPI surprise for SEK.

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

EM Highlights. Polish MPC neutral – for now? GDP release with limited effect on MXN. CBR downgrade Russian growth forecast.

FX Portfolio Recommendation. We cut our long USD basket.

Technical Analysis. USD-CAD short term weakness is viewed as corrective only.

Event calendar. Euro zone PMI’s and Philly Fed the key highlights this week.

Taking Stock

The German Constitutional Court's referral of the ECB's OMT programme to the ECJ means that the ECB have to ensure that OMT is never used. They can only do this via further expansionary measures.

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The majority of analysts expect lower rates in EUR-USD until year-end and, based on the development since the start of the year, they are incorrect with this view. Why is that? Only if we understand why EUR-USD is currently so robust will we be able to get an impression whether this situation might possibly continue longer term thus requiring a change in the forecast.

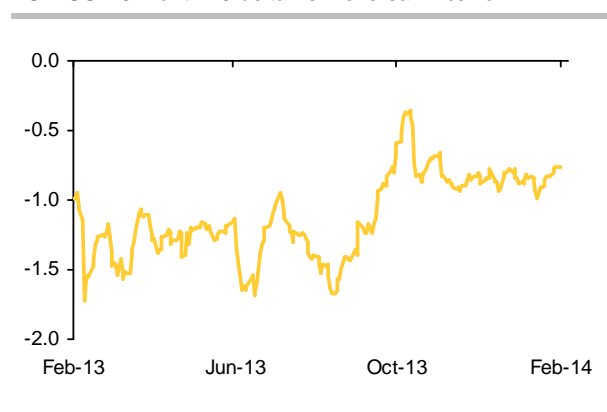
Will the ECB cut rates again in March? This question is currently occupying the market. Based on the inflation data the answer to this question would be straight forward. Inflation is simply too far below the ECB's target. However, there is also real economic data. The latter has developed much better than expected recently. Would an upward revision of growth expectations compensate for the low inflation outlook in the eyes of the ECB? After all an improved economy should lead to a rise in inflation. That means that recent data has made a rate cut less likely. These considerations can be continued at will, but one thing will remain unchanged: in the end the question of a further ECB rate cut is not decisive for future monetary policy in Europe.

The German Constitutional Court's recent decision has illustrated that the ECB can't even dream about normalising its monetary policy. After all Germany's highest court is of the view that the ECB is beyond its mandate with the OMT programme. The fact that it has passed the question to the European Court of Justice for clarification does not mean that the German Constitutional Court has finished with this matter should the European Court of Justice declare it to be legitimate. The final decision will be taken in Germany. Instead the German Court has passed the buck to the European Court of Justice. That means for the ECB: It will have to do everything to ensure that the OMT will never be required. The ECB's ability to act has been limited considerably.

And the Fed? It has started reducing its bond purchases. But clearly it has been unable to completely overcome market confusion about its future approach, as a glance at the 1 month risk reversals in EUR-USD illustrates. After the Fed surprised the market in September 2013 by delaying the start of its tapering measures the riskies rocketed up. Apart from the surprise ECB rate cut in November they have remained at these levels. That means for me: So far the markets have not really priced in a change of direction on the part of the Fed.

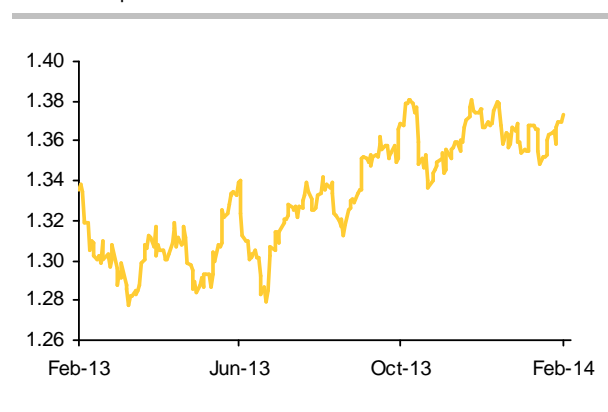
Against this background it is hardly surprising that EUR-USD has not shown any weakness so far in 2014. However, who relies on this development to continue is implicitly assuming that the divergence between monetary policies on both sides of the Atlantic will be ignored by the market long term. That said; there is no reason for a change in forecasts.

CHART 2: EUR-USD riskies to correct?
EUR-USD 3 Month 25 delta risk reversal in % vol



Source: Commerzbank Research, Bloomberg LP

CHART 3: EUR remains well bid
EUR-USD spot



Source: Commerzbank Research, Bloomberg LP

G10 Highlights

BoE minutes a non event. RBA move to a neutral bias. Negative CPI surprise for SEK.

GBP: This week promises to be a pretty quiet one for GBP. The Inflation Report of last week means that this week's BoE minutes from the last rate meeting will be irrelevant. Hence the only real potential mover for sterling exchange rates will be Wednesday's unemployment data. Expectations are for an unchanged print of 7.1% though it should be noted that any positive surprise here will not move sterling as it has done in recent weeks, given that the MPC are now focussing on measures of spare capacity rather than the unemployment rate alone.

AUD: The detailed minutes of the RBA's meeting in early December illustrate very clearly that the RBA shifted to a neutral stance. A large paragraph is dedicated to inflation, as the latter surprised with a notable rise in Q4. The RBA sees an element of noise in economic data, a quicker than usual pass-through from the lower exchange rate, a slower than usual pass-through of low wage growth, less spare capacity or a combination of these factors as possible reasons. According to the RBA the rise in core inflation is partially due to the depreciation of the exchange rate, which fuelled a rise in prices of tradable goods. Moreover housing costs are also rising. However, the RBA is a bit unsettled that the increase in non-tradables inflation was somewhat at odds with the soft growth in labour costs associated with the weak labour market. The RBA raised the inflation outlook slightly. The outlook for the economy is cautiously optimistic and slightly better than in November, partially as a result of the low AUD. The RBA is hoping that the depreciation of the AUD will remain sustained, but is much more cautious in its wording due to the rise in inflation. No mention of an "uncomfortably high" AUD any longer, but only of an expansionary effect of a weaker exchange rate on economic activity and more balanced growth in the economy. With rising inflation rates the RBA cannot do anything else but dampen the rise of the AUD based on improved economic prospects with verbal interventions. As a result the area of 0.8600/50 will remain the bottom in AUD-USD in our view.

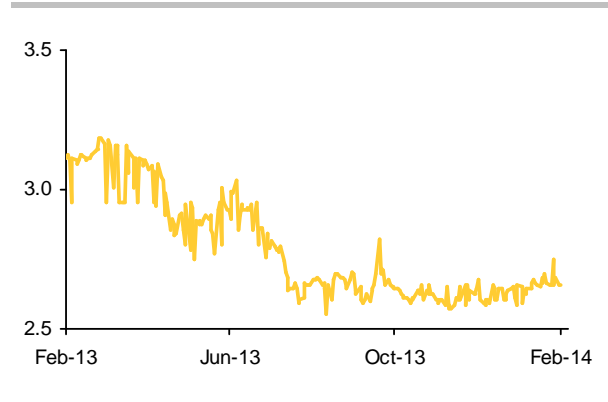
SEK: Swedish CPI data for January surprised to the downside with -0.2% (total) and 0.4% (core) yoy. Some of the negative result is due to reweightings of the basket. Nevertheless, the result is disappointing and justifies Riksbank's reluctance last week to lift the inflation path. EUR-SEK even moved further away from the support at 8.75. As a result it will get increasingly difficult for the pair to finally break to the downside. For the support at 8.75 to seriously come under threat all economic data due for publication at the end of this week (sentiment indicators) and next week (retail sales, trade balance Q4 GDP) would have to be positive.

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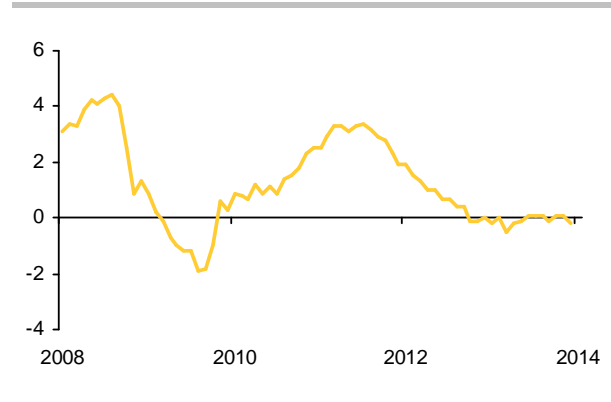
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CHART 4: Recent improvement in AUD carry
AUD 3 month deposit in %



Source: Commerzbank Research, BloombergLP

CHART 5: Swedish CPI in the doldrums
Sweden CPI yoy in %



Source: Commerzbank Research, Statistics Sweden, Bloomberg LP

FX Metrics

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.

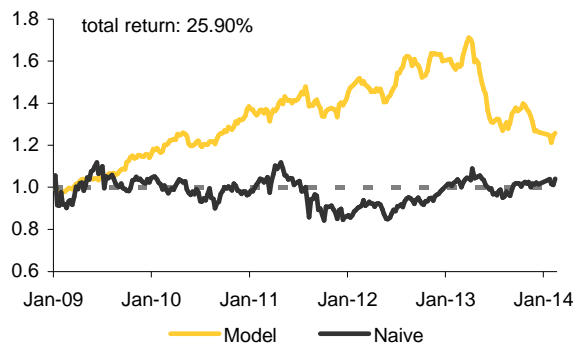
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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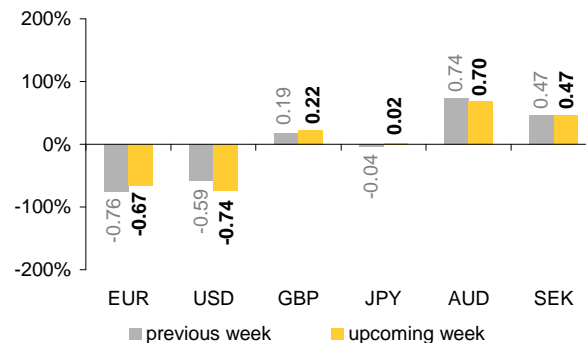
CHART 6: Historic performance of optimized Carry Trade Portfolio

Cumulative return¹ since 6 January 2009, weekly rebalancing, target variance: 6%; Naive 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 18 to 25 February
 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

Polish MPC neutral – for now? GDP release with limited effect on MXN. CBR downgrade Russian growth forecast.

PLN: The Polish MPC minutes due on Thursday are unlikely to provide any significant momentum for the PLN. So far, the Polish central bank had no reason to change its forward guidance of keeping rates unchanged until the middle of the year. However, both January inflation and Q4 GDP growth came in lower than expected recently. This is likely to be factored in at the next NBP meeting. The doves are going to take this as a reason for extending the forward guidance. However, the data is backward looking. Leading indicators suggest that the economy is on a strong recovery path with the manufacturing PMI continuing its buoyant upward trend. We therefore continue to be optimistic that rate hikes remain on the agenda for the second half of the year. PLN should thus continue to appreciate gradually.

MXN: This Friday GDP for Q4 2013 and for the whole year will be published. After a period of rather disappointing economic data this week's release will probably also hint to a rather weak recovery of the economy. Since the market is already focussing on 2014, where a strong pick-up in growth is expected, the data release will probably have only a limited effect on the peso. That the economy disappointed last year is nothing new. Since there are no other interesting data publications on the agenda external factors such as US data releases and market sentiment will be the main driver for the peso. After the strong recovery against the USD it will get harder for the peso to continue its upward move. Therefore we expect the peso to take a breather against the USD – unless the data on Friday does not surprise significantly on the upside.

RUB: Yesterday's poor IP print at -0.2% yoy (consensus +1.0%) underlines why CBR downgraded their 2014 growth forecast to 1.5% - 1.8% at last weeks interest rate meeting . CBR also highlighted that the FX pass through to the CPI level would be in the region of 0.5% over the course of 2014. All told this means that the outlook for RUB, from a purely fundamental point of view remains challenging. The remainder of the week is relatively busy with retail sales and unemployment data being released though we don't expect these releases to be market moving.

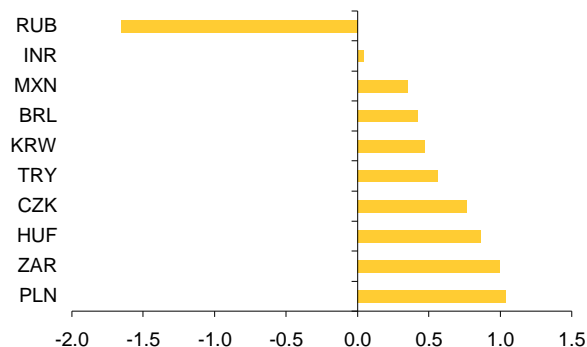
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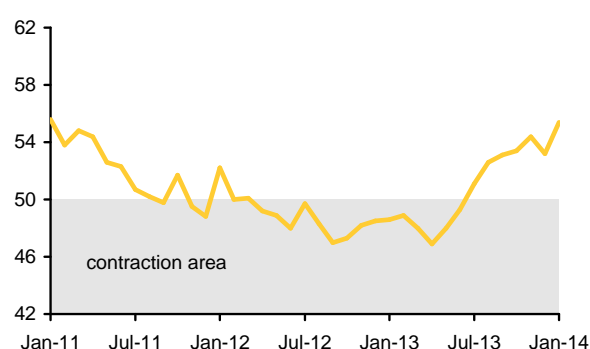
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CHART 8: RUB the clear underperformer
% Gain / Loss Vs. USD since 11th Feb



Source: Commerzbank Research, BloombergLP

CHART 9: Poland PMI surging
Manufacturing PMI



Source:Commerzbank Research, Markit

FX portfolio recommendation

Core trading views:

- Position for sterling outperformance in Q1
- Close Long USD basket trade
- Maintain low delta downside in EUR-JPY as a tail hedge

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Tactical trading views:

- We initiate an 0.87 USD-CHF put
- We initiate a downside put spread in EUR-GBP

Over the course of last week our long USD basket underperformed slightly with the overall position showing a slight loss of -0.22%. USD weakness comes largely as a result of moves in US rates markets, as markets reprice the possibility of early rate hikes from the Fed. Given the rather patchy data background in recent weeks this is understandable. What is more worrying from our point of view is that not only is the USD trading weakly, but it is doing so when equity markets are near all time highs. Given that the USD trades with a higher correlation to risky assets in recent months, this means that any negative setback here could have a deleterious impact upon the USD. As such we close the long USD basket and will look to re-implement the position later in the quarter once the data picture from the US becomes clear.

Elsewhere the BoE's attempt to talk down rate expectations at last week's Inflation Report backfired with short sterling selling off and the pound strengthening as the BoE upgraded their growth forecast. Whether this is a case of the UK economy overheating is another issue, but for the moment investors should seek to increase long sterling exposure, ideally against the EUR where we feel there is more room for outperformance. We suggest a downside put spread.

The EUR-JPY downside 127 put had a flat performance over the course of the week but are content to hold onto the position at the moment given that it is a cheap hedge to the general themes which are currently performing within the G10 complex.

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	0.17%	1.2610	Closed
14.01.2014	Long USD-CHF	1	0.9015	0.8745	1.05%	0.9730	Closed
14.01.2014	Long USD-CAD	1	1.0900	1.0560	0.56%	1.1760	Closed

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%	0.01%	0.14%	Open
18.02.2014	Long EUR-GBP put spread 0.81 / 0.78	15.05.2014	1	-0.78%	0.69%	0.09%	Open
18.02.2014	Long USD-CHF 0.87 put	31.03.2014	1	-0.21%	0.19%	0.02%	Open

Source: Commerzbank Research, Bloomberg LP

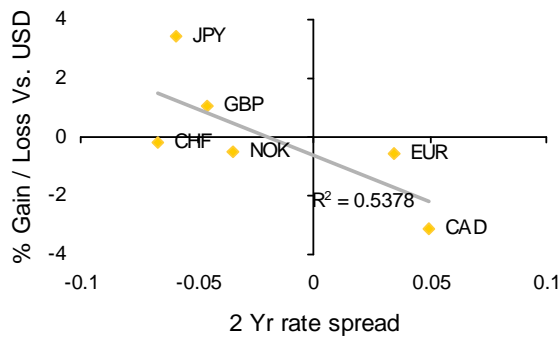
Tactical trading views:

- We recommend investors to buy downside puts in USD-CHF, 0.87 strike on a 6 week tenor for approx. 0.25% of notional. The rationale behind this position is that it will benefit from any further USD weakness and also from any deterioration in equity market sentiment. Coming into March, normally a rather volatile month, we ideally prefer long gamma positions and this is the perfect trade in this case.
- Following last week's BoE Inflation Report we are adding an equally weighted 3 month downside put spread in EUR-GBP, 0.81 / 0.78 strikes to the portfolio. The reasons for sterling outperformance are clear by this stage; lower than expected inflation and better than expected growth. Seen in the context of a broadly weak USD and the possibility of further easing measures from the ECB, this leaves GBP as being the only show in town. The risk reward is also compelling with a payoff profile of 4:1.

Portfolio Risk:

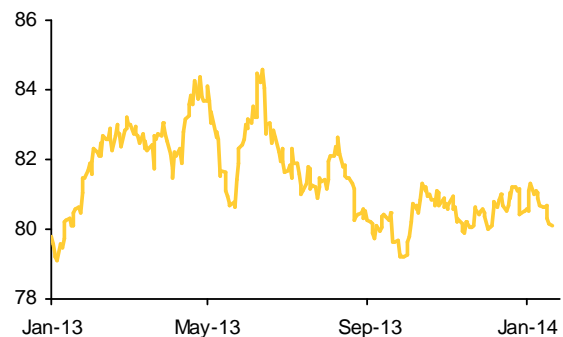
- The portfolio is positively correlated with volatility

CHART 10: USD losses year to date mainly rates led
 % Gain / Loss Vs. USD since 1st January, 2 Yr rate spread move since 1st January in basis points



Sources: Commerzbank Research, Bloomberg LP

CHART 11: Dollar Index continues to lose ground
 Dollar Index



Sources: Commerzbank Research, Bloomberg LP

Technical Analysis

USD-CAD – Short term weakness is viewed as corrective only.

We maintain that the USD/CAD chart is bullish longer term. It has completed a large base between 1.0660 and 0.9403, this base took almost 3 years to complete, and the pattern broke higher earlier this year. It offers an upside measured target to 1.19 longer term. Given that the base took 3 years to complete, this target is achievable in approximately half of that time, i.e. by Q2 2015. We should therefore see the Canadian Dollar come under pressure throughout much of this year.

Our initial upside target of 1.1187/1.1244 has been met, this is the 1991 low and the 50% retrace-ment of the move down from 2009-2011. The setback that we have seen from here is viewed as corrective only and we look for the slide to terminate between 1.0930 and 1.0750 and the market to resume its bull move (these are Elliott wave counts taken off the daily and weekly charts). The previous high charted in 2011 at 1.0660 is expected to offer strong support also, however key support remains the 1.0408 2012-2014 uptrend – while above here a longer term upside bias is maintained.

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CHART 102: USD/CAD Weekly chart
Major base has completed



Source: CQG, Commerzbank Research

Event Calendar

Date	Time (GMT)	Region	Release	Unit	Period	Survey	Prior	
19 February	05:00	JPY	Leading Index CI		DEC F	-	112.1	
			Coincident Index CI		DEC F	-	111.7	
	08:00	ZAR	Consumer prices	mom	JAN	0.6	0.3	
				yoy	JAN	5.7	5.4	
	09:30	GBP	Unemployment rate	%	DEC	7.1	7.1	
	10:00	CHF	ZEW business expectations		FEB	-	36.4	
	12:00	RUB	CPI weekly year to date	%	FEB 17	-	0.9	
	12:00	USA	MBA Mortgage Applications	%	FEB 14	-	-2.00	
	13:00	PLN	Producer price index	mom	JAN	0.1	0.0	
				yoy	JAN	-0.8	-0.9	
	13:00	PLN	Sold Industrial Output	mom	JAN	2.7	-9.7	
				yoy	JAN	3.5	6.6	
	13:30	USA	Housing Starts	K	JAN	950	999	
			Housing Permits	K	JAN	975	991	
20 February	07:00	GER	Producer price index	mom	JAN	0.2	0.1	
				yoy	JAN	-0.8	-0.5	
	08:30	GER	PMI (Markit)		FEB A	56.3	56.5	
	08:30	GER	PMI Services (Markit)		FEB A	53.4	53.1	
	09:00	EUR	PMI (Markit)		FEB A	54.0	54.0	
	09:00	EUR	PMI Services (Markit)		FEB A	51.9	51.6	
	11:00	RUB	FX and gold reserves	USD bn	FEB 14	-	490.2	
	13:30	USA	Initial jobless claims	K	FEB 15	334	339	
	13:30	USA	Consumer prices	mom	JAN	0.1	0.3	
				yoy	JAN	1.6	1.5	
				core rate	mom	JAN	0.1	0.1
					yoy	JAN	1.6	1.7
	15:00	EUR	Consumer confidence		FEB A	-11.0	-11.7	
15:00	USA	Philadelphia Fed Index		FEB	8.0	9.4		
15:00	USA	Leading indicator CB		JAN	0.4	0.1		
21 February	09:30	GBP	Retail sales	mom	JAN	-1.0	2.6	
				yoy	JAN	5.0	5.3	
	13:30	CAD	Consumer prices	mom	JAN	0.1	-0.2	
				yoy	JAN	1.3	1.2	
15:00	USA	Existing Home Sales	mn	JAN	4.67	4.87		
			mom	JAN	-4.1	1.0		
24 February	08:00	CZK	Composite confidence indicator		FEB	-	5.5	
	08:00	CZK	Producer price index	mom	JAN	0.1	0.8	
				yoy	JAN	0.7	1.7	
	09:00	GER	ifo business climate		FEB	-	110.6	
			Current assessment		FEB	-	112.4	
			Business expectation		FEB	-	108.9	
	10:00	EUR	Consumer prices	mom	JAN	-	-1.1	
				yoy	JAN F	0.8	0.7	
				core rate	yoy	JAN F	0.8	0.8
GER	Import Prices	mom	JAN	-	0.0			
		yoy	JAN	-	-2.3			
-	GBP	Nationwide House Price Index	mom	FEB	-	0.7		
			yoy	FEB	-	8.8		

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