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FX Alpha

18 March 2014

The curious case of FX volatility

The curious case of FX volatility. We explain the evident dichotomy between G10 and EM volatility profiles and argue that EM volatilities have reset to structurally higher levels. The question investors face is for how long G10 volatility will remain subdued.

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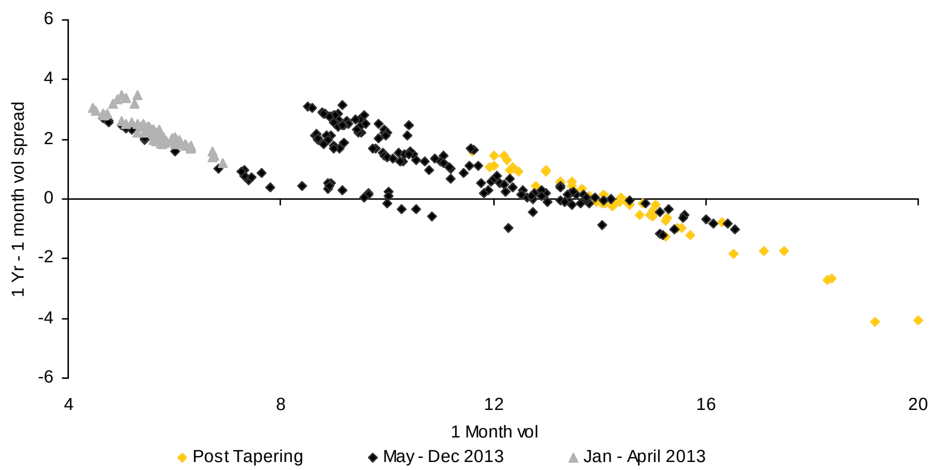
USD-TRY 1Yr – 1 Month vol spread, 1 Month vol in % vol



Sources: Commerzbank Research, Bloomberg LP

G10 Highlights. EUR-USD might try a test of 1.40 ahead of the FOMC meeting. Focus on BoE Minutes. EUR-NOK in a comfort zone around 8.30. No reason to sell the CAD on soft inflation data.

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The curious case of FX volatility

Author:

Peter Kinsella
+44 20 7475 3959
peter.kinsella@commerzbank.com

We explain the evident dichotomy between G10 and EM volatility profiles and argue that EM volatilities have reset to structurally higher levels. The question investors face is for how long G10 volatility will remain subdued.

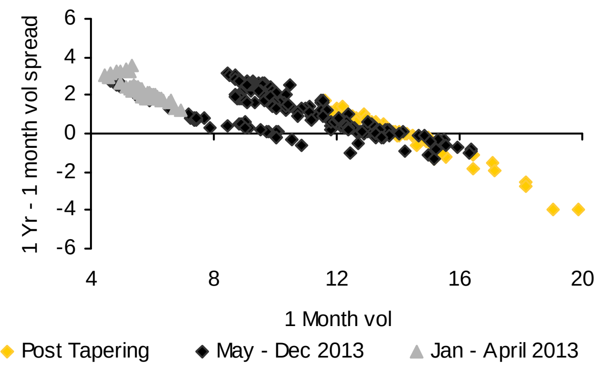
Since the beginning of the year both EM and G10 volatility structures have been notable by an evident divergence since the Fed began its tapering programme. Market assumptions were that the tapering programme, like other QE programmes, would see a greater impact upon asset prices during the announcement phase of the programme rather than the implementation phase itself. However, the performance of EM currencies year to date argues that the opposite is the case (Chart 2). By most measures EMFX volatilities traded at subdued levels in the early part of 2013 mainly due to continuing QE programmes on the part of developed market central banks along with idiosyncratic intervention policies in certain EM currencies, TRY in particular.

At the same time, concerns regarding current account financing led to rapid idiosyncratic EMFX weakness. The policy response function, when it eventually came, led to higher interest rates. Thus, riskier EM currencies now have higher risk premia. Which is as it should be; in our view this development will be here to stay over the medium to longer term. The confluence of monetary normalization and eventual tightening in developed markets, along with lower growth profiles in EM, means that EMFX volatility will likely remain well bid.

The problem for investors is in making sense of the still incredibly low G10 volatility profile. Volatility curves display a flat profile at incredibly low levels in relative and absolute terms. Indeed, EUR-USD volatilities have traded at higher levels than at present for 90% of the time since the EUR's inception. Hence although level wise volatility is clearly low and therefore a screaming buy, at the same time anyone who has done so over the last year would have constantly lost money. On the other hand the low absolute levels mean selling G10 volatility offers a most uncompelling risk reward profile.

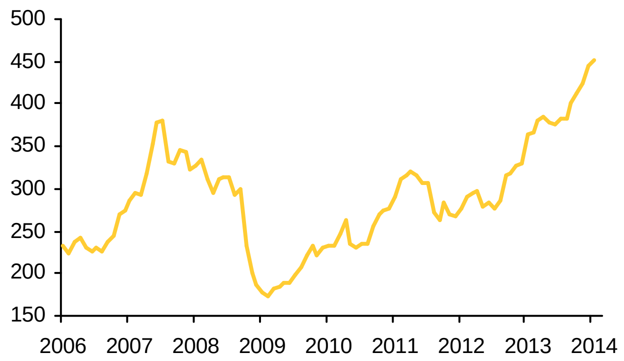
To my mind the main reason for G10 volatility remaining at low levels is due to the success of central bank forward guidance policies in managing down rate expectations along with still buoyant equity market sentiment. Obviously the latter feeds off the former, but nonetheless one has to admit that so far at least, policy makers have managed expectations quite well. Likewise the lack of inflationary pressures in most G10 currencies means that for the moment at least, there is little from a fundamental point of view to warrant a significant pickup in volatility. The only potential banana skin lies with developments in equity markets, where the use of margin debt leverage now exceeds the 2007 high. In a sense, forward guidance policies may have been too successful in convincing market participants to take on excess leverage. Sometimes, we should be careful what we wish for.

CHART 2: **EMFX volatility moves higher**
USD-TRY 1Yr – 1 Month vol spread, 1 Month vol in % vol



Sources: Commerzbank Research, Bloomberg LP

CHART 3: **Margin debt at all time highs**
NYSE member firms debit balances in margin accounts USD bln



Sources: Commerzbank Research, Bloomberg LP

G10 Highlights

Author:

Antje Praefcke
+49 69 136 43834
antje.praefcke@commerzbank.com

Peter Kinsella
+44 20 7475 3959
peter.kinsella@commerzbank.com

EUR-USD might try a test of 1.40 ahead of the FOMC meeting. Focus on BoE Minutes. EUR-NOK in a comfort zone around 8.30. No reason to sell the CAD on soft inflation data.

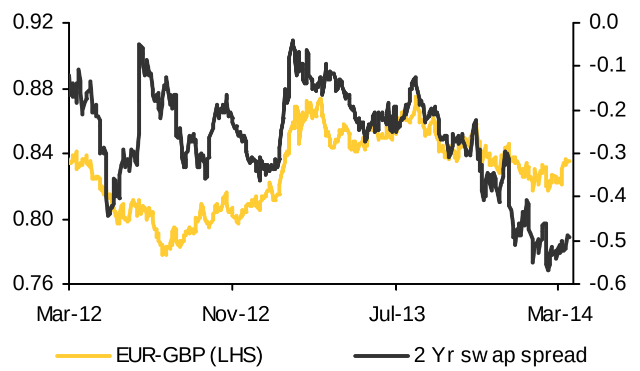
EUR-USD: Ahead of the FOMC meeting, EUR-USD might try to test the 1.40 level. It is just too tempting, regardless of the fact ECB President Mario Draghi stated again last week that a too strong exchange rate could weigh on inflation and that the ECB stands ready to act in case inflation becomes too low. Draghi said that a 10% rise of the nominal external value leads to a reduction in inflation of 0.4 to 0.5 percentage points. It should have been a clear verbal warning, but we know that markets tend to test such signals and – probably – burn their fingers.

GBP: The release of BoE minutes this week could prove to be an important development. Recent speeches by various MPC members indicated that there is a growing split on the MPC regarding when policy should be tightened. Should the minutes show a split developing in terms of voting patterns, then it is inevitable that market participants will begin pricing in earlier rate hikes. As things stand, markets currently price in rate hikes in the first half of 2015. Elsewhere we don't expect this week's UK budget to be market moving with the likelihood of tax cuts now rather small.

NOK: Norges Bank's most recent regional network survey amongst companies confirms that the Norwegian economy will continue to record moderate growth. With the exception of slightly lower momentum for oil industry suppliers and in the construction sector other industries and commercial services are reporting stronger growth since the last poll. Moreover many companies see increased growth momentum over the coming six months. So generally positive news for the NOK. However, we are having a week, which is very low on domestic data. Things will only get interesting again at the end of March when Norges Bank's rate meeting is taking place. That also means that over the coming days EUR-NOK will mainly be driven by external factors. Due to the currently more cautious approach amongst investors further NOK gains will be difficult to achieve. However, we continue to assume that EUR-NOK is in its comfort zone in the area of 8.30. First good offers are located in the area of 8.32. At 8.33 we would also be selling EUR-NOK as we assume that EUR-NOK will hold around that level for the time being.

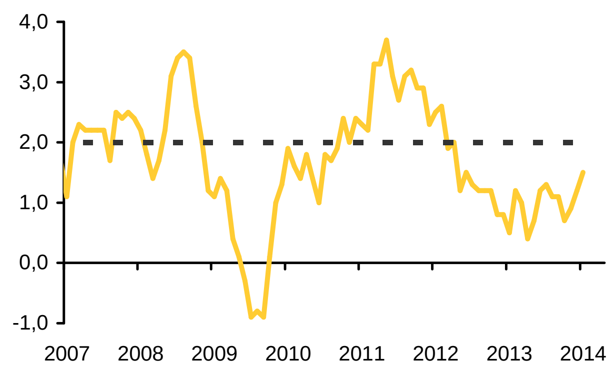
CAD: After the rise in inflation in January the February data due on Friday will see a setback due to base effects. The BoC won't be concerned to see inflation fall back to around 1.0% yoy since it pointed out again last week at its meeting that downside risks to inflation remain important. Therefore, there is no reason to sell the CAD on soft inflation rates in line with market expectations. USD-CAD might crawl higher in case risk aversion rises again, though. Nevertheless, we don't see the 1.1200/25 resistance in danger for the time being. Only unexpectedly low inflation rates or a strong and sudden rise in risk aversion could lead to a serious test of this level in the short-term.

CHART 4: **EUR-GBP likely to move lower**
EUR-GBP spot, 2 Yr swap spread in %



Source: Commerzbank Research, Bloomberg LP

CHART 5: **Inflation still far below BoC target**
CPI yoy, in percent, inflation target



Source: Commerzbank Research, Bloomberg LP

FX Metrics

G10 carry trade indices

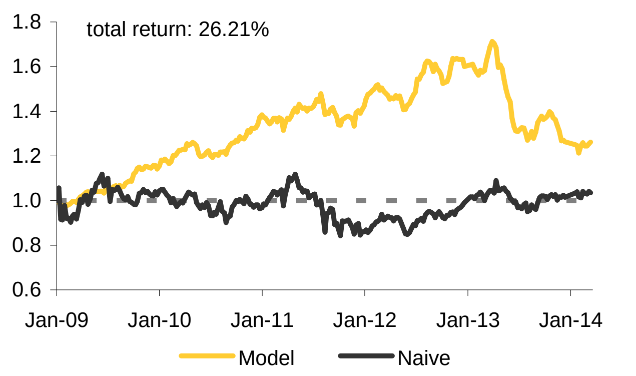
Author:

Thu Lan Nguyen
+49 69 136 82878
thulan.nguyen@commerzbank.com

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.

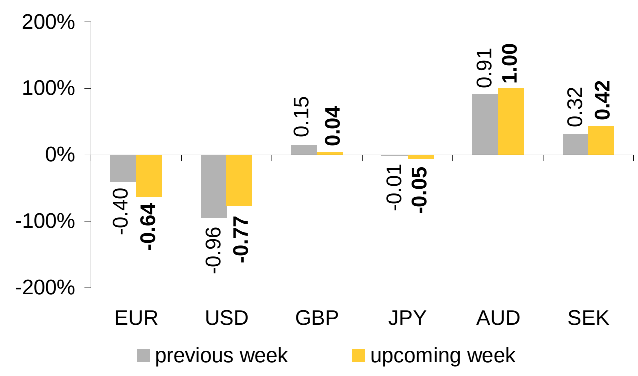
Below we illustrate an example of a mean-variance optimised carry trade portfolio on a selected currency basket with a pre-set risk level. For the optimization the variance has been chosen randomly and can be adjusted as required.

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 18 Mar to 25 Mar**
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

NBP minutes to reveal concerns regarding crisis in Ukraine. RUB – External factors now in focus. Retail sales and central bank decision should have limited effect on MXN. Inflation release could give more hints abou the speed of the next rate hike by the BCB.

Author:

Thu Lan Nguyen
+49 69 136 82878
thulan.nguyen@commerzbank.com

You-Na Park
+49 69 136 42155
you-na.park@commerzbank.com

Peter Kinsella
+44 20 7475 3959
peter.kinsella@commerzbank.com

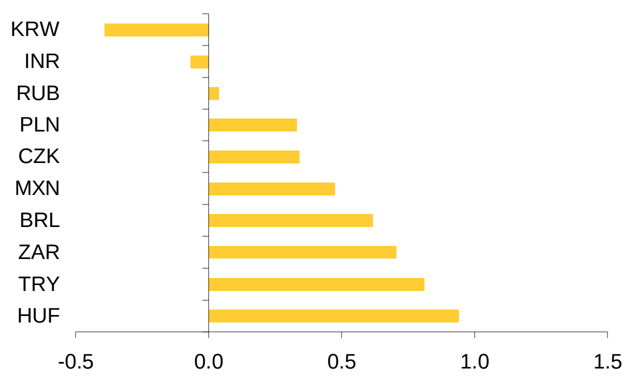
PLN: The NBP minutes due on Thursday will reveal in more detail what had been the main reason for the monetary council to extend its forward guidance, i.e. pledge that interest rates will remain unchanged at least until Q3 this year instead of Q2. According to NBP governor Marek Belka the crisis in Ukraine was one reason to speed up the decision to adjust the forward guidance. There are likely to have been concerns regarding the economic impact of the crisis in the neighbouring country. In our view only a further escalation of the conflict would really dampen the economic recovery in Poland, which is mainly dependent on the energy imports from Ukraine. If this risk does not materialize, the PLN is likely to continue to benefit from the rosy economic outlook.

RUB: Following the weekend vote in the Crimea the focus will shift to possible sanctions by the international community. Whilst sanctions will generate all the headlines, the truth of the matter is that continuing capital outflows will be a burden for RUB over the medium term. The Ministry of Finance expected 35 bln USD outflows in Q1 alone, but this is likely to be a significant underestimate.

MXN: This week main events are only due on Friday with the release of January's retail sales and the rate decision by the central bank. The release of the retail sales will be watched closely since the market is still searching for signs of a recovery in the Mexican economy. However, retail sales have likely stagnated in January. Therefore the market will probably have to continue its search. The central bank rate decision will be a non-event. We don't expect a change and since we expect the central bank to keep its rates unchanged at 3.50% during this year the statement should be neutral. So the domestic events will probably have no major impact on the MXN. However since we don't expect a surprise from the FOMC meeting in the US the same can be said of the external events – unless geopolitical risks rise – and therefore we expect the MXN to continue its sideways move against the USD this week.

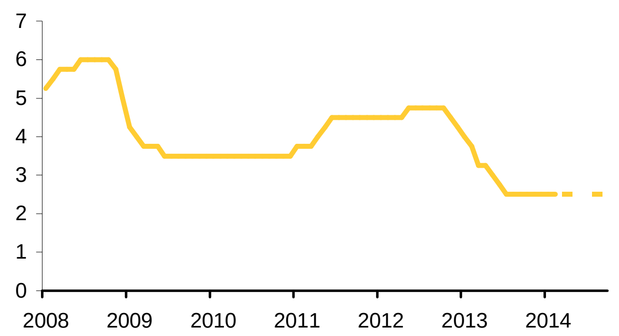
BRL: This week's data calendar is rather uneventful. Only on Friday we get the release of the IPCA-15, a price index which measures price developments to the 15th of each month. Most of the economists expect an increase from 5.65% to around 5.90% yoy. If the release surprises to the upside speculations will probably rise that the central bank might hike its rates by more than 25 bps on its meeting on the 2nd April. The positive effect on the BRL should be limited. The central bank is already trying to fight inflation for some time now therefore a quickly rising inflation could raise concerns about the effectiveness of the central bank measures.

CHART 8: **RUB steady, for now**
Gains/losses against USD since 11th March 2014



Source: Bloomberg L.P., Commerzbank Research

CHART 9: **NBP keeping rates unchanged for longer**
Key interest rate in %



Source: Commerzbank Research

FX portfolio recommendation

Author:

Peter Kinsella
+44 20 7475 3959
peter.kinsella@commerzbank.com

Core trading views:

- Position for sterling outperformance in Q1
- Expect USD weakness to persist in the short term
- Sell upside volatility in USD-RUB
- Maintain low delta downside in EUR-JPY as a tail hedge

Tactical trading views:

- We refrain from adding to positions at present

Over the course of the week the portfolio underperformed due in large part to the RBNZ's rate hike and hawkish statement in particular, which leaves our topside short 0.86 strike looking vulnerable. At the same time however key relationships such as copper to gold ratios have declined significantly which is normally a bad omen for commodity currencies. Nonetheless we are content to maintain the position given there is still a significant amount of time left until expiry.

Elsewhere the short strike in USD-RUB underperformed slightly although again we are of the view that much of the current spot moves are overdone. CBR's interventions combined with a significant cost of carry should make the RUB far less attractive to short. That being the case we are content to maintain the position.

Our EUR-GBP put spread performed slightly better over the week and there is some scope for further decent performance over the coming week when the BoE releases its minutes from the March meeting. There seems to be a growing split on the MPC and it will be interesting to see whether this is reflected in voting patterns. If so, then rate hike expectations will lead to sterling gains.

Elsewhere, the low delta 127.00 EUR-JPY put is set to expire worthless next week. We will consider adding another low delta structure as a hedge to generally positive risk 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	1.3780	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)**

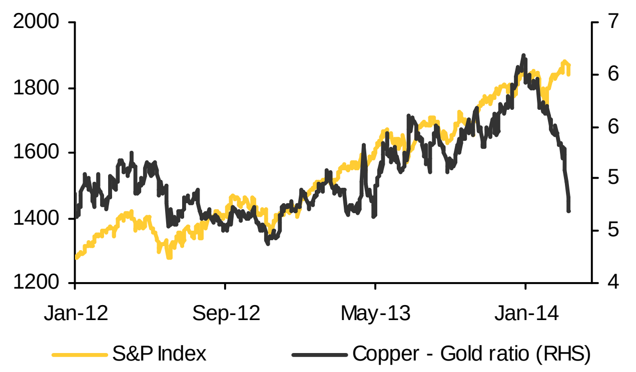
Trade date	Strategy	Expiry	Size (€ mln)	Premium	Value	P&L	Open / Closed
28.01.2014	Long EUR-JPY 127.00 put	24.03.2014	1	-0.15%	0.00%	0.15%	Open
18.02.2014	Long EUR-GBP put spread 0.81 / 0.78	15.05.2014	1	-0.78%	0.17%	0.61%	Open
04.03.2014	Short USD-RUB 39.00 call	04.07.2014	1	+1.00%	1.20%	0.20%	Open
04.03.2014	Short NZD-USD risk reversal 0.86/ 0.78	03.09.2014	1 x 1	-0.13%	0.73%	0.86%	Open

Source: Commerzbank Research, Bloomberg LP

Tactical trading views:

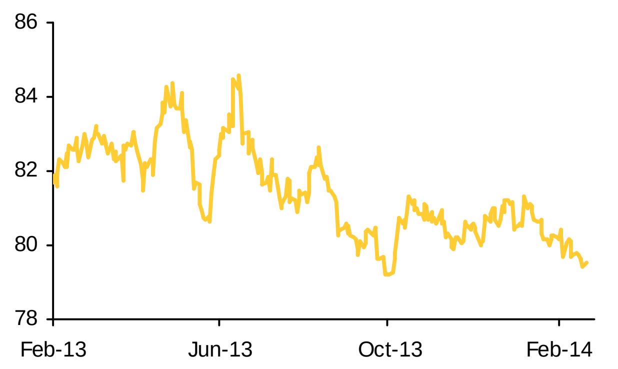
- We maintain a neutral position for the coming week and do not add to the portfolio.

CHART 10: **Copper to gold ratio collapses**
S&P Index, Copper - Gold ratio



Sources: Commerzbank Research, Bloomberg LP

CHART 11: **USD continues to trade weakly**
DXY Index



Sources: Commerzbank Research, Bloomberg LP, ICE

Technical Analysis

AUD-NZD dips back to the major 1.0501/1.0434 support area which should again hold.

Author:

Axel Rudolph
+44 20 7475 5721
Axel.Rudolph@commerzbank.com

AUD-NZD's decline from the 1.0948 early February high is ongoing but we expect it to halt ahead of or within the major support area found at 1.0501/1.0434. It is made up of the 1995 and 2005 lows and should again hold, if retested.

Minor support above the major support area can be seen between the 78.6% Fibonacci retracement of the January-to-February rise at 1.0590 and the current March low at 1.0539.

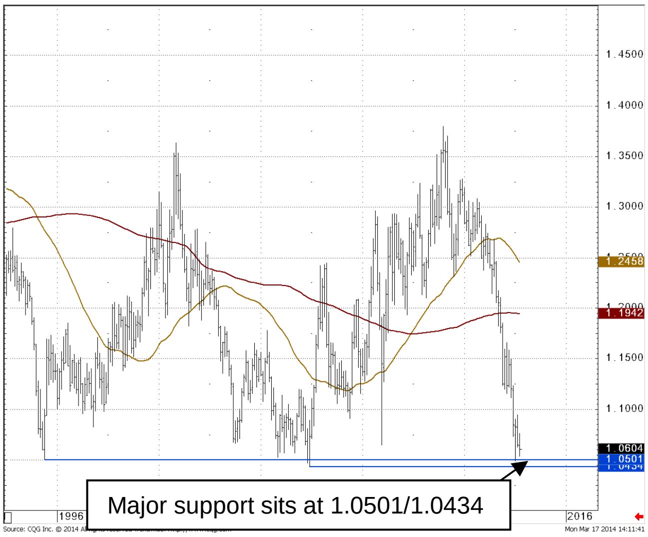
Resistance between the mid-February low at 1.0735 and the 38.2% Fibonacci retracement at 1.0774 will need to be overcome, however, for the one month resistance line at 1.0813 to be back in play.

Once this resistance line has been broken, the 2013-14 resistance line at 1.0906 and then the August and September lows at 1.1157/99 will be targeted. There the currency pair is likely to struggle, though.

CHART 12: **AUD-NZD Daily Chart**
Should find support ahead of or within the 1.0501/1.0434 zone

Sources: CQG, Commerzbank Research

CHART 13: **AUD-NZD Monthly Chart**
Major support comes in at 1.0501/1.0434



Sources :CQG, Commerzbank Research

Event Calendar

Date	Time	Region	Release	Unit	Period	Survey	Prior
18 March	10:00	EUR	ZEW business expectations		MAR	-	68.5
	10:00	GER	ZEW business expectations		MAR	52.0	55.7
	12:00	TRY	Interest rate decision	%	MAR 18	10.00	10.00
	12:30	USA	Consumer prices	mom	FEB	0.1	0.1
				yoy	FEB	1.2	1.6
			core rate	mom	FEB	0.1	0.1
				yoy	FEB	1.6	1.6
	12:30	USA	Housing Starts	K	FEB	910	880
			Housing Permits	K	FEB	960	937
	13:00	PLN	Wages	mom	FEB	0.5	-9.9
				yoy	FEB	3.2	3.4
	13:00	USA	Tic data	USD bn	JAN	40.0	-45.9
19 March		JPY	Leading Index CI		JAN F	-	112.2
			Coincident Index CI		JAN F	-	114.8
	08:00	ZAR	Consumer prices	mom	FEB	1.1	0.7
				yoy	FEB	5.9	5.8
	09:30	GBP	Unemployment rate	%	JAN	7.2	7.2
	10:00	CHF	ZEW business expectations		MAR	-	28.7
	11:00	USA	MBA Mortgage Applications	%	MAR 14	-	-2.10
	12:00	RUB	CPI weekly year to date	%	MAR 17	-	1.6
	13:00	PLN	Producer price index	mom	FEB	0.1	0.1
				yoy	FEB	-1.1	-0.9
	13:00	PLN	Sold Industrial Output	mom	FEB	-1.0	2.9
				yoy	FEB	6.1	4.1
	18:00	USA	Interest rate decision	%	MAR 19	0.25	0.25
20 March	07:00	GER	Producer price index	mom	FEB	0.1	-0.1
				yoy	FEB	-0.9	-1.1
	08:30	CHF	Interest rate decision	%	MAR 20	0.00	0.00
	11:00	RUB	FX and gold reserves	USD bn	MAR 14	-	494.6
	12:30	USA	Initial jobless claims	K	MAR 15	322	315
		USA	Philadelphia Fed Index		MAR	3.2	-6.3
	14:00	USA	Leading indicator CB		FEB	0.2	0.3
		USA	Existing Home Sales	mn	FEB	4.60	4.62
				mom	FEB	-0.4	-5.1
21 March	12:30	CAD	Consumer prices	mom	FEB	0.6	0.3
				yoy	FEB	1.0	1.5
	15:00	EUR	Consumer confidence		MAR A	-12.3	-12.7
24 March	08:00	CZK	Composite confidence indicator		MAR	-	5.5
	08:30	GER	PMI (Markit)		MAR A	-	54.8
	08:30	GER	PMI Services (Markit)		MAR A	-	55.9
	09:00	EUR	PMI (Markit)		MAR A	-	53.2
	09:00	EUR	PMI Services (Markit)		MAR A	51.7	52.6
	-	GBP	Nationwide House Price Index	mom	MAR	-	0.6
				yoy	MAR	-	9.4
	-	GER	Import Prices	mom	FEB	-	-0.1
				yoy	FEB	-	-2.3

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DLZ - Gebäude 2, Händlerhaus Mainzer Landstraße 153 60327 Frankfurt	PO BOX 52715 30 Gresham Street London, EC2P 2XY	2 World Financial Center, 32nd floor New York, NY 10020-1050	71 Robinson Road, #12-01 Singapore 068895	29/F, Two IFC 8 Finance Street Central Hong Kong
el: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000	Tel: +852 3988 0988