Deutsche Bank
Markets Research

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FX Blueprint

It Lives!

Theme #1: Euro Pah! – Sell EUR trade-weighted, sell EUR/USD

Theme #2: Another Ten for Dollar Yen – Buy USD/JPY

Theme #3: Stirling Stayed , Swiss Squished – Buy GBP/CHF

Theme #4: Rampant Mountie Seeks Milky Bounty – Sell NZD/CAD

Theme #5: Dingo no Drongo – Buy AUD vs EUR and JPY

Theme #6: Helga so Hot – Buy NOK and SEK vs EUR

Theme #7: Canton Talks, Gangnam Walks – Buy CNH/KRW

Theme #8: Join Rupee Groupies now Sing Out of Time – Sell SGD/INR

Theme #9: Trade Slavic Cold for Latin Gold – Buy MXN & BRL vs CZK & HUF

Theme #10: Stand Up Dollar Shekel Buy USD/ILS, TRY/ZAR and PLN/HUF

Theme #11: Russia Bores, Canada Snores – Use dual digitals to sell EUR/USD and USD/CAD correlation; sell EUR/USD and USD/RUB correlation

Theme #12: Kiwi Grounds while Yen Astounds – Sell 3m NZD/USD vol swap; buy 3m CAD/JPY and USD/JPY vol

Theme #13: These Inhale from Nose to Tail – Buy a basket of MXN, COP, PLN, INR, sell against TWD, ILS, ZAR, CLP

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Welcome Back!

FX is back

After a grueling first half of the year currency markets are coming back to life: the dollar is strengthening, volatility is rising and investors are re-engaging. This is a very different environment to last year's "taper tantrum", however. US yields are range-bound, the focus has expanded to central banks beyond the Fed and cross-market correlations are declining. This lack of a one-sided driver makes current market moves all the more powerful.

Our premise for the rest of 2014 is that FX trends continue. Divergent business cycles and shifts in cross-border capital flows all have the potential to drive an extension of price moves, particularly after a period of such unusually low volatility. In the pieces that follow we stick with dollar longs in some places, avoid others, and identify relative value opportunities that should perform independently of the broad dollar trend.

A new regime for the euro

We expected a range-bound euro over the summer, but the picture into winter looks very different. On the monetary policy front, downside risks to inflation are rising, together with the likelihood of large-scale QE. The portfolio flow picture is also turning, with foreign equity inflows reversing, and European buying of offshore fixed income picking up. We expect the next few months to mark the beginning of a global "European reach for yield", and therefore forecast meaningful euro under-performance. We target 1.25 in EUR/USD by year-end and are bearish the EUR trade-weighted index.

Sticking to the yen

It has paid to be a strong yen bear and we remain as committed as ever. Capital outflows are starting to accelerate after a quiet first half, helped along by the large portfolio changes in public pension funds. Base money divergence between the BoJ and Fed is speeding up, and the Abenomics machine remains in full swing ahead of the end-year consumption tax decision. Potential PRDC re-hedging demand combined with safe-haven unwinds as yen basis widens and GPIF re-allocation all have the potential to push the market into year-end. We re-iterate our 115-120 USD/JPY objective for next year.

More than just the euro

With the Scottish referendum out of the way, cyclical drivers should return in the UK and we are bullish GBP again. FDI inflows are rebounding helped by corporate inversion deals, fixed income inflows are resuming, and market pricing of the Bank of England is much more cautious. The opposite is true in Switzerland. The SNB is missing its inflation mandate, and we see a high probability of negative rates from the SNB in coming months. We recommend buying GBP/CHF. In Scandinavia, we like both NOK and SEK vs EUR. Pipeline price pressures suggest inflation has bottomed in Sweden, removing the last few months' most important drag on the krona. Norway remains one of the few economies generating above-target CPI growth and with rates pricing still dovish we like being long the krone as well.

Commodity currencies diverge

We keep the bearish NZD/CAD recommendation from the last Blueprint on the back of stretched valuation and relative commodity and interest rate differentials. We are more constructive on the AUD which should remain one of the few positive carry trades in G10; we like longs versus EUR and JPY.

A mixed bag in EM

We have a positive bias on LatAm over EEMEA. We like BRL on the possibility of additional inflows following the elections and MXN in light of positioning and ongoing reforms. We recommend buying both against shorting CZK and HUF. The crown should continue to suffer on the back of disinflation, while the forint may be hurt by a dovish NBH and the FX loan stock conversion. We are also long PLN/HUF and TRY/ZAR. In Asia, we are bullish CNH/KRW on differing currency policies and sensitivities to the yen and dollar. We recommend being short SGD/INR on the back of India's continued twin deficit improvement and the Sing dollar's high sensitivity to the USD.

No volatility blow-up

Despite the recent spike we are not overwhelmingly bullish on volatility: risk premia are already elevated. We recommend buying JPY vol and shorting NZD/USD volatility. We also recommend buying dual digitals between EUR/USD and USD/CAD (and USD/RUB) to take advantage of lower realized correlations than are currently priced.

May trades

Our last Blueprint trades finished up an average of 0.8% with five out of six themes in the black (see appendix). The best performing trade was short EUR vs MYR and PHP and worst performing trade was the long GBP/USD volswap.

The FX Strategy Team

Theme #1: Euro Pah!

We are bearish EUR/USD and EUR TWI for six reasons.

1. Real Yields Are Finally Turning

Nominal rate differentials have been moving against the euro for a long time, but it is real yields that matter more. These finally turned this summer, coinciding with the last phase of ECB easing (chart 1). The central bank has finally acknowledged that it is willing to do "whatever it takes" to under-write inflation expectations. In turn, this provides assurance that Draghi will aggressively resist any rise in real yields. With geopolitics, commodity prices and medium-term inflation expectations all still pointing to downside price risks, the odds of full-blown sovereign QE from the ECB have risen materially. Risks are therefore skewed towards even lower real yields by year-end.

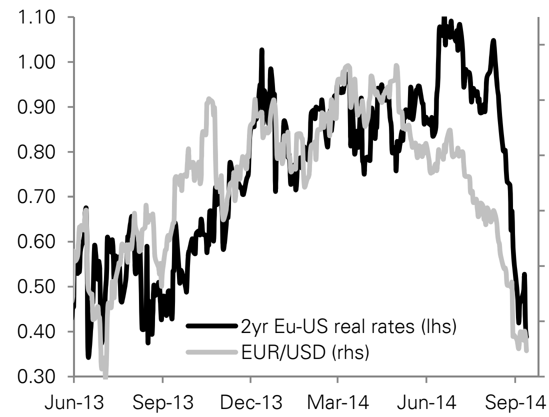
2. Equity inflow story has peaked

The major flow story supporting the euro has been foreign equity purchases. Cheap valuations, a re-building of foreign underweights and easy policy elsewhere have all helped. All seem to be turning. Our high-frequency monitor shows record equity outflows this summer, evidence of the maturity of the inflow (chart 2). Broader mutual fund data show that Euroarea equity holdings are well above their pre-crisis peaks. Valuations are now more stretched, with our global asset allocation team favouring US over European equities. Finally, US QE is drawing to a close, which should reduce risk-appetite from US-based investors, the biggest buyers of European stocks.

3. Fixed Income outflows is next big story

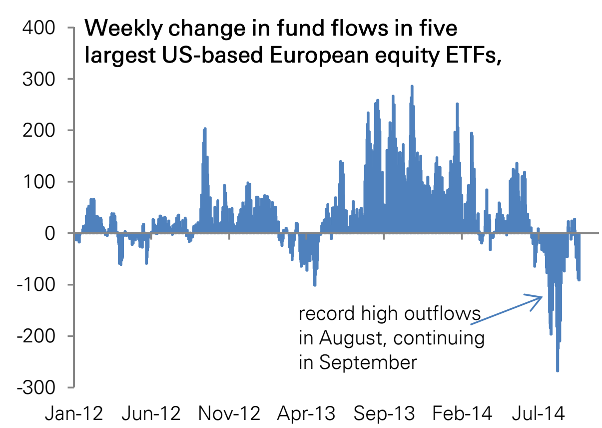
The most important development this year has been the huge rally in European fixed income. Combined with lower real yields, we believe the next few months will mark the beginning of large fixed income outflows from Europe to the rest of the world: a global "reach for yield". Indeed, the current level of the yield differential has historically been correlated with large outflows (chart 3). The last two years have been an aberration due to the Eurozone "re-convergence" trade, but the traditional relationship should re-assert itself now that peripheral spreads have narrowed. Beyond this, Europe will have an increasing need to recycle its current account surplus abroad. At more than 300bn USD, these flows have so far been used to finance the reduction of Eurozone bank foreign liabilities. With bank balance sheet repair now close to completion, European outflows should be the next thing that offsets the current account surplus. High-frequency flows are already pointing in this direction – portfolio flow data for Q2 show European purchases of foreign debt rising to the highest levels since Lehman.

Real Rate Differentials Have Finally Turned



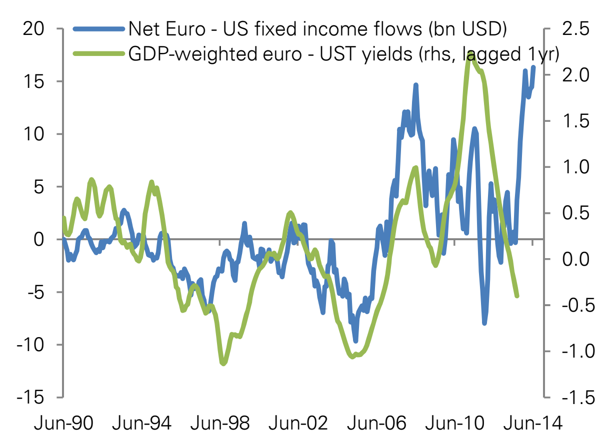
Source: Deutsche Bank, IMF

Equity Inflow Story Is Over



Source: Deutsche Bank, Bloomberg Finance LP, Datastream

Next Big Story Is Fixed Income Outflows from Europe



*Source: Deutsche Bank, Bloomberg Finance LP, *we proxy world by the FTSE and Hang Seng*

4. USD has rallied into last three hiking cycles

History suggests that the dollar does well into hiking cycles. Over the last three major cycles, the dollar has typically appreciated 5-10% going into the first hike, with an appreciation trend starting 6-9 months ahead. Assuming the Fed is on track to hike rates by Q2, the dollar is just entering this appreciation phase. With FOMC pricing still benign and risks tilted towards an earlier, rather than later hike, the odds are skewed towards more, not less rate support for the dollar.

5. Dollar positioning is not that extended

The large dollar reversal last year was helped by a significant accumulation of longs from speculative accounts. Positioning this September looks cleaner however. First, IMM holdings are half the size compared to last year, mostly due to smaller longs from asset managers. Second, the option market isn't at extremes either. Most dollar-cross risk reversals are close to the narrowest they've been in years, with the 25delta EUR/USD skew at less than one vol for puts compared to close to double last year.

6. Dollar driven by "cycle", not portfolio flows

The portfolio flow picture into the US has been extremely disappointing, but dollar drivers seem different this time. Support is coming from an inflow of cash and derivative hedging. Investors may be waiting for higher yields before allocating their cash to US fixed income. Or global liquidity and excess risk aversion may be reflected in higher "safe haven" inflows to the US. Either way, the lack of equity and fixed income inflows does not appear to be a constraining factor for dollar strength.

We target 1.25 in EUR/USD by year-end.

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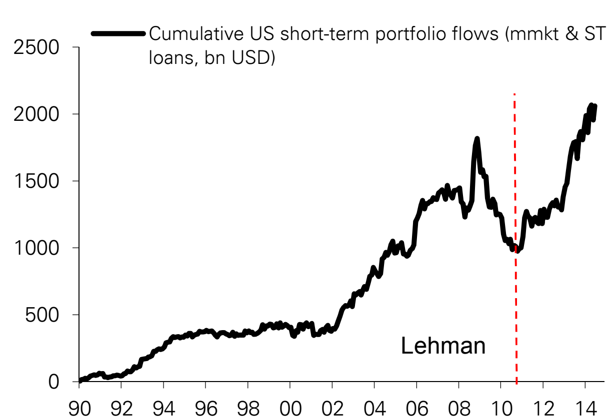
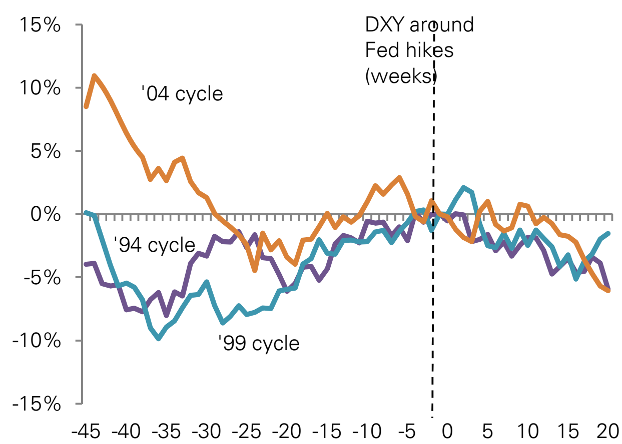
Investors Moving Into Dollar Cash



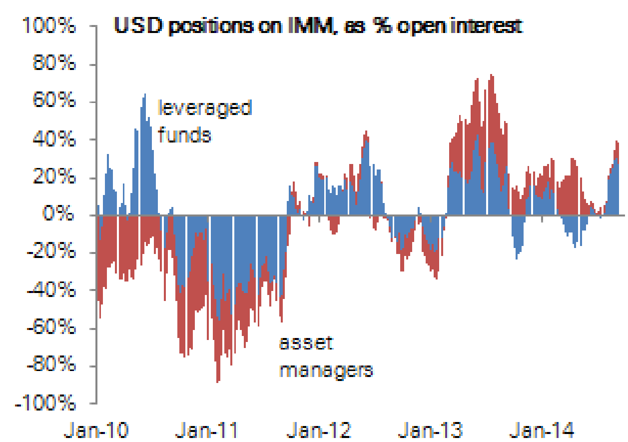
*Source: Deutsche Bank, Bloomberg Finance LP, *we proxy world by the FTSE and Hang Seng*

Dollar Rallies Into Fed Rate Hikes



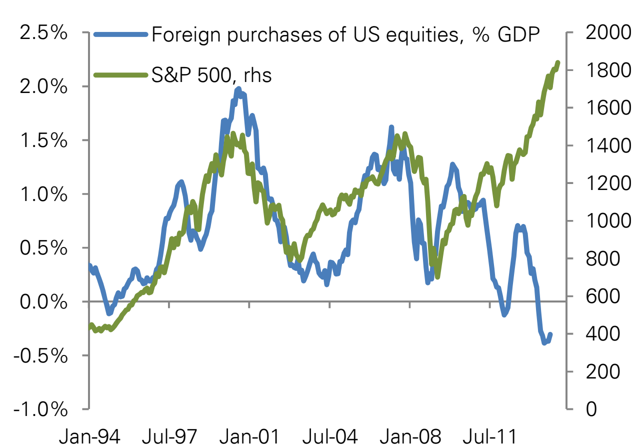
Source: Deutsche Bank, Consensus economics 1-yr ahead expectations

Positioning In Dollar Not That Extended



Source: Deutsche Bank, Bloomberg Finance LP

No-One Is Buying US Equities



Source: Deutsche Bank, Bloomberg Finance LP.

Theme #2: Another Ten for Dollar Yen

- Stay long targeting 112 by year-end, 120 next year

This is our seventh consecutive *FX Blueprint* recommending a yen selling trade; we started in May 2012. USDJPY has gained 40% since then and still see at least 10% more upside. One might think the-prospects in terms of risk versus reward have deteriorated by now, but we don't believe that is true.

Sustainable trends rely on rotation, rotation, rotation

USD/JPY really started to rally in the fourth quarter of 2012 on short covering as Japan's economy stabilized and the policy environment shaped up for a dramatic reflationary turn. Leveraged players only jump aboard when the BoJ out-eased its peers 18 months back, then get chopped up as they struggled to grasp Abe's 'third arrow' growth plan and waited in vain for more QE to materialize. Activity in 2014 has been subdued as a result, heightened by uncertainties over the consumption tax hit. The Japan-trade thus has reverted to being more domestically driven, with a focus on better risk appetite and GPIF's eventual portfolio shift. Spot settled comfortably into a 101-105 range, lifting only as the Fed's final taper has come into view and big players returned from their summertime breaks.

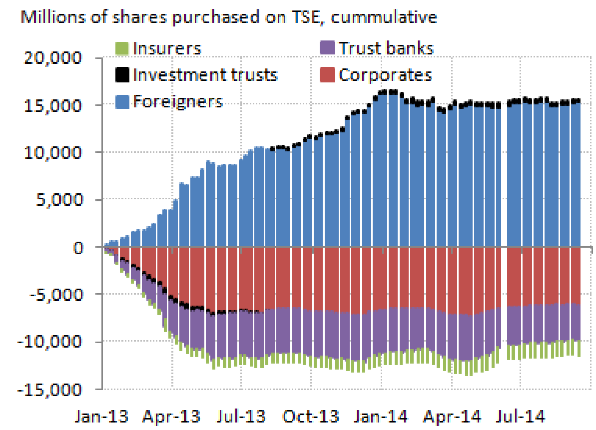
Market asymmetry still growing

Adding seven big figures over the past five weeks has put conventional momentum metrics like the 14-day RSI in historic overbought territory (>85). Naturally, it has made market participants wary of chasing the move higher, and measures of positioning remain relatively benign as a result. But that does mean they will be strongly inclined to buy dips or chase technical breakouts, as most are missing out.

Such expectations of proximate support in USDJPY are strengthened by asset reallocations trend that are beginning to take place in the domestic market. GPIF's new benchmark weightings should imply about USD50billion shifts into local stocks and more than twice that amount flows offshore over the next year or two. Valuation effects could reduce these estimates by as much as 50% if the TOPIX and USD/JPY continue to rally hard and JGBs sell off. But because GPIF's move will constitute a signal for other public and private funds to follow, we still expect to see historic outflows.

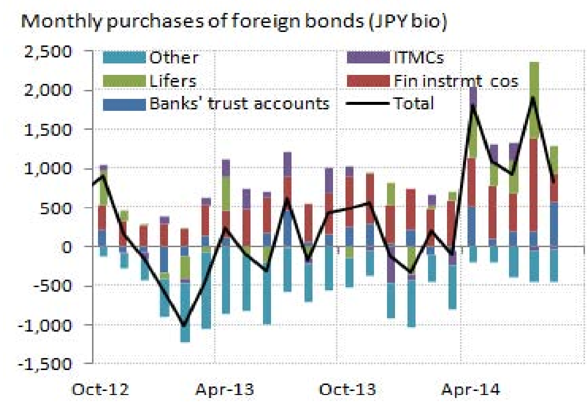
So far, the data show a relatively small pickup in pension fund demand for foreign assets (intermediated by trust banks), a moderate increase in interest from life insurance companies (doubtless spurred by falling JGB yields), and a clear acceleration in purchases by investment trusts. The latter captures stirring 'animal spirits,' which we also see in surging MOTHERS index and JASDAQ volumes. It may get boosted by a year-end rush to use (or loose) the new NISA allowances.

Stalled equity purchases ape the year in FX



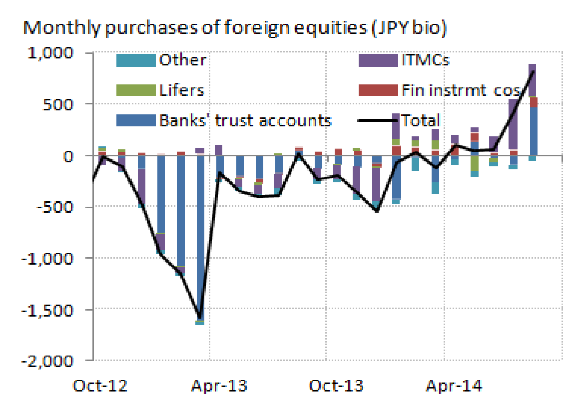
Source: Deutsche Bank, Bloomberg Finance LP

Pension funds and lifers driving pickup in bond outflows



Source: Deutsche Bank, Bloomberg Finance LP

Retail and pensions behind foreign equity surge



Source: Deutsche Bank, Bloomberg Finance LP

Basis might bite

The BoJ has is now purchasing front-end government paper at negative yields, causing a bit of a rumpus. It was largely inevitable when yields dipped – possibly encouraged by the ECB -- since the Japanese central bank has a purely quantitative (balance sheet and monetary base target). But in the context of yen basis swap also having widened on demand for dollars to cover the calendar year-end, it has sparked fresh fears of money market unwinds. This is relevant in so far as large foreign flows have accrued in short-term yen debt instruments since the Crisis, much apparently safe-haven inflow that came from Europe and the UK. Though volatile and anecdotally partially FX-hedged, these flows have a clear relationship with the currency and in trend terms have just turned (yen) negative.

Separate talk has resurfaced of potential PDRC (re-) hedging demand as spot approaches 110, since legacy structures are callable. Were this to occur we should see simultaneous moves in longer end basis swaps, and not just in yen contracts but mirrored in higher yielding markets like the Aussie.

Meanwhile, things are quiet on the current account front. The trade deficit has stabilized but exports remain disappointing, and imports are unlikely to drop much before a handful of nuclear reactors are get back on in the first half of next year. Also disappointing has been FDI, where a well advertised USD20+ billion outbound telecom M&A deal was aborted. Even so, corporate appetite for foreign acquisitions remains strong as Japanese management teams have increased their focus on ROE and are seeking to regain leading positions in several global sectors.

Some way from overshoot

The domestic political focus has now turned to the next leg of the consumption tax hike, and the need for a supplementary budget to cushion the economy. It would take a very weak Tankan to get the BoJ to expand its current asset purchase program. But even extension at the current rate promises further support for USD/JPY as the Fed's balance sheet in contrast starts to shrink.

Inevitably voices protesting the distributional consequences of further yen weakness will get louder at home and abroad. However, Japan's policymakers and advisors who matter (Kuroda, Iwata, Hamada, Ito) are unlikely to be swayed anywhere this side of 120. That was the level prevailing pre-Crisis in 2007. It is also the point below which MOF has never sold USD in intervention. Beyond that point, however, the 'easy money' will have been made, and USDJPY will become a much more tactical trade.

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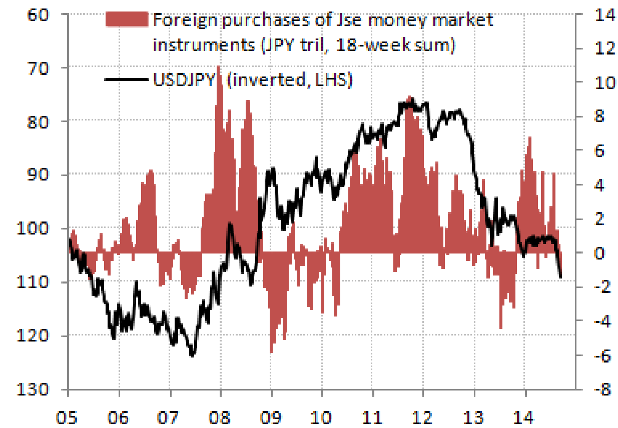
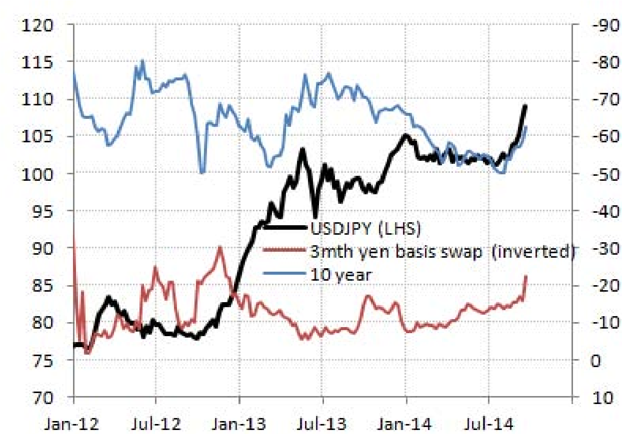
Watch for short-term debt unwind



Source: Deutsche Bank, Bloomberg Finance LP

Keep an eye out for bigger basis moves



Source: Deutsche Bank, Bloomberg Finance LP

Upcoming events

Imminent	GPIF Investment Advisory Committee agrees new portfolio recommendation
22-27 Sep	Abe visits USA, to addresses UN General Assembly
1-Oct	BoJ's quarterly Tankan business survey
Early Oct	Extraordinary Diet session convenes
07-Oct	BoJ meets
Mid Oct	Council for Econ and Fisc Policy meets again (atypical as usually every 3 mths)
26-Oct	Fukushima governor election
31-Oct	BoJ meets, issues semi-annual Outlook Report
Oct/Nov	Next Trans-Pacific Partnership ministerial-level meeting
Nov	Casino Promotion bill likely to be passed in Diet
10-11 Nov	APEC Summit, Beijing
Mid Nov thru Dec	July-Sep corporate earnings released
19-Nov	BoJ meets
16-Nov	Okinawa governor election
17-Nov	Q3 GDP report paves way for formal Dec cons tax decision
19-Dec	BoJ meets
Spring '15	Supplementary budget, collective defense bills, unified local elections, nuclear power starts to come back online
Sep '15	Abe term as LDP leader expires

Source: Deutsche Bank, various news sources

Theme #3: – Stirling Stayed, Swiss Squished

- Increasing growth divergence, lighter positioning and M&A and fixed income inflows should all help sterling.
- By contrast, the franc looks increasingly vulnerable to the prospect of negative rates from the SNB. Buy GBP/CHF.

Scotland and a dovish Bank of England helped our tactical short GBP/USD trade in May, but now we see reason to be more optimistic on sterling.

Growth divergence increasingly stark

With the Scotland referendum out of the way, attention should quickly revert to the UK domestic cycle. Not only has the UK continued as the world's outstanding major economy, divergence is becoming starker as growth worries have surfaced in the Eurozone, China and Japan.

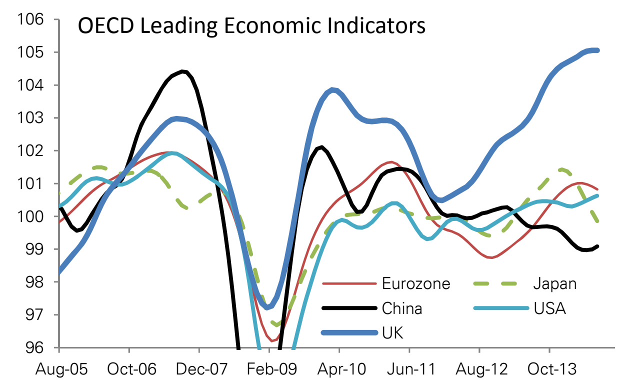
Slowdown to be weathered

On the domestic side, a slowing housing market and downturn in the Eurozone should cast an autumnal chill on growth. However, the FX market is much better placed to tolerate a slowdown than in the summer. Positioning has lightened considerably, with the CFTC showing leveraged fund longs have been chopped by over 50% from June. Indeed, overall speculative positioning is now short for the first time since November last year as players pared back risk heading into last week's Scottish referendum. Data surprises are only just off their lows, suggesting that analysts' cycle expectations are not that elevated. Most importantly, the Bank of England has noted that they predict a late-year slowdown. Of more focus for the MPC is labour market slack. On that front, weak wages have been the main concern. However, the market is already factoring this in with the first hike not priced until April, while pay growth is showing tentative signs of picking up. It's also important to note that with two MPC members having already voted for hikes, the bar for a surprise has been lowered.

Flow story looking rosy

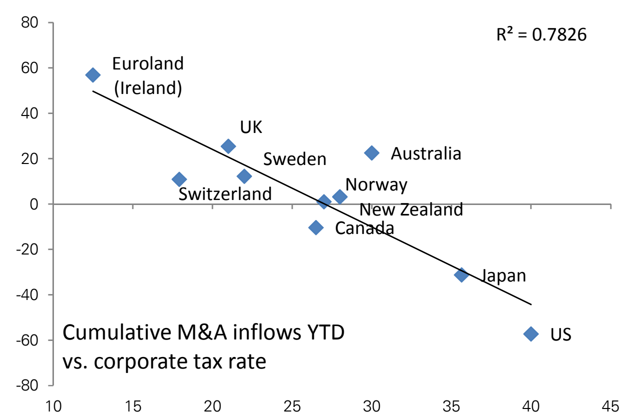
Last quarter the UK's basic balance moved into positive territory for the first time since 2010 in spite of the continued deterioration of the current account. The improvement has been driven by FDI inflows, and the pipeline looks very positive. The 3m M&A pulse is the strongest globally, with over USD 64bn of inflows. We noted in January that relative growth could see the UK benefit from FDI inflows, and an explosion of corporate tax inversions also appears to have contributed. Fears of changes to US law and a further fall of the UK's corporate tax rate next year, to the lowest of any developed country except Ireland and Switzerland, should support this trend. Medium term, we are increasingly optimistic that UK inflows will broaden out,

UK growth continues to diverge from the pack



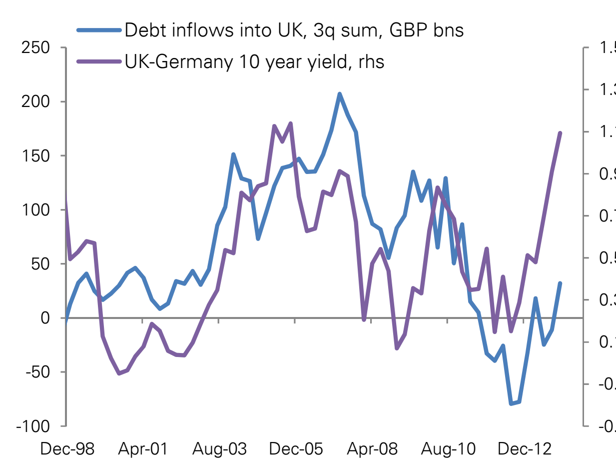
Source: Global Markets Research; Bloomberg Finance LP, OECD

Corporate tax inversions driving M&A inflows



Source: Deutsche Bank, Bloomberg Finance LP, KPMG

Low euro yields mean investors should buy gilts



Source: Deutsche Bank, Bloomberg Finance LP

particularly to debt. Bond inflows over the last two quarters have been the largest since the crisis. They should be helped by the rally in European fixed income, as investors are forced to hunt abroad for yield. Foreign purchases of gilts have closely tracked the differential between Euro and UK yields over time (chart 3).

Swiss still sore

We think risk/reward has never been better to be short the franc. It is increasingly probable that the SNB will be forced to cut interest rates to negative. For one thing, the central bank is beginning to lose credibility. The last set of inflation forecasts shows them missing their price stability mandate in the medium term, something even the ECB has never owned up to (chart 4). There are limits to how much the SNB can disappoint the market. Moreover, negative rates could bring macroprudential benefits by dampening the domestic housing market if the experience of Denmark is anything to go by.

The effect of negative rates on CHF should not be underestimated. Excess liquidity in Switzerland dwarfs that of the Eurozone at its peak and an inverted yield curve means investors cannot escape, which will lead to capital outflows. This impact was sufficiently large in Denmark's case that the Nationalbank was actually able to unwind its FX intervention-related assets while the krone still depreciated. We still like long EUR/CHF but also think playing short CHF against GBP is an excellent RV trade. In contrast to Switzerland, where disinflationary trends are causing consumers and business to postpone spending, the fall of shop prices has been a boon to the UK consumer (chart 6). The export-orientated Swiss economy is also more heavily exposed to a slow-down in the Eurozone. Finally, relative yields show plenty of potential for GBP/CHF upside (chart 7).

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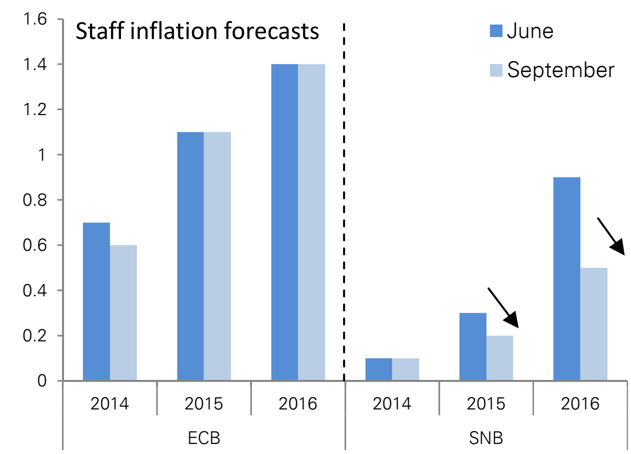
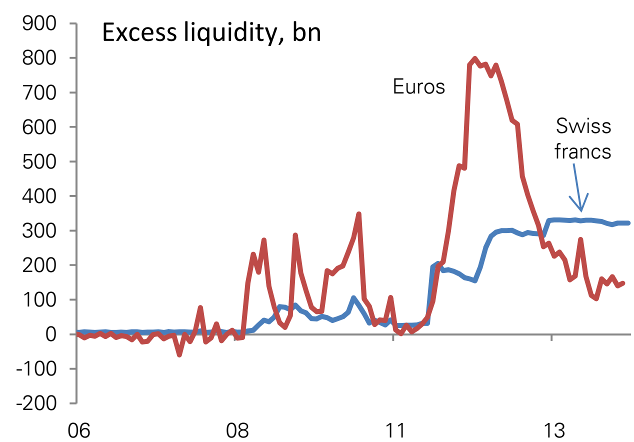
SNB at even more risk of missing mandate than ECB



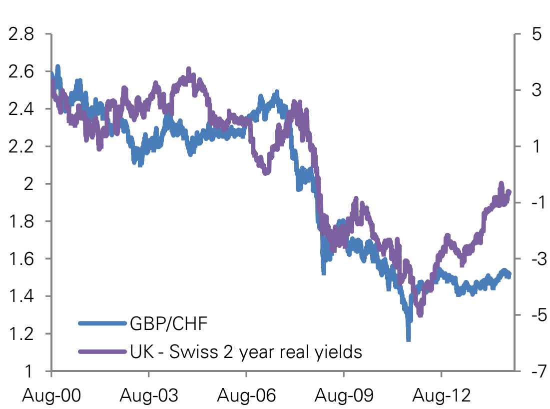
Source: Global Markets Research; Bloomberg Finance LP, ECB, SNB

Negative rates would have big currency impact



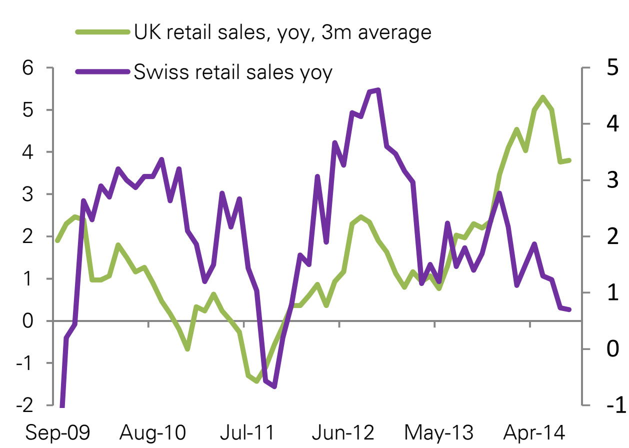
Source: Deutsche Bank, Bloomberg Finance LP

Real rates show plenty of potential for GBP/CHF upside



Source: Global Markets Research; Bloomberg Finance LP, Haver

Switzerland has 'bad' disinflation, UK has 'good'



Source: Deutsche Bank, Bloomberg Finance LP

Theme #4: Rampant Mountie Seeks Milky Bounty

- NZD/CAD has fallen ~4% in the last four months. We continue to think it is stretched on relative yields, commodity prices and relative economic performance, so we maintain our short position.[1]
- History since 1975 suggests that CAD is appealing during Fed tightening cycles.

Maintaining our NZD/CAD short

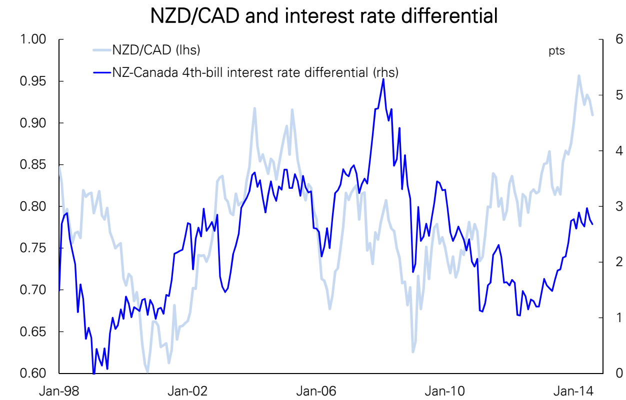
In May, with NZD/CAD at 0.93, we wrote that NZD/CAD appeared at risk of a substantial move to the downside given rate differentials, a downturn in dairy prices and a shift in relative economic performance in Canada's favour.

The cross has fallen 4% but continues to trade above the levels suggested by the interest rate differential (Figure 1). Commodity prices have moved decisively in Canada's favour (Figure 2), with prices of New Zealand's key commodities exports falling further. Dairy prices – 31% of New Zealand's merchandise exports – are down 45% at auctions since February. Timber prices – 8% of the export basket – are down 5%. New Zealand's monopsony dairy cooperative Fonterra is likely to reduce its forecast payout to farmers for the second time this season. Lower prices have seen export revenue sag and the external deficit widen.

In May we noted that relative labour market performance was at levels that typically see some mean reversion. That ratio has moved towards more normal levels (Figure 3) but the gap could close further. New Zealand's economic performance has been robust – the RBNZ is forecasting 2015 GDP growth of 3.6%, an output gap of 1.1% and an unemployment rate of 5.1% – and New Zealand continues to offer the highest 10Y yields in the G10. NZD has returned more against USD than any other G10 currency except AUD this year. But the hawkish outlook for interest rates has moderated, and we do not expect further rate rises until March at the earliest. On the other hand, recent Canadian data has shown a strengthening of domestic and external demand, with GDP growth picking up from 0.9% qoq annualised in Q1 to 3.1% in Q2, the strongest quarterly gain since 2011. A gradual strengthening in the US economy should see net exports contribute further to Canadian performance.

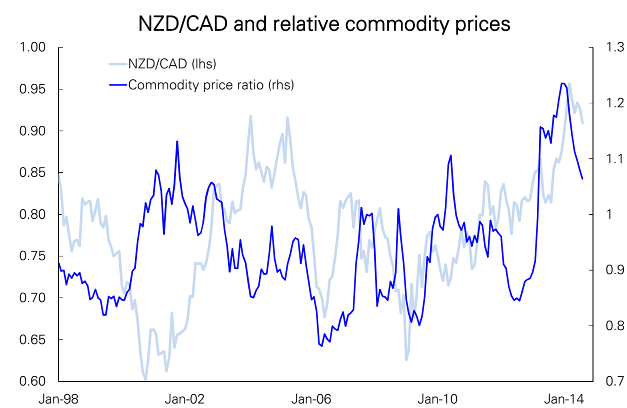
While NZD/CAD has fallen 7% from its March peak, it remains above every other high since 2005 and 14% above the 10-year average. For these reasons we think the cross has further to fall.

Figure 1: NZD/CAD and interest rate differentials



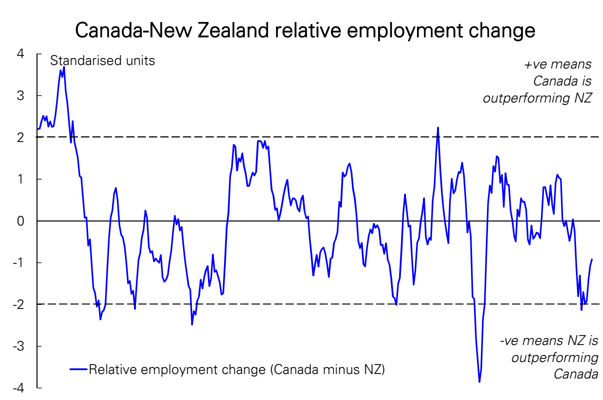
Source: Bloomberg Finance LP, Deutsche Bank

Figure 2: Commodities have turned against NZD/CAD



Source: Bloomberg Finance LP, Deutsche Bank

Figure 3: Relative labour market performance has further scope to return to normal



Source: Bloomberg Finance LP, Deutsche Bank

[1] We recommended a NZD/CAD short in the 23 May *Dollar Bloc Weekly* too but set a relatively tight target and were stopped out on 12 June.

CAD appealing during Fed tightening cycles

CAD is also appealing in the context of the Fed tightening cycle.

Firstly, the Canadian business cycle remains closely tied to the US growth cycle, in contrast to the New Zealand cycle that has increasingly been influenced by China and other Asian trading partners. In the last 15 years, US y/y% GDP can explain as much as 73% of the variation in coincident Canadian GDP, but 'only' 29% of the variation in NZ GDP.

In this cycle, Canada has been climbing up the global export league rankings in no small part because of its dominant trade linkage to the US (Figure 5).

Even before the 'China effect' was prevalent, the CAD has shown a much smaller response than the NZD to broad USD trends in Fed tightening cycles. Fed tightening cycles since 1975 show a consistent pattern: the CAD adjustment to broader changes in the USD TWI is about half the reaction of NZD to a stronger USD (Figure 6).

This is another way of saying that the CAD is a good alternative to the USD in tightening cycles where the USD is generally appreciating. Betas for Fed tightening cycles show on average that a 1% move in the USD TWI has been associated with NZD falling 0.47% versus the USD in tightening cycles, while CAD declines 0.21%. All cycles are not equal, but with cycles in NZD less synchronized with the US, there should be more capacity for the CAD to move closely with the USD versus NZD.

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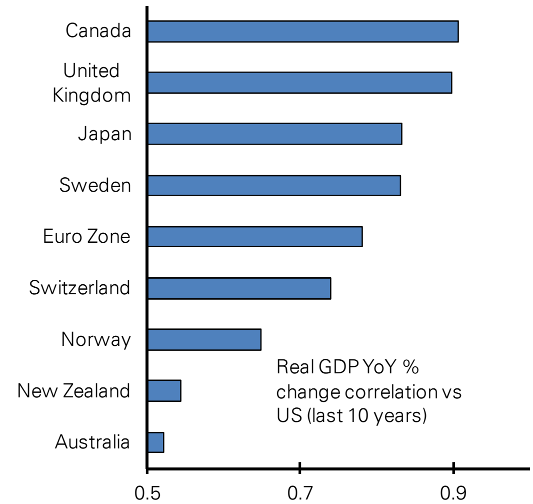
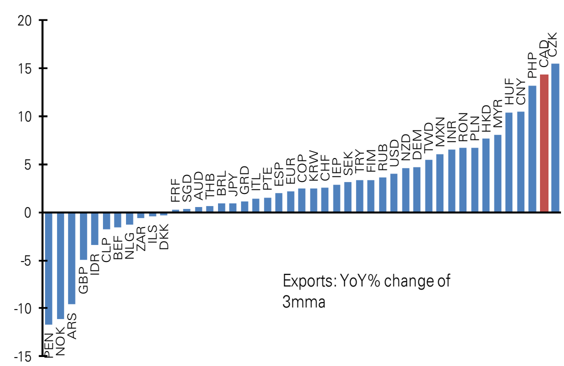
Figure 4: Canadian and US growth are closely tied



Source: Deutsche Bank, EcoWin

Figure 5: Canada has climbed the export rankings



Source: Deutsche Bank, EcoWin

Figure 6: CAD reacts less than NZD to a stronger USD

Betas during Fed tightening cycles - 1 % change in USD TWI implies for:

	Jan 76-May 76	Nov 76-May 81	Nov 82-Aug 84	May 85-Sep 85	Aug 86-May 89	Sep 92-Feb 95	Jan 96-Mar 97	Nov 98-May 00	Jun 03-Jun 06
USD/JPY	0.53	1.47	1.29	0.81	1.16	1.01	1.21	1.47	0.73
USD/EUR	1.30	0.95	1.11	1.28	1.03	1.32	1.10	1.11	1.02
USD/CAD	0.70	0.21	0.23	0.28	0.13	0.08	0.12	0.20	0.74
USD/GBP	1.62	1.02	1.12	1.82	0.99	1.26	0.80	0.56	0.84
USD/CHF	1.54	1.84	1.52	1.77	1.32	1.41	1.24	1.13	1.10
USD/AUD	0.23	0.59	0.81	0.92	0.31	-0.05	-0.03	0.43	1.05
USD/NZD	0.06	0.59	0.82	0.47	0.30	0.05	0.20	0.50	1.00
USD/SEK	0.67	0.82	0.99	1.09	0.91	1.23	0.87	0.93	1.10
USD/NOK	0.91	1.00	1.04	1.18	0.83	1.26	0.92	0.87	1.01
USD/DKK	1.07	1.28	1.41	1.46	1.13	1.30	1.12	1.09	1.02

Source: Deutsche Bank, EcoWin

Theme #5: Dingo no Drongo

- Our view is – in the wake of the significant re-pricing of AUD/USD over the past few weeks – neutral through year-end.
- But we see scope for AUD *outperformance* against the low-yielders, buy AUD versus JPY and EUR.

Fed rules down under

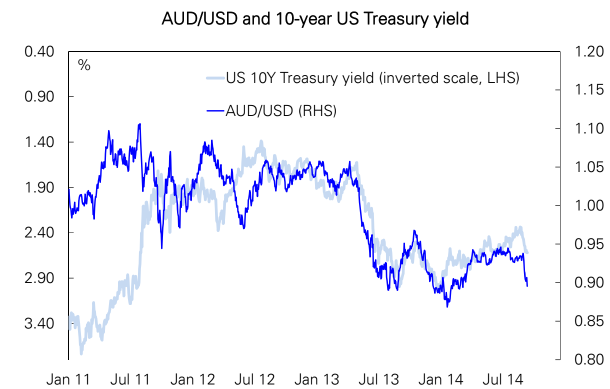
We argued in the May Blueprint that "We see downside risks to AUD/USD by the end of 2014, but struggle to see the cross making new year lows over the coming months. In our view the Fed – and the US bond market – are more important drivers of the AUD than iron ore."

The price action in AUD/USD – especially last week – appears to have provided some support to that view. Namely, after having been largely resilient in the face of both weaker iron ore prices and also a stronger USD, it was the sell-off in US yields ahead of the 16-17 September FOMC meeting that finally pushed AUD/USD lower. The 'dominance' of US yields over AUD/USD has been a consistent theme since mid 2012 – which is when the Australian rates market priced a 2.50% RBA cash rate. This suggests that a stronger USD driven by *lower European yields* (as was the case over much of August) is ambiguous for the Aussie.

With our view on the domestic (i.e. Australian) economy continuing to be one that sees the RBA on hold all through 2015 and H1-2016, external influences are likely to continue determining trends in the AUD. That means – given the influence of US yields – any view on AUD/USD rests heavily on one's outlook for Treasuries. In this vein, we think the longer term picture remains bearish for AUD/USD – both from a spread perspective and also from an absolute perspective. From an absolute perspective if we assume a 'terminal' Fed funds rate in the order of 3.75%, then the previous two cycles would imply a peak in US 10-year yields at or below that level (see Figure 3). On the basis on the relationship shown in Figure 1, would suggest a much lower AUD - one in the low 80s – albeit not for some time yet.

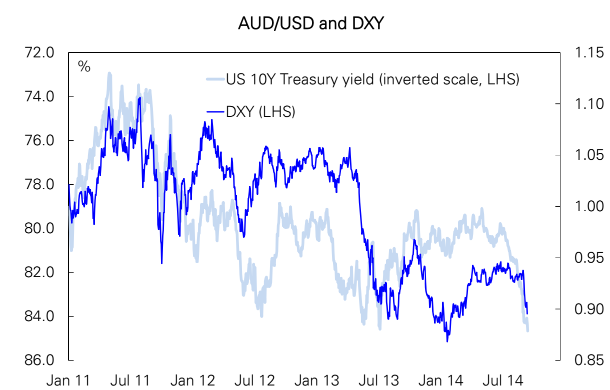
On a spread basis, Figure 4 uses the median 'Fed dots' versus our RBA cash rate forecasts for 2015 and H1-2016 to examine where the spread between 10-year AUD and US yields might go. As that chart shows, we would expect the 10-year bond spread to narrow through 2015, although the vast bulk of the narrowing in spreads has already been seen.

Figure 1: The lower AUD/USD reflects higher US yields



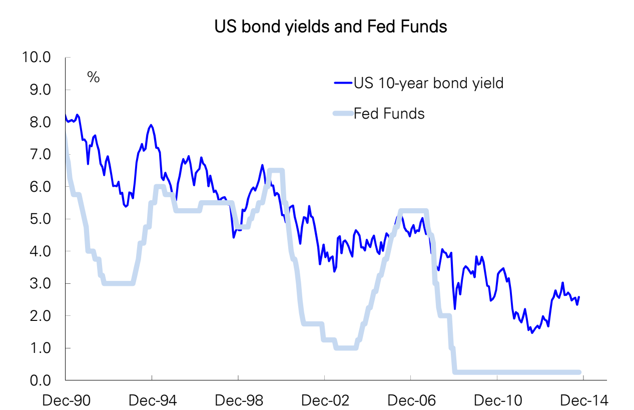
Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: AUD was resilient to a stronger USD in the *absence* of higher US yields.



Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: US 10-year yields could peak below Funds



Source: Deutsche Bank, Bloomberg Finance LP

Consistent with much of our research published over the past few months, this suggests considerable upside to our end 2015 AUD target of 0.69. As a result, we now target 0.80 come end 2015; with upside *and downside* risks balanced. Our end 2014 AUD/USD target is now 0.90. So in the wake of the significant re-pricing of AUD/USD over the past few weeks, we are neutral for now.

Be cross and carry on

Where we see scope for AUD *outperformance* through to the end of the year is on crosses. As an example, Figure 5 plots the spread between Australian and French 10-year bonds yields and AUD/EUR. For reference we have also included the spread between Australian and US 10-year bonds. As Figure 5 shows, the recent pull-back in AUD/EUR is out of line relative to a widening in the spread between Australian and French yields.

To be sure, we acknowledge a general trend toward short EUR positions through much of this *Blueprint*. Our aim here is to highlight the attractiveness of AUD in terms of carry. We hold a similar view on AUD/JPY – here also carry remains significant, vol low, and major central banks (including the Fed) are continuing with ultra-accommodative monetary policy. Of course the Fed is in the process of exiting, although that exit has – so far under Chair Yellen – been conducted in such a way as to minimize disruption to markets.

Carry trumping commodities for now

While terms of trade may be the major long-run driver of the Aussie's TWI, AUD can and does deviate for long periods. Indeed the 'over-shoot' of the late 1980s and the 'under-shoot' of the late 1990s / early 2000s both lasted around 4 years. So far the real AUD TWI has only been over-shooting the terms of trade for the past 2 years. We should therefore not be surprised if deviations from a ToT 'fair-value' estimate were to persist for another two years. Put simply, carry can trump commodity prices for a little while longer.

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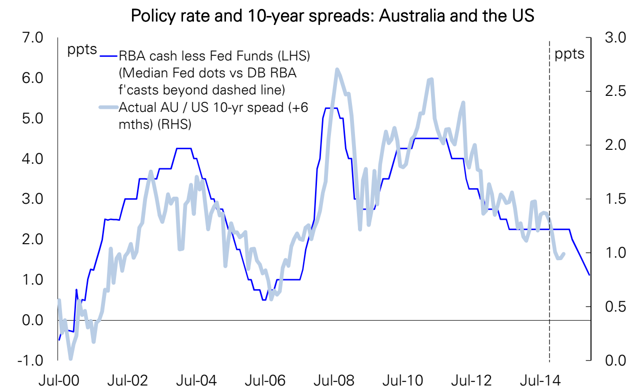
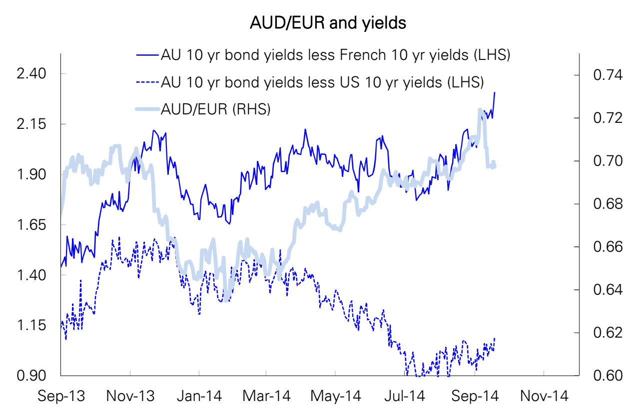
Figure 4: The Fed's dots imply a narrower spread



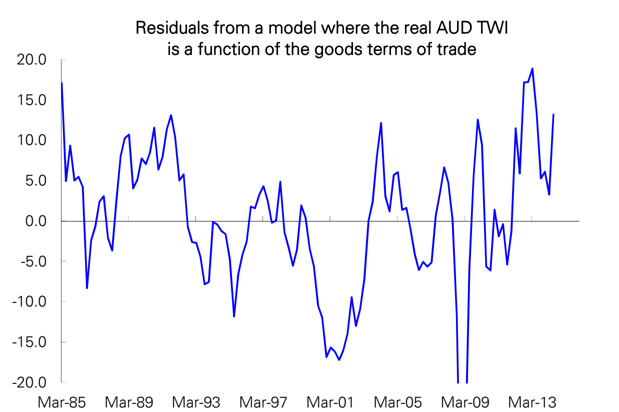
Source: Deutsche Bank, Bloomberg Finance LP

Figure 5: For now lower global yields suggest AUD should do well on crosses through to year's end.



Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: The TWI can 'ignore' the terms of trade for years



Source: Deutsche Bank, Bloomberg Finance LP

Theme #6: Helga so Hot

- SEK in good position to strengthen once clear inflation has bottomed, sell EUR/SEK
- In Norway elevated CPI to translate into grudging acceptance of gradual appreciation, sell EUR/NOK

Rate re-pricing driving SEK underperformance

The last 12 months have been anything but stellar for the krona, with the currency the worst performing in DM, losing some 10% vs. USD, and almost 5% weaker vs. EUR. The reason is the Riksbank, which in December last year reduced rates by 25bp to 0.75%, and, faced with sustained disinflation, reduced rates by a more aggressive than expected 50bps to 0.25% on July 3rd. The immediate question is therefore whether disinflationary pressures will persist, prompting the Riksbank to consider ways of making policy more expansionary yet, or if inflation really has bottomed in line with the Riksbank's projections and will pick up from here on.

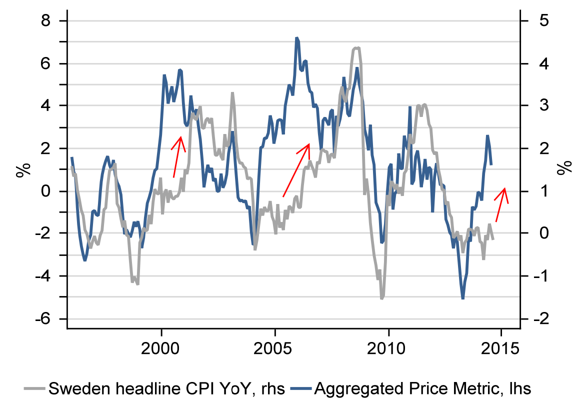
Judging by broader price pressures, including PPI, domestic supply prices, import prices, export prices, and the net price index in an aggregated price metric, underlying inflation troughed in Q2 2013 at around -5% YoY on average, but has since edged back up to around 2% YoY currently. Typically there is a substantial lead/lag between an uptick in pipeline price pressures and prices at the consumer level. Looking back at previous cycles, our pipeline price metric peaked in Oct 2000 and Dec 2005, with headline CPI not peaking until Sep 2001 and Jul 2008, respectively. Indeed, in 2004/2005, headline CPI was in a tight and subdued 0% to +1% range. This is similar to the past two years, when headline CPI been largely stuck between -0.5% to flat YoY despite pipeline price pressures rallying back. While we cannot be certain about the lead/lag between our aggregated price metric and headline CPI, history suggests that the wide and growing gap between pipeline price pressures and CPI will at least provide a floor for the latter. This would remove the biggest drag on the krona over the past 12 months, namely reluctant rate cuts from the Riksbank. It would also mean that potential currency performance would be better assessed through:

Economic backdrop – SEK positive: The Swedish economy has recovered well over the past year, with YoY growth accelerating from +0.6% in Q2 2013 to +2.6% YoY in Q2 2014. This has been driven by domestic demand in particular, with retail sales in a steady but accelerating trend, and with confidence in industry rising above its long-term average. Elsewhere house prices (owner-occupied one- and two-dwelling buildings) were up a solid 9.7% 3m YoY in August. Meanwhile, the job market is strong, with employment growth edging higher, currently just below 2% on the year, but with rising labour participation limiting the decline in unemployment.

Repeated Riksbank rate cuts have driven SEK lower

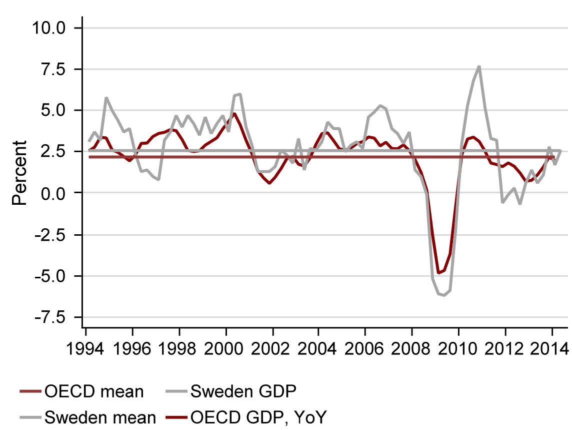
Source: Deutsche Bank, Bloomberg Finance LP

Will pipeline price pressures lead CPI higher?



Source: Deutsche Bank, Bloomberg Finance LP

OECD and Sweden GDP YoY



Source: Deutsche Bank, Bloomberg Finance LP

Valuation – SEK positive: On a PPP basis, SEK remains very undervalued against the EUR. There is also substantial undervaluation against GBP and NOK. The same pattern can be found in our BEER metric, where trade-weighted SEK is around 15% undervalued.

Flow dynamics – SEK positive: Debt flows continue to improve, albeit gradually, with no sign of investors taking profit on the 'safe haven' inflows of the past few years. Equity inflows are also improving slowly. On the commercial side, the trade balance remains robust, currently around SEK50bn, largely in line with the average over the past 10 years.

Overall, we believe SEK is in a good position to strengthen, in particular against the EUR. An ongoing recovery and signs that disinflation has bottomed suggest that the Riksbank easing cycle likely has come to an end. In addition, the SEK remains among the cheaper currencies on all our valuation metrics, certainly the most undervalued cyclical currency in developed markets. Finally, flow dynamics remain supportive, with steady inflow into Swedish debt and equity securities, as well as a large and stable trade surplus. Go short EUR/SEK, targeting 8.75, with a stop 9.40.

NOK resurrection, or just another mirage?

Norway is almost the only DM economy able to generate sustained price pressures above/around 2%. Core CPI-ATE in August dropped to 2.2% YoY, but in September should bounce back to 2.6% YoY. That compares with 2.5% YoY CPI-ATE at the time of the last FX Blueprint. Despite the largely stable and high CPI, rate expectations have moderated, with the NOK FRA curve having shifted down by around 10bps on average in the front 4 contracts, and by around 15bps further out the curve. That is a reflection of the strong disinflationary pressures in the Eurozone and Sweden, but also no more than moderate price pressures in other key Norwegian export markets such as the UK and the US. However, while the external environment means rate hikes are off the table for now, Norges Bank on Sep 18th at least removed the probability of a further rate cut that was previously incorporated in its rate trajectory. This 5-6bps of scaling up of rate expectations generated an instant 1.5% appreciation in NOK vs EUR, showing just how sensitive FX presently is to even minor adjustments to the policy outlook.

Given the sensitivity to the front-end of the rates market, and with the rates market still not fully priced for an initial Norges Bank hike until early 2017, we take the view that the policy outlook can only be NOK supportive going into the turn of the year. Adding to the case for a more constructive trend in the krone is Norges Bank's data showing that until very recently foreigners had been consistent net sellers of NOK, suggesting that positioning is cleaner than it has been for some time. Target 7.75 in EUR/NOK, with a stop @ 8.30.

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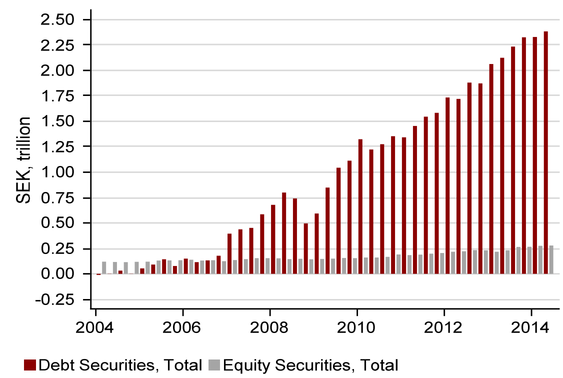
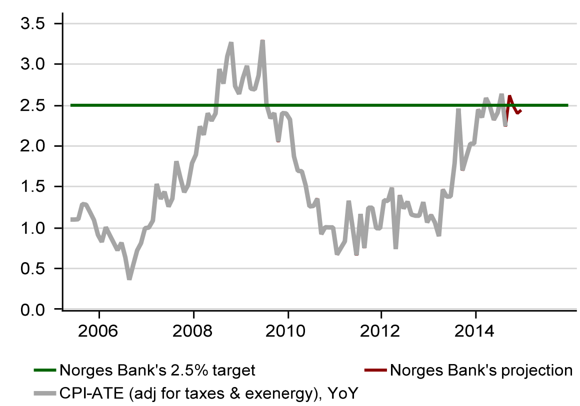
Debt/equity investment in Sweden, agg. 1998 to date



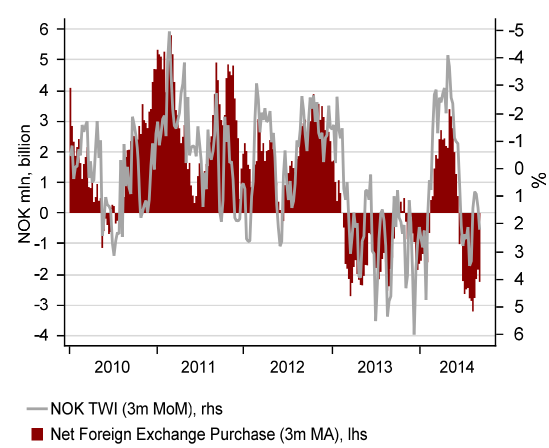
Source: Deutsche Bank, Bloomberg Finance LP

Core inflation - actual and Norges Bank's projection



Source: Deutsche Bank, Bloomberg Finance LP

Foreign banks net NOK purchase - spot & forward



Source: Deutsche Bank, Bloomberg Finance LP

Theme #7: Canton Talks, Gangnam Walks

- Buy CNH/KRW, targeting 176. Key reason being divergence in; 1) beta to the dollar; 2) currency policy; and 3) sensitivity to the yen.
- China is likely to use FX as a monetary policy tool, and allow more RMB appreciation to help loosen onshore liquidity by encouraging inflows.

The Fed is clearly shifting closer to the lift off, even if the exact timing remains dependent on data as before. Asia is starting to see a move up in correlations across the region, and to global factors. But this is unlikely to be a repeat of 2013 either. Two things are different. One, it is a more complicated mix of global policy factors, which is not just limited to higher rates and higher USD/EM. The Europeans are starting to extend more balance sheet just as the Fed's plateaus. And commodity prices are softening. Two, Asia itself is in a better place to handle volatility, both versus in 2013, and increasingly versus other parts of EM. Election risks are largely over, external balances have been adjusting, and policymakers are more on the ball.

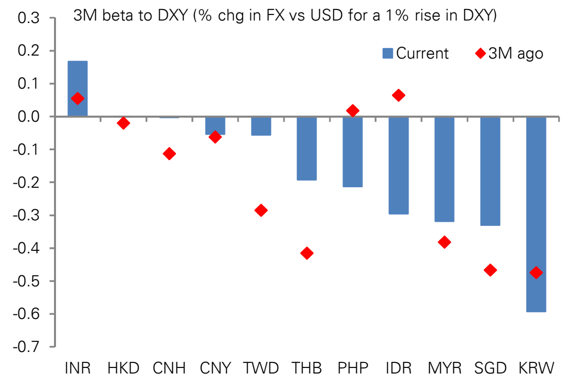
Asian currencies will likely find it hard to fight off the dollar trend, though should hold up well versus European FX (EUR, CHF, EEMEA) and the yen. We are keen on intra-Asia crosses to avoid dollars. One such trade is to buy CNH against the KRW (6M tenor). Key reason being the divergence between the two currencies in terms of; 1) beta to the dollar; 2) currency policy; and 3) sensitivity to JPY.

Won looking worn out

Over the past few months, flows into Korea have been strong both on account of the trade balance and portfolio investments. Foreign investors, for example, bought net $1.7bn of Korean equities in August; the YTD amount of $8.8bn, the highest since 2012, is a reflection of the continued attraction of Korean assets. But these trends are running out of steam. Note that half the improvement in the goods surplus for Korea in the past three years has come from compression in imports. Exports remain disappointing. And portfolio flows too are starting to reverse. KRW has one of the highest betas to the dollar in the region (and indeed to US Treasury yields), in keeping with the high levels of foreign ownership in its capital market. Foreigners own about 33% of the domestic equity market, for example. With the Fed expected to further shift its monetary policy stance in the coming months, this reversal of flows will likely persist. In addition, we also see more evidence of domestic investors diversifying into overseas assets to add to the low levels of return in Korea.

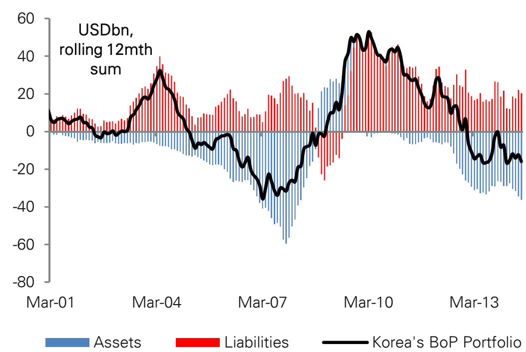
The other reason we like the cross is due to divergence in FX policy. Given the weakness in the

KRW has the highest beta against USD



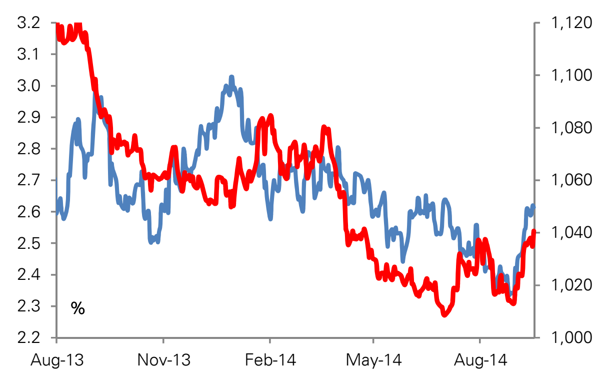
Source: Deutsche Bank, Bloomberg Finance LP

Korea investors are starting to diversify offshore to enhance return



Source: Deutsche Bank, Bloomberg Finance LP.

KRW also exhibits strong correlation with US 10Y Treasury



Source: Deutsche Bank, Bloomberg Finance LLP, CEIC domestic economy and the lackluster performance of its exports, the Korean authorities have been more active of late to curb KRW appreciation, as suggested by increase in FX reserves. After adjusting for valuation changes, we estimate that authorities have bought about $33.2bn in spot and forward markets over the past four months to limit KRW appreciation. And this we believe will continue for two reasons. First, the rhetoric from both the central bank and the government has shifted towards a distinctly more dovish policy stance, including introducing a string of stimulus measures. Our economists now expect the central bank to cut rates by 25bp at the October MPC. We believe it would be rather incongruent for the authorities in that instance to permit further FX appreciation at a time when the bias seems to lean towards supporting the economy. Second, there is growing concern over JPY's continued weakness against KRW. The head of FX division in the BoK and the Vice Finance minister recently stated that the fast declining JPY/KRW is a concern and that they are closely monitoring the situation. We suspect dollar buying could get more aggressive particularly if USD/JPY was to breach 110 and Korean exports remain weak.

RMB as a lever to ease liquidity conditions

On the other hand, we remain comfortable with the outlook on RMB, and expect further appreciation in the currency. Sentiment towards the currency has shifted significantly over the last few weeks, driven in particular by; (1) a rebound in China's trade surplus, which our economist expects will continue, given the gradual recovery in the G3 economies; and (2) expectation that the Chinese government will introduce more stimuli to support domestic demand. Although the risks to growth remain to the downside, we do not believe this will translate into a weaker RMB because; 1) flows into China have become more balanced; and 2) PBoC is likely to allow more RMB appreciation to help loosen onshore liquidity by encouraging inflows. There are signs of the same in; 1) the persistent fixing of USD/CNY at levels below our static trade-weighted basket model; and 2) likely selling of dollars by the authorities to limit weakness in the spot in response to the broader dollar move. We see this as an indication that PBoC has shifted to using FX more actively as a monetary policy tool, and is keen to encourage offshore inflows to ease up onshore liquidity conditions. We recommend buying CNH/KRW 6M NDF with a target of 176 and a stop at 164.

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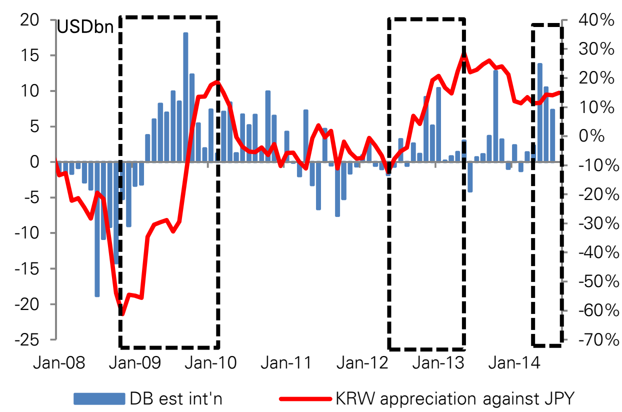
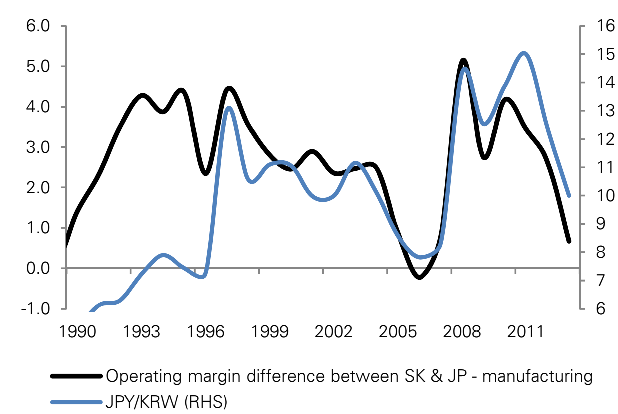
USD buying by Korean authorities could increase



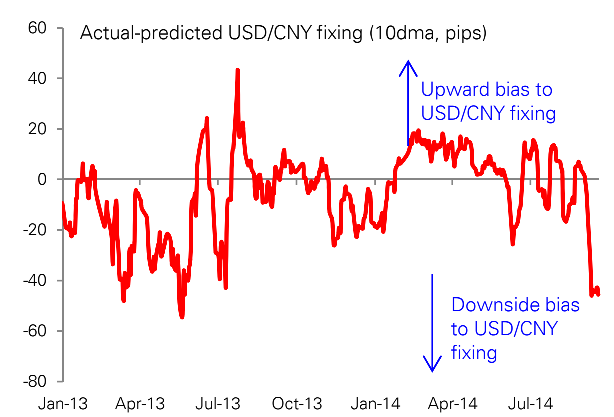
Source: Deutsche Bank, Bloomberg Finance LP, CEIC

Operating profit margin between Japanese and Korean manufacturers is narrowing with JPY weakness



S Source: Deutsche Bank, Bloomberg Finance LP, CEIC

Downside bias to USD/CNY fixing



Source: Deutsche Bank, Bloomberg Finance LP

Theme #8: Join Rupee Groupies now Sing Out of Time

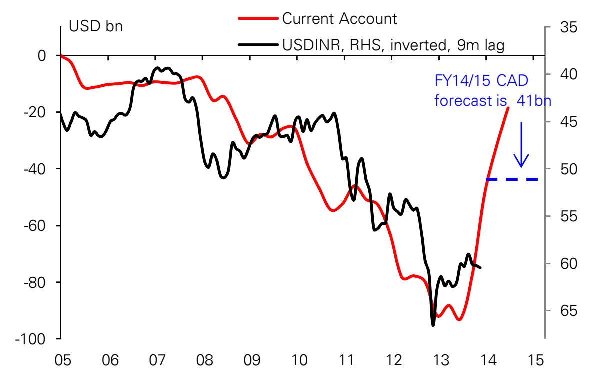
- Sell 6M SGD/INR, targeting 46. Compression in India's twin deficits should endure, INR is a big winner from lower oil prices, and RBI's hawkish stance is positive for long-term FX value.
- In Singapore, the property market is softening, the currency is overvalued at stretched levels, exports are underperforming, and SGD has a high sensitivity to USD strength.

The core of our positive rupee view is India's current account turnaround, which has created room for a stronger currency. The historical relationship between the deficit and the rupee (with a 6-12m lag) is tight. Our forecasts for this fiscal year's deficit, would then suggest significant scope for appreciation (Chart 1). A reasonable concern is that this turnaround could be transitory, as half of the trade account improvement is due to lower gold imports (Chart 2). However, deficit compression now appears set to endure for longer than previously expected. The new government has surprisingly kept gold import restrictions in place, gold prices are unlikely to return to their early-2013 levels, and households are beginning to shift savings back from physical assets like gold into financial assets, encouraged by declining inflation and the rising stock market. Separately, exports have played almost as significant a role in the trade improvement as well.

Current account compression will also be supported by falling commodity prices. India's terms of trade are a big winner from the turn in the commodity super cycle. Oil makes up over a third of India's import bill, with the decline in oil prices likely to help moderate the trade deficit (Chart 3). India's fiscal and inflation profiles could also see relief. Incremental monthly rises in diesel prices have finally led to a convergence between subsidized and market prices for the first time in 12 years, opening a window for the government to cut or deregulate diesel prices. With energy making up close to 10% of India's CPI basket, this would be also be a welcome source of disinflation.

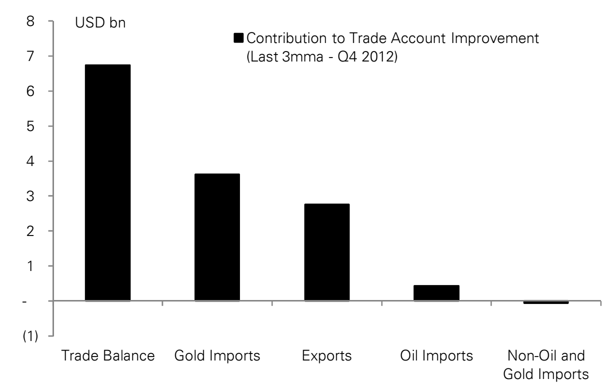
RBI's firm anti-inflation stance – while encumbering hopes of a rapid growth revival – is positive for the currency. Real rates, based on consumer prices, are back in positive territory for the first time since early 2012. The contrast between RBI's continued hawkish stance, and the trend of creeping easing across much of the globe is itself an optical positive. But equally important are the valuation implications. The rupee's purchasing power has been eroded over the years by stubbornly high inflation much above trade partners. If the RBI finally manages to break inflation back, it would improve the long-term fair value of the rupee.

India's current account turnaround makes room for a stronger rupee



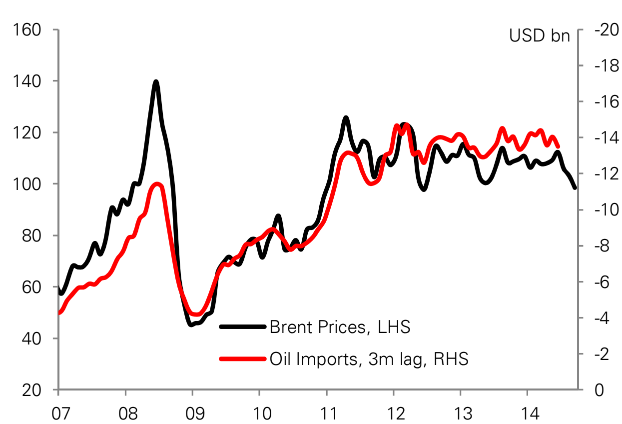
Source: Deutsche Bank, Bloomberg Finance LP, CEIC

Keeping gold restrictions will contain the deficit



Source: Deutsche Bank, CEIC

Falling oil prices should help reduce the import bill



Source: Deutsche Bank, Bloomberg Finance LP, CEIC

There are a number of risks worth considering for the rupee. Most obvious, is the ongoing re-pricing in US rates that could pose a threat to carry trades. However, a combination of ECB QE, Japanese outflows, and a benign global inflationary impulse, should help keep long-end rates better anchored, containing damage to EM carry FX. Moreover, passive carry positions appear limited. Our dbSelect platform shows speculative INR positioning at close to the lowest level in the past year.

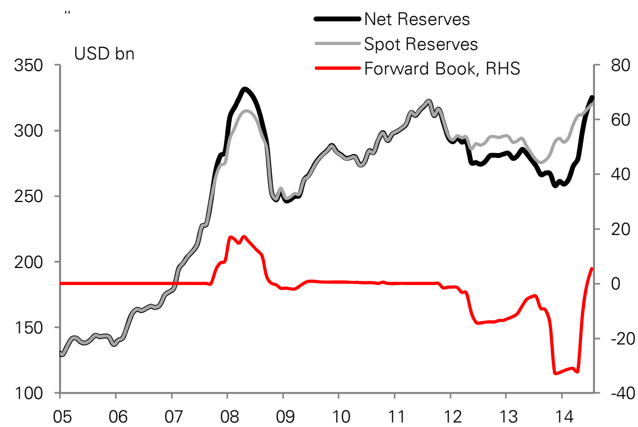
The other key detracting factor to consider is intervention by RBI, given likely aims of improving reserves adequacy and maintaining the currency's fair value. However, there could now be scope for RBI to reduce intervention intensity on the margin. They have bought $65bn this year, equivalent to a 25% increase in reserves from December levels. Importantly, this has taken reserves back to all-time peaks (Chart 4). India now runs a positive forward book, and has secured an import cover that exceeds peers like Malaysia.

The final risk is that inflow momentum slows down. Over 50% of portfolio flows to India this year have come in debt markets, but the scope for further debt money now looks very limited with 99% of the open quota for government bonds taken up, and RBI has thus far resisted further liberalization. However, a healthy run-rate on flows can still be maintained with help from FDI and foreign interest in government stake sales, with disinvestments in large public sector energy companies worth $7bn due to begin in coming weeks.

We cross our long INR view, with a short position in SGD. Our negativity on the SGD is not predicated on a dovish shift by the MAS. We expect them to keep their 2% slope in October. However, the appreciation bias is no longer a reason to be constructive on SGD. Despite a consistent upward slope, SGD NEER has tellingly not traded near the top band this year. Reserves, net of the forward book, have been gently declining, suggesting MAS has supported the currency near the mid-band. This atypical price action in the SGD basket is indicative of a shift in demand for the SGD.

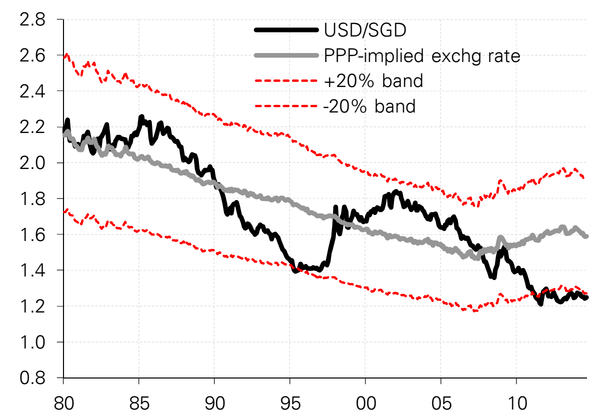
Our bearishness stems from a combination of four negative factors. First, widespread consensus across FX models of overvaluation. With other stubbornly overvalued currencies – like NZD – beginning to turn, the SGD could be next. Indeed, USD/SGD is trading at overvaluation extremes on our purchasing power parity framework, and is at levels from which it has historically turned in the past (Chart 5). Second, the property market, to which the currency has had a strong correlation, is softening (Chart 6). The required rise in domestic interest rates along with the US rates cycle could pressure the property market further. Third, Singapore's loss of competitiveness in electronics and manufacturing sectors has begun to show up in relatively disappointing export numbers. Fourth, SGD has had a traditionally high correlation to USD strength, and should participate in the multi-month USD trend we anticipate.

RBI has regained the prior peak in reserves



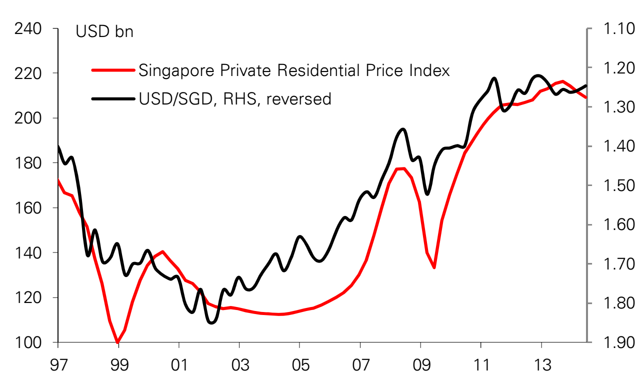
Source: Deutsche Bank, Bloomberg Finance LP, CEIC

SGD valuations are extremely stretched



Source: Deutsche Bank, Bloomberg Finance LP, CEIC

SGD exports are underperforming with loss of competitiveness in manufacturing and electronics



Source: Deutsche Bank, Bloomberg Finance LP, CEIC

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Theme #9: Trade Slavic Cold for Latin Gold

- We are bullish MXN, mostly based on progress in the reforms process, and BRL, which has potential for post-election appreciation.
- We are bearish CZK on disinflation and HUF on FX-loan stock conversion prospects and a dovish NBH.

Times have been difficult for EMFX, plagued by lackluster local growth, dovish central banks, bouts of risk aversion and most recently a surge in USD demand. Despite the underperformance versus USD, the prospects of further re-pricing in Fed Funds expectations, the likelihood of further ECB stimulus, support the choice of alternative funding for EM longs. As we expect the euro to continue to slide, with compressing yields incentivizing capital flight, we focus on intra-EMFX crosses which provide high exposure to EUR weakness while maximizing carry.

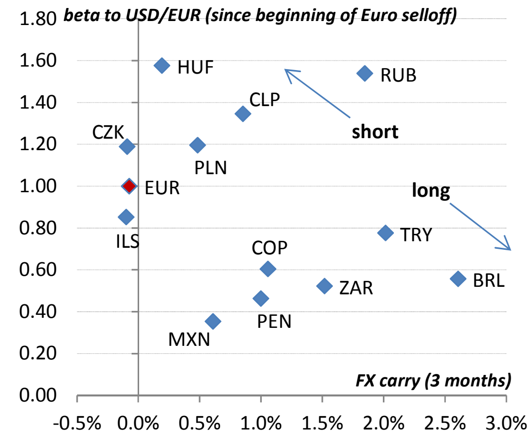
To select intra-EMFX short euro trades, we examine how currencies have co-varied with the euro since the beginning of the sell-off in May. The first chart on the right plots betas of USD/EM crosses to USD/EUR vs. 3M carry. Unsurprisingly, CE3 currencies, HUF in particular, exhibit high sensitivity to EUR weakness, with betas that are higher than 1.2. CLP and RUB also exhibit very high betas over this period. At the other end we observe positive, but low, betas to the euro. MXN has the lowest beta: 0.35. Other Lat Am (ex-CLP), and ZAR show low sensitivity to EUR.

Moving on to intra-EMFX crosses, MXN/HUF has a beta of almost -1.3 to EUR (rallying on EUR weakness) but exhibits relatively low carry. BRL/HUF is less sensitive to EUR weakness, with a beta closer to -1, but has significantly higher carry (about 2.5% at 3M). To reduce exposure to idiosyncratic factors, we prefer a basket to a simple long-short. We like combining MXN and BRL for the long side (70% MXN, 30% BRL). On the short side, we like HUF and CZK (equal weights). As the chart shows, our basket achieves high sensitivity to EUR weakness together with high carry, outperforming a USD/EUR position on both dimensions.

MXN to benefit from reforms, positioning

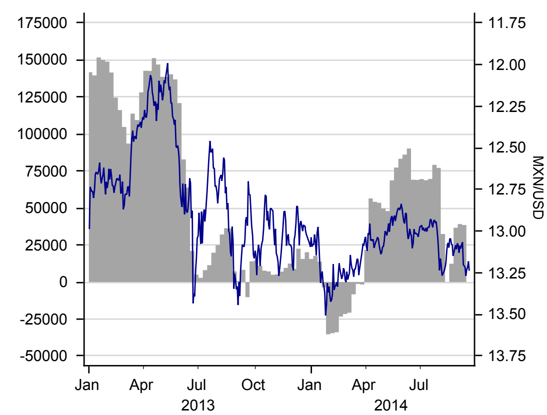
We remain constructive MXN for reasons beyond its low beta to EUR. The economy has been showing signs of pick-up after the disappointing beginning to the year, and we expect significant recovery in 2H14. In particular, manufacturing and construction seem to be gaining traction. Domestic demand is still weak, but we expect a pickup in US demand to benefit the local economy. Importantly, the legislative process for the two most important reforms, telecommunications and energy, was completed in late July. While actual

EMFX proxies for Euro weakness



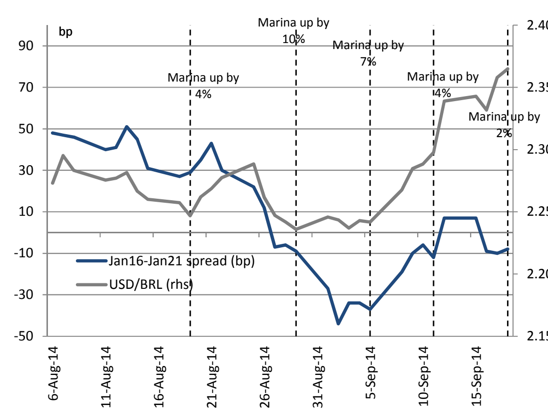
Source: Deutsche Bank

IMM MXN FX Net position - past 10 years



Source: Deutsche Bank

BRL: FX oversold vs rates on latest election polls



Source: Deutsche Bank

[2] We scale raw betas by current ratios of USD/EM to USD/EUR.

implementation and direct impact on growth and FDI flows will take some time, the reforms will continue to positively impact expectations and benefit the currency. Another positive is speculative positioning, which is heavier than it was at the beginning of the year, but still very light compared to pre-taper tantrum figures.

Election key for BRL

As for BRL, volatility has increased as we approach the October elections, with polls currently indicating a very close 2nd round vote between incumbent Dilma Rousseff of PT and Marina Silva of PSB. With Silva's policies favored by market participants, markets reacted positively to August polls, but retraced some of its earlier moves as her lead narrowed, with USD/BRL breaking nearly a 6 month 2.20-2.30 range as the central bank shied away from intervening more aggressively. This shows that the outlook for the BRL is very binary and dependent on the election results.

The other recent driver has been the BCB's FX intervention program, through which the BCB has accumulated a USD95bn long BRL position in swaps. The future of this program also seems to depend on the election, with the current administration saying that it would continue into 2015, possibly at a higher rollover pace, and a senior Silva adviser indicating she would end the program. In principle, this might narrow the gap between the election-dependent scenarios for the BRL. However, one needs to consider USD demand as well. Should policymakers change and the quality of policymaking improve the demand for hedging (that has been met by the CB) could collapse. Also, equity inflows could surge, adding to BRL appreciation pressure, while it is also likely that some of the capital flight seen over the past 6-9 months would reverse on back of a change of government. A low EUR beta, high carry, recent underperformance, potential inflows and unwinding of FX hedges, and lingering inflationary pressures lead us to include BRL in the long side of our basket. However, adverse speculative positioning, uncertainty regarding intervention, and the elections (along with the current account deficit) lead us to place a lower weight, assigning it 30% vs. 70% on MXN.

Policy and FX loan conversion to hinder CZK and HUF

On the short side, we like HUF and CZK (equal weights). In Hungary, government officials have stated that they aim to convert the entire remaining FX loan stock (EUR11.6bn) to forint by year-end. While this is too optimistic in our opinion, the process could only impact HUF negatively either indirectly through higher risk premia if banks have to absorb large losses, while the more direct impact would come from banks needing to access FX liquidity as FX loans are converted into HUF. The early repayment scheme in 2011 saw EUR4.4bn repaid by borrowers. Banks bought EUR2.6bn from the NBH, and EUR1.8bn on the market. A similar 40% share of the EUR11.6bn would suggest EUR4.6bn will be bought on the market this time around, i.e. more than twice as much. In 2011 HUF depreciated by 6-7% vs PLN and CZK over this period. On the policy front, continuous low inflation pressures could keep the NBH on hold for longer than what the market is pricing in currently (markets now pricing ~10bps of hikes by year-end and another 30bps to 2.50% by end-15).

In CZK, fundamentals have not changed over the last two months. Despite softer activity data, the Czech recovery is largely intact, benefiting from a gradual decline in the unemployment rate and historically low refinancing costs. However, low inflation pressure will keep rates depressed going forward, with the CNB recently extending the EUR/CZK floor (27.00) until Q1 2016 (from Q2 2015). The market continues to price another cut to 0% in official rates by end-14, and sees 0.10% by end-15 (current rates at 0.05%). A basket of long BRL (30%) and MXN (70%) vs. short CZK (50%) and HUF (50%) is currently trading @ 13.15. Target 13.90, with a stop @ 12.90.

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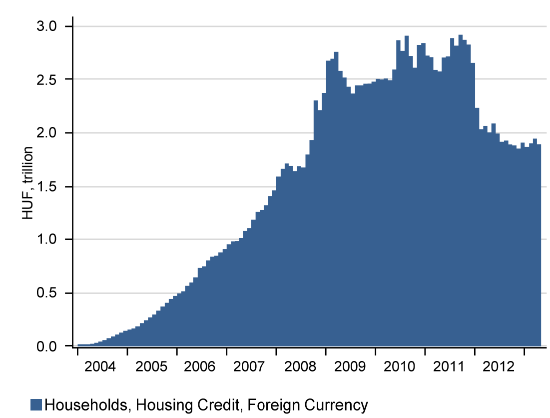
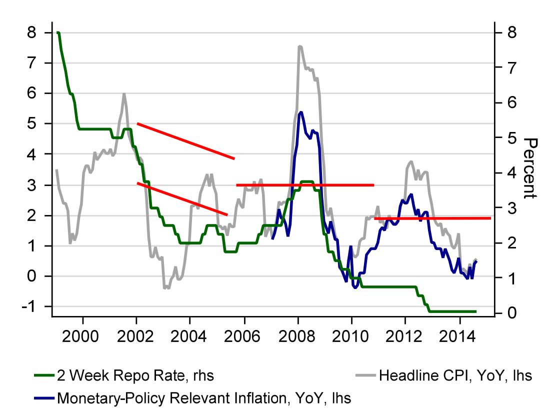
Hungary's FX loans stock



Source: Deutsche Bank

Strong disinflation will keep CZK rates anchored



Source: Deutsche Bank

Theme #10: Stand Up Dollar-Shekel

- We are bullish USD/ILS on more BoI easing, bullish TRY versus ZAR on relative growth and carry, and bullish PLN/HUF on relative monetary policy

Diverging Eastern Promises

In Eastern Europe more unorthodox policies from the NBH (the granting of HUF200bn to its foundations for them to invest into HGBs), at the same time as Poland's NBP remains a very reluctant rate cutter, would suggest rates markets will have to re-assess the policy outlooks in Poland and Hungary (markets currently priced for around 75-80bps of easing by the NBP by the end of next year, vs. more than 30bps of hikes from the NBH).

Add to that the potential for the FX loans conversion in Hungary to result in banks selling up to EUR5bn worth of Forints on the open market, while in Poland indications are that a large chunk of the EU funds for 2014 has yet to be converted on the market. Moreover, 3m carry is worth around 1.3%, and PLN is increasingly oversold on our 'Financial fair-value' calculations. **Target 78.50, stop @ 73.65.**

TRY Lira over ZAR

We also maintain a preference for TRY over ZAR. Both currencies are vulnerable to changes in US monetary policy, due to external shortfalls and poor growth prospects. However, in order to avoid chasing USD/EM higher at a time when USD positioning is increasingly stretched, and as a way to negate the carry we recommend going **long TRY/ZAR, targeting 5.15, with a stop 4.85.** The position is carry positive and relatively speaking the growth outlook as well as the deterioration in SA's external balances favour TRY, where sticky inflation should leave CBT more cautious over the next couple of months.

ILS next to be floored?

We also recommend **longs in USD/ILS, targeting 3.80, with a stop @ 3.59**. With inflation expected to continue to decelerate in the next couple of months the pressure will mount on BoI to ease policy further. With policy rates approaching zero, they will have to provide some clarity with regards to its next steps. So focus will remain firmly on further easing, and regardless of what sort action by the BoI (FX floor, QE, simply ramping up intervention), it will be shekel negative.

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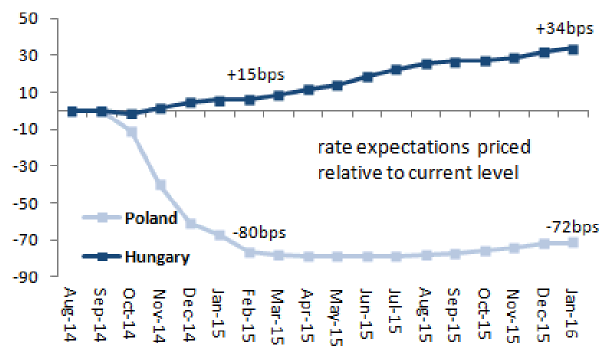
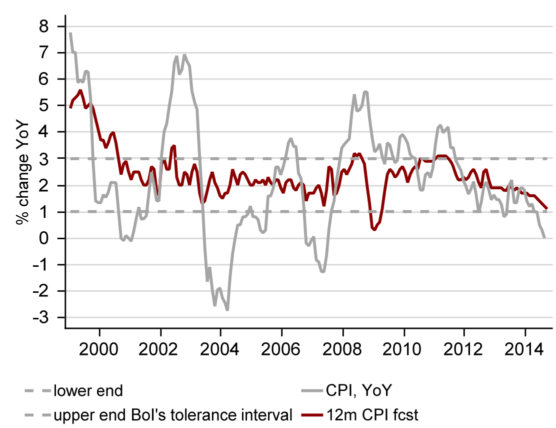
Markets expecting policy to diverge substantially



Source: Deutsche Bank

Inflation expectations at the lower end of the BoI's tolerance interval



Source: Deutsche Bank

Theme #11: Russia Bores, Canada Snores

- The market is pricing a correlation between EUR/USD and USD/CAD & USD/RUB that is too high. Sell correlation between EUR/USD and these two crosses via dual digitals

Some of the best opportunities for correlation related trades come when currencies exhibit strong day to day correlation, but with levels exhibiting substantial drift over time. At other times opportunities are provided by periods where drivers of correlation in the recent past are erratic and or bound to change, not least when politics briefly intercede. In current circumstances there are opportunities of both sorts, helped by the strong implied correlations of USD pairs with EUR/USD (chart 1) that provide for potential discount in correlation related instruments like dual digitals.

For those who believe the ECB will continue to be a key driver of the EUR/USD rather than USD specific factors, there is the prospect of independent EUR weakness. An example of this would be if the ECB is struggling to expand its balance sheet in the way President Draghi suggested is desired, and the ECB are forced to resort to sovereign QE. One opportunity we see here is a dual digital that encapsulates a continuation of recent price action with EUR/USD drifting lower and USD/CAD going sideways. (For more on Canada see the piece recommending short NZD/CAD).

Buy a 4m dual digital with EUR/USD < 2% OTMS and USD/CAD < ATMS offered indicatively at 10%. The zero correlation price is 15.5%. (Priced with EUR/USD and USD/CAD ATMS @ 1.2840 and 1.0965 respectively and EUR/USD 2% OTMS at 1.2583)

Another alternative that combines independent EUR weakness and more random political distortions to correlation is to do a similar trade with the RUB.

Buy a 4m dual digital with EUR/USD < 2% OTMS and USD/RUB < ATMS offered indicatively at 8.5%. The zero correlation price is 13%. (Priced with EUR/USD and USD/RUB ATMS @ 1.2840 and 38.504 respectively and EUR/USD 2% OTMS at 1.2583)

For those who think USD/RUB tracking sideways is unlikely, consider these four factors:

(i) It is the first time since the 2009 crisis sell-off that USD/RUB is trading more than 2std deviations away from PPP.

(ii) The pair has moved into overbought territory on a number of our regression estimates taking carry (1m carry around 8.6%), crude, broader USD and equity sentiment into account. Also, RUB has never before

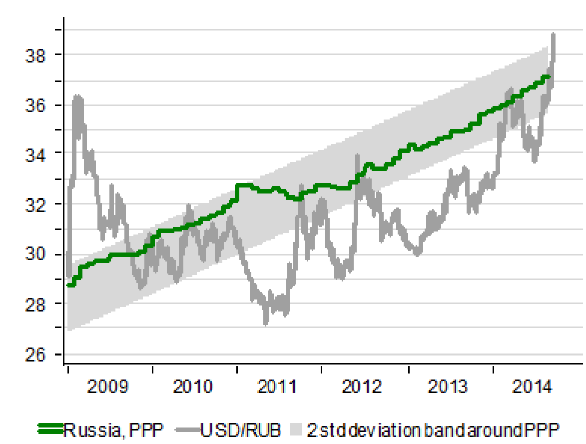
Figure 1: Correlations Between EUR and Other FX

Top Correlations
4m EURUSD-CCYUSD

EUR	
92.1%	CHF
86.6%	CZK
79.0%	PLN
69.0%	HUF
67.5%	SEK
65.8%	NOK
56.8%	SGO
55.5%	GBP
51.1%	ILS
49.4%	JPY
48.1%	AUD
48.0%	KRO
47.2%	NZD
43.1%	**CAD**
38.7%	MYO
37.0%	TRY
35.7%	TWO
34.5%	ZAR
32.1%	MXN
31.7%	CLP
28.3%	RUB
26.3%	PHO
16.1%	BRO
12.3%	INO
-12.0%	CNH

Source: Deutsche Bank

Figure 2: RUB Cheap On Valuation



Source: Deutsche Bank

diverged to this extent from Russia's terms of trade. The Russian unit is 7 - 8% weaker compared with the early 2009 lows despite no significant deterioration in the terms of trade.

(iii) RUB is also increasingly oversold on a number of technical measures, such as the RSI, currently at around 77, and our 'stretch-o-meter', where spot currently is more than 2std deviations away from the 10y mean. Similarly, IMM positioning is almost, at the record lows from February, when it preceded a 4-5% rally versus the USD in the 2nd half of March, and some 8-9% rally from mid-March up until the end of June.

(iv) As winter approaches there is much more chance that events on ground will slow down, even if the autumn will be closely watched to see if Russia is prepared to use energy exports to counter sanctions.

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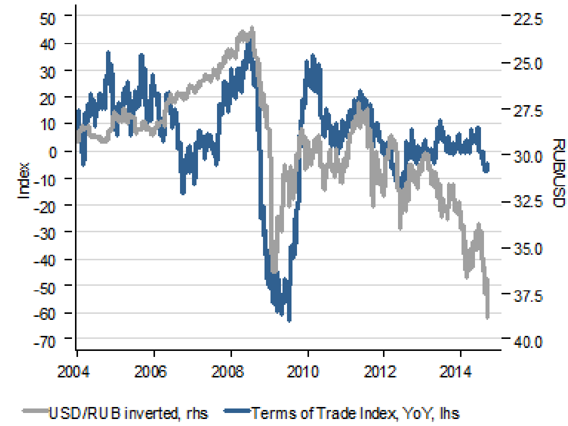
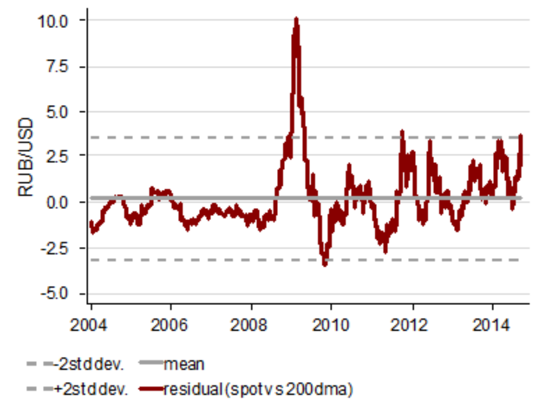
Figure 3: RUB Overshooting Terms of Trade



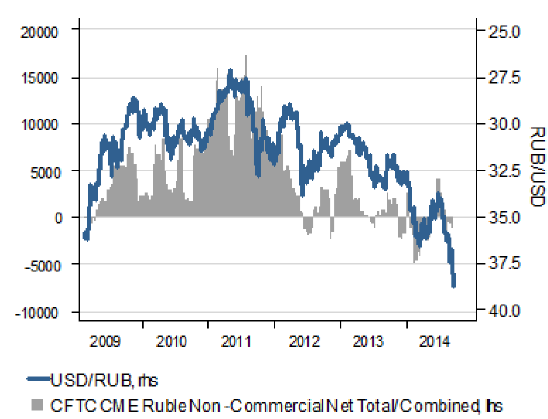
Source: Deutsche Bank

Figure 4: RUB Looks Cheap On Short-term Fair Value



Source: Deutsche Bank

Figure 5: RUB Positions Light



Source: Deutsche Bank

Theme #12: Kiwi Grounds while Yen Astounds

- Short-dated volatility has kicked up in the last several weeks after laying dormant all year; but given elevated risk premiums it appears too early to buy vol outright.
- We like owning CAD/JPY volatility indirectly via correlations, being short 3M NZD/USD vol, and retain our core long USD/JPY volatility view into year end

It feels like a long time ago that 3-month EUR realized volatility hit 3.3% (a 37-year low), even though it was only in August. Since then we have seen unprecedented action from the ECB along with a rebound in fed funds expectations that has driven the dollar up 5% in Q3. These events have the "feel" of a major turning point and some investors may be tempted to buy FX volatility now, locking in levels that are low historically in absolute terms.

On second thought it may be tougher than expected to escape the low volatility regime. The CVIX was trading cheap to short-dated rates volatility (the "MOVE" index) until recently but has caught up in September. Nonetheless, currency volatility tracks rates volatility closely and both measures are still down year-on-year.

More generally currency volatility tends to lag the Fed hiking cycle by several years (Figure 2). The 3-month CVIX rose in the late 90s and during the crisis, several years *after* Fed tightening cycles squeezed asset valuations. Alan Ruskin argues the lag should be truncated this cycle for the following reasons (FX Daily 15-May-14):

i. Ending QE will raise bond volatility
ii. Any change in policy will send a powerful signal following a record period of accommodation
iii. The Fed and BoE are the only G7 banks to tighten; rate spread volatility will increase substantially
iv. Fed cycle is poorly synchronized with the EM cycle

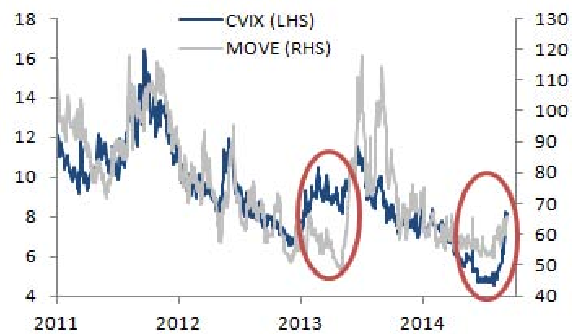
Nonetheless history suggests a rise in volatility should be contained if the macro environment such that the Fed is not seen as 'behind the inflation curve'. Given a subdued inflation outlook it is premature to buy volatility outright on a Fed view; we prefer to be selective in our approach.

Death of the carry trade may be exaggerated

In a similar vein one might believe it is time to take profits on the FX carry trade. Carry trades have not done particularly well historically during periods of dollar strength or heightened volatility and many pairs (AUD, NZD, BRL) look potentially overvalued.

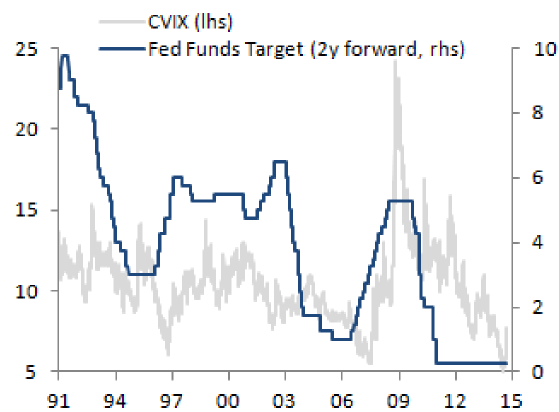
Figure 3 illustrates the rebound in carry-to-vol ratios since the crisis that sustains the appeal of FX carry. Although these ratios fell recently due to the volatility

Figure 1: Currency volatility caught up to rates volatility since they diverged last summer



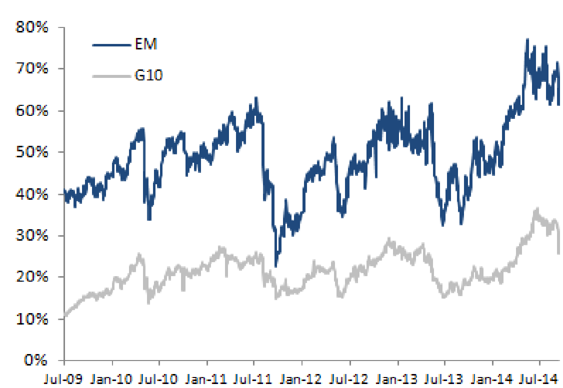
Source: Deutsche Bank, Bloomberg Finance LLP

Figure 2: CVIX has historically lagged the Fed Funds target rate by two years



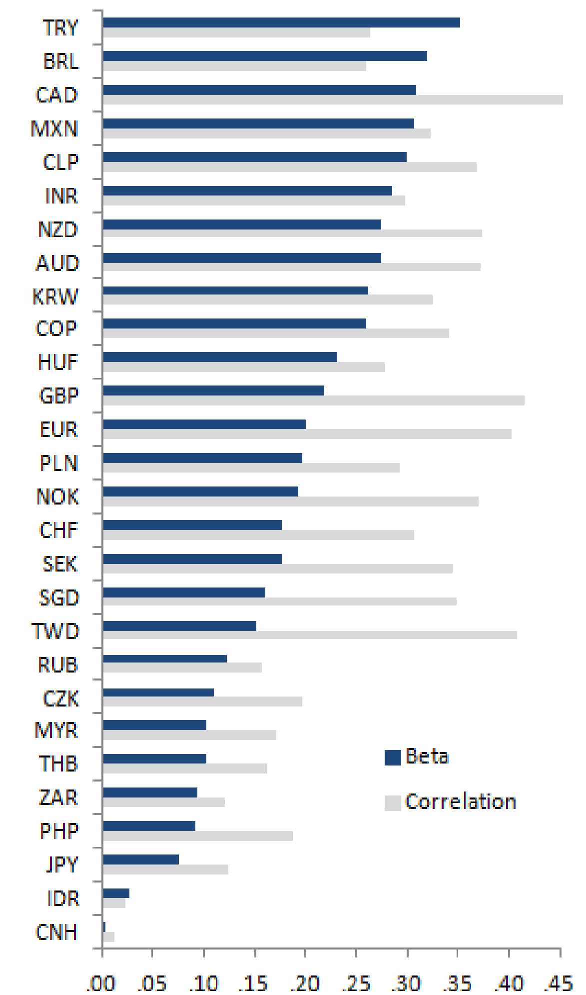
Source: Deutsche Bank, Bloomberg Finance LLP

Figure 3: Carry-to-vol ratios dip slightly since volatility rebound but still near post-crisis highs



Source: Deutsche Bank, Bloomberg Finance LLP. Note: average carry-to-vol for BRL, TRY, ZAR, MXN, IDR (EM) and AUD, NZD, NOK (G10)

Figure 4: Beta = change in 6-month volatility following 1% USD TWI gain. Carry and commodity FX volatilities are sensitive to further dollar appreciation.



Source: Deutsche Bank, Bloomberg Finance LLP. Note: two year betas and correlations.

spike, carry-to-vol is still near five years highs due to mid-2013 EM rate hikes and the NZD tightening cycle. In a world of sub-2.5% periphery yields, carry and commodity currencies remain resilient to dollar strength. Indeed, over the past two years, implied volatility of these carry and commodity currencies have been the most sensitive to dollar gains (Figure 4). 6-month TRY, BRL and CAD implied volatility rise over 30bp for every 1% rise in the USD TWI; NZD and AUD volatility jump 27bp.

Elevated volatility risk premiums too high to buy vol outright

Yet even a 5% USD appreciation may not make volatility attractive. Volatility term structures are still mostly upward sloping so FVAs do not offer attractive roll down characteristics. And heightened volatility risk premiums are the most striking feature of the FX options market: many of the G10 crosses have premium near the top of their 12-month ranges (Figure 5). Persistently low realized volatility has even made carrying GBP volatility through the Scottish referendum difficult (see the May Blueprint recommendation). Therefore, we like to own volatility in the dollar-bloc, but only selectively via crosses that exhibit a modest risk premium, namely long CAD/JPY volatility indirectly through a three month USD/JPY call at 110 (40-delta) with a USD/CAD 1.1450 (~17-delta) cross knock-out, for 65bps or at a 44% discount to the vanilla, off spot refs 109 and 1.10 respectively. In NZD/USD, given the considerable risk premium and with the national elections already behind us, the near term drivers of volatility are likely to be dominated by commodity prices and the mildly static rate curve following a moderation of RBNZ's tightening cycle – a tactical short via a 3M vol swap indicatively offered at 8.95% appears appealing.

Outside of the commodity crosses, we retain our core long USD/JPY volatility view via a vol swap into year end.

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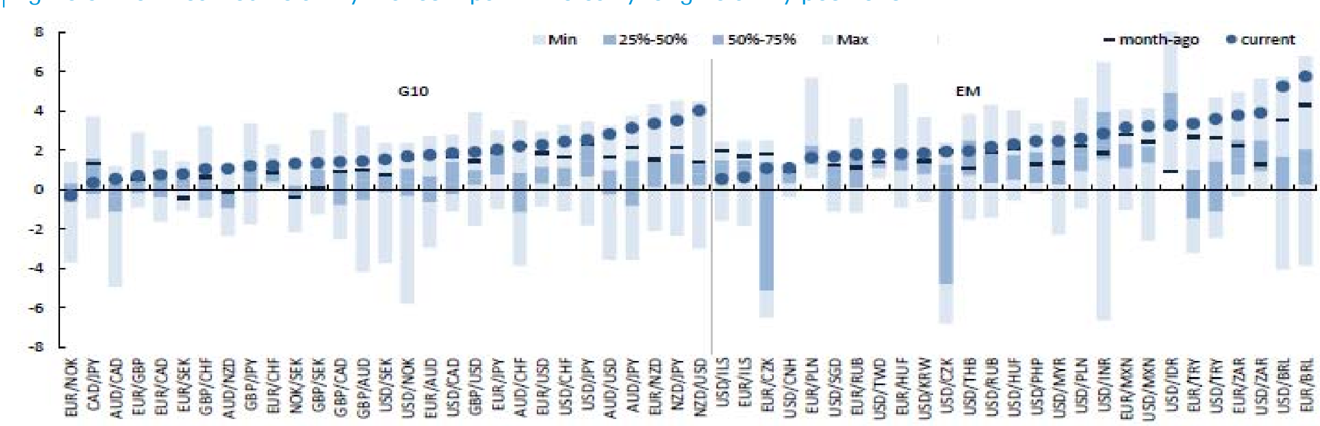
Nicholas Weng, London, +44 (20) 754 7661

Figure 5: Low realized volatility makes it painful to carry long volatility positions



Source: Deutsche Bank, Bloomberg Finance LLP. Data as of 22-Sep-14.

Theme #13: These Inhale from Nose to Tail

We propose a long MXN, COP, PLN, INR, & short TWD, ILS, ZAR, CLP basket trade.

With so many moving parts between shifting Fed and ECB expectations, and weaker Chinese demand, inter regional baskets have been low on the list of currency trades. Nonetheless this year, has been filled with opportunities, with Asian currencies dramatically outperforming their Eastern Europe and Latam counterparts.

Each region has its advantages, but particularly in current circumstances, global macro drivers can dominate domestic fundamentals. The key macro drivers for the regional backdrop divide up as follows:

Eastern Europe's past Achilles heel, the balance of payments trends, have largely turned into a virtue for the region. As the Table across shows, CEE3 exports are near the top of the global league tables and are surprisingly strong in the context of weak EUR area demand. Real yields are also relatively supportive. The most improved domestic fundamentals are however trumped by vulnerability to three important global macro factors: 1) being so closely aligned to the EUR area. The balance of payments and real yields offer some protection for CEE3 currencies against the EUR even in a riskier environment, but offer no such protection versus USD linked currencies in a weak EUR environment. 2) These currencies have surprisingly high betas to higher US rates; 3) geopolitical uncertainties are likely to prove persistent.

Latam economies may historically be closely linked to the US, but China's dominance of the commodity cycle, has left only the MXN and COP to strictly fall into a USD area. Similarly, most Latam countries have shown relative weak export growth, and some deterioration in their balance of payments. Mexican exports are only belatedly picking up and this should give the currency ongoing resilience to USD strength. Colombia is expected to see still strong 5% growth and policy tightening.

While the slowdown in China demand is dominated by weakness in construction sensitive commodities, there is the irony that Latam appears to be more materially impacted by China slowing than EM Asia. Asia manufacturing base has benefitted from lower oil prices and Asian exposure to China will be more directly impacted by China's credit cycle and the impact on domestic assets. Asia is less exposed than Latam to a stronger USD pushing down commodity prices, creating a negative terms of trade shock that thereafter adds to currency pressures. Most recently an asset allocation shift from Eastern Europe has

Figure 1: EM countries' balance

	Positives	Negatives
Eastern Europe	*Balance of payments* *Real yields*	*EUR link* *High beta with US yields* *Russia-Geopolitics*
Asia	*Soft oil* *Balance of payments* *Region alternative*	*China slowdown* *Valuations* *Asset allocation*
Latam	*Links to the US*	*China/commodity cycle* *Balance of payments*

Source: Deutsche Bank

Figure 2: EM Indicators: Balance of payments

	C/A + FDI (as a % of GDP)	12 month change in C/A (as a % of GDP)	Exports YoY % change of 3mma	Terms of trade (YoY % change)	Net reserves as a % of imports
Czech Republic	1.7	1.6	15.5	1.7	37.3
Hungary	3.8	2.3	10.4	0.4	37.4
Poland	-0.4	2.1	6.7	2.0	43.0
Romania	0.0	0.1	6.7	-8.2	36.3
Russia	1.9	0.4	3.6	-5.5	139.3
Israel	4.0	0.4	-0.4	-0.2	120.9**
Turkey	-5.2	0.2	3.3	1.0	15.8
South Africa	-4.7	0.2	-0.6	-3.2	47.9
Mexico	-1.3	-0.1	6.0	-5.9	48.2
Argentina	0.1	-0.7	-9.6	-9.4	18.4
Chile	1.3	1.7	-1.8	-3.2	50.0
Colombia	-0.9	0.0	2.4	-0.8	66.5
Brazil	-1.1	-0.4	0.9	-1.4	160.0
Peru	-1.0	-0.5	-11.6	-8.0	125.8
India	0.3	3.9	6.5	NA	71.0
Indonesia	-1.7	0.2	-3.4	-2.0	51.4
Malaysia	4.6	1.1	8.0	0.8	62.9
Philippines	3.5	0.2	13.2	NA	119.5
Singapore	30.2	1.3	0.4	-0.3	72.2
Thailand	5.5	4.8	0.7	-0.2	73.0
China	3.8	-0.9	10.5	3.5	204.2**
Hong Kong	-3.2	0.4	7.6	-0.4	60.5
Taiwan	10.8	1.8	5.5	2.0	156.3**
South Korea	5.0	0.8	2.5	0.8	69.3

*Source: Deutsche Bank, EcoWin, IMF. ** Gross reserves* propelled most real exchange rates well above long-term averages, with KRW and SGD vulnerable in this regard.

The above macro characteristics inclusive of a coming Fed tightening cycle, a EUR under pressure, and a disappointing China growth performance are likely to continue to dominate the landscape.

This should continue to favor long Latam trades only for those economies most closely linked to US growth, and, selective long Asia trades not linked to the commodity cycle, or better still benefiting from lower energy prices. In contrast, shorts should be weighted against CEEMEA, either because currencies are linked to the EUR or in the few cases of independent balance of payments weakness. In Asia we prefer shorts linked to China slowing. As one example Taiwanese bank are seen exposed to China's credit cycle, and earlier equity inflows have started to reverse

Using this approach favorite longs include: the MXN, COP, PLN, INR.

Most vulnerable currencies or favorite low yield funders include: PEN & CLP in Latam, ZAR, CZK, ILS in CEEMEA, and KRW (following the JPY), TWD, SGD and IDR in Asia.

Of all the above currencies, the PEN balance of payment trends have deteriorated particularly sharply but we are excluding this currency as a potential short because of liquidity reasons, and a Central Bank that is not ready to let the currency go. For obvious reasons we prefer shorts, where the Central Bank are encouraging of currency weakness. One currency where the Central Bank is having more success in encouraging weakness is the ILS, where the threat of outright deflation and QE have become real possibilities. All the shorts recommended below have a Central Bank that has been far from resistant to currency weakness.

Go long a MXN, COP, PLN, INR basket versus short CLP, ILS, ZAR, TWD.

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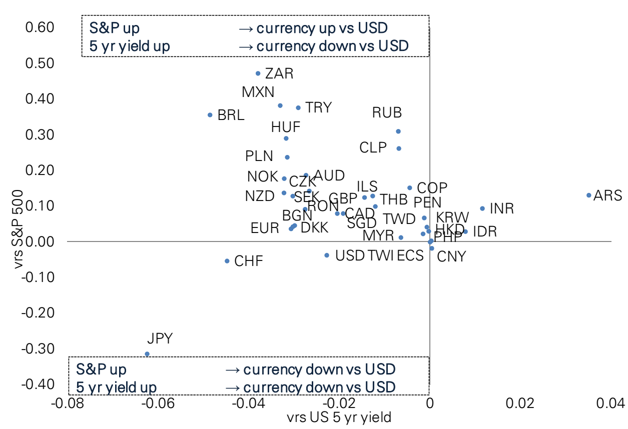
Figure 3: EM Indicators: Value, credit and international risk

	Real TWI deviation from 5 yr average	Real TWI deviation from 10 yr average	Real 3 month rates	Change in private credit as a % of GDP since 2008	Fiscal Impulse	1 year beta vs US 10 year yield
Czech Republic	-8.5	-5.3	-0.2	17.4	0.1	0.023
Hungary	-7.6	-8.0	1.5	6.6	0.9	0.023
Poland	-1.6	-3.4	2.8	21.5	-0.3	0.025
Romania	1.7	0.2	1.3	NA	NA	0.027
Russia	-1.3	5.6	1.5	15.4	-0.8	0.000
Israel	5.1	10.6	0.3	NA	-0.4	0.012
Turkey	-5.4	-5.4	1.0	33.5	0.2	0.017
South Africa	-13.4	-14.3	0.6	-6.5	-0.1	0.029
Mexico	1.8	-1.6	-1.3	4.4	0.2	0.021
Argentina	-21.5	-29.6	NA	1.8	-0.2	-0.032
Chile	-9.2	-7.7	-1.5	NA	0.1	-0.002
Colombia	4.8	15.1	1.1	NA	0.1	0.002
Brazil	-4.4	5.3	4.3	27.9	-0.2	0.037
Peru	1.2	5.4	-2.3	NA	0.1	0.002
India	-5.0	-5.0	0.9	9.1	-0.1	-0.010
Indonesia	-8.6	-5.3	4.2	11.5	0.2	-0.006
Malaysia	1.9	3.6	0.4	20.1	-1.0	-0.002
Philippines	6.4	14.2	-3.5	NA	0.5	-0.003
Singapore	6.0	13.8	-0.8	40.7	0.8	0.014
Thailand	1.8	6.0	0.0	30.0	0.6	0.010
China	8.6	17.9	0.6	73.9	0.2	0.000
Hong Kong	4.5	1.3	-3.6	92.8	-1.5	0.000
Taiwan	1.4	-2.4	-2.3	NA	NA	0.004
South Korea	10.6	3.1	-0.6	26.0	-0.3	-0.005

Source: Deutsche Bank, EcoWin, BIS

Figure 4: Currency betas versus S&P and US 5 year yield (YTD)



Source: Deutsche Bank, EcoWin

Trade Recommendation Update

Trades from May 22nd 2014 to September 19th 2014

Trade	Theme	Gain/Loss on trades	Gain/Loss on theme
EUR/USD DNT	1	3.30% (-1.25%)	+3.30%
Long USD/JPY	2	6.84%	4.23%
USD/JPY call	2	1.61%	
Short GBP/USD	3	-1.60% (2.74%)	-1.34%
Long EUR/CHF	3	-1.07%	
Short NZD/CAD	4	-1.16% (3.78%)	-1.16%
USD/CAD digital	5	-1.35%	-1.35%
EUR/SEK DNT	6	-1.50%	-0.75%
EUR/NOK put	6	0.00%	
GBP/USD 6M vol swap	7	-1.77%	-1.77%
Short EUR/MYR, EUR/PHP	8	4.30%	6.22%
Short USD/THB	8	1.50% (1.81%)	
Short USD/KRW	8	0.00% (-1.31%)	
USD/CNH call spread	8	0.42%	
Short EUR/HUF, EUR/PLN	9	-1.29%	1.83%
Long USD/ZAR	9	4.94%	
Short CLP/PEN	10	5.26%	0.14%
USD/BRL 1x2 put spread	10	0.00%	
Short USD/COP	10	-2.60%	
Short USD/PEN	10	-1.45%	
USD/MXN RKO put	10	-0.50%	
Long NOK-SEK correlation	11	-1.82%	-0.20%
Short JPY-NZD correlation	11	-0.50%	
Short GBP/USD cross KO	11	-0.30%	
Zero cost USD/JPY call	11	0.68%	
No. of winners:		12	5
No. of losers:		13	6
Hit Ratio		48%	45%
Average gain/loss:		0.5%	0.8%

**Parenthesis indicates no risk management. All DNT, digital and correlation trades assume a 10% base notional*
Performance is since trade inception; blueprint trades are specifically 4-month recommendations.
Past performance is no guarantee of future results.
Source: Deutsche Bank

Appendix 1

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