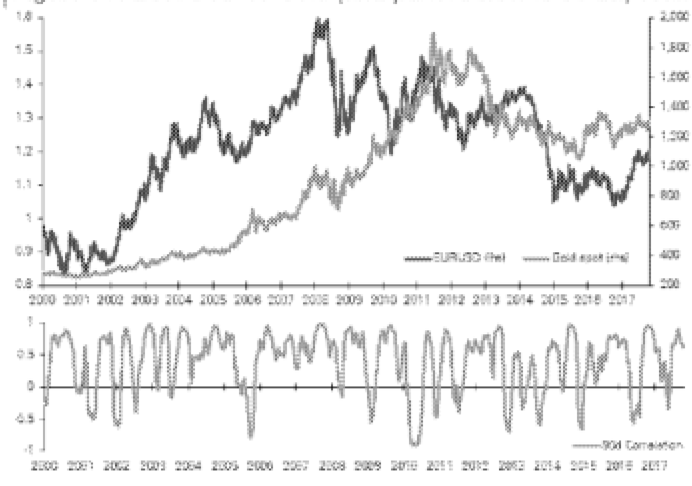
Theme #13: Breakdown cover– buy EUR/USD up & XAU/USD down dual digital; US 10yr yield up & USD/JPY dual digital

Last year's breakdown in the link between some major currencies like the EUR and rate spreads has been widely remarked upon. It is not, however, too late to put on trades that are consistent with an additional break in FX and rate relationships. Two opportunities, with good risk - reward, are dual digitals that have EUR/USD up and spot Gold down; and, secondly, USD/JPY sideways to down and 10y USD yields up.

i) Firstly a 4m dual digital with EUR/USD up 2% and Gold down 3% (EURUSD > 2% OTMS; XAUUSD < 3% OTMS) is indicated at 7.5% for a pay-out ratio of close to 13 to 1. (This compares with the individuals at 38% and 27% for EUR/USD and Gold respectively, and a zero correlation cost of 10.25%).

The rationale is as follows. We see a stronger case for EUR/USD at least partly ignoring the rise in US yields, than we see Gold ignoring higher US yields. Gold had a late year flurry in part because of some front-loading of favorable January seasonals (gold was up sharply in each of January 2014 through January 2017). More important, if speculation of tighter ECB policy, and higher EUR rates becomes an issue, we would expect this to directly play out as EUR/USD positive, but gold negative. The same holds true, if the broader story of rate normalization takes place, which is inherently gold negative, given the post-2008 run-up in gold was about extreme accommodation and monetization from major Central Banks. The above trade also fits with any step up in goods inflation, which is gold negative, as long as Central Bank anti-inflation credibility is maintained. In short, as time goes on there will be less reasons why gold is dominated by the USD and numeraire issues, rather than macro forces related to asset substitution like rising interest rates encouraging a shift from low/no yielding assets. In sum, we recommend a 4m dual digital because this covers the market until the next Blueprint, but if needed, we note this trade would work even better extending the maturities to include more global Central Bank tightening.

Figure 77: EUR/USD vs Gold (and panel below is 90 day rolling correlation)



Source: Deutsche Bank, Bloomberg Finance LP