



Trade 3: Leverage the USD/JPY skew: The supposed stalling of Abenomics 'third-arrow' reforms, uncertainty on tapering and likely poor investor timing in the USD/JPY trade has seen risk reversals diverging from spot for much of the second half of 2013. The current level of divergence, at <1.5% percentile over the past decade, is nearing historical extremes (chart 4). Since the '08 financial crises there had been only two episodes where this occurred, in Q1 2012 and Q1 2013, each time followed by a strong reversion of risk reversals to spot.

Beyond historical precedent, we see two drivers that may propel risk-reversals higher. A steepening of the US yields and further traction of Abenomics would argue for a firmer spot-risk-reversal correlation in the near term, as uncertainty in both whiplashed riskies for much of H2. Furthermore, if spot moves higher in line with our forecasts, the impact of hedging of structured notes should then become a stronger driver of mid to back-end risk-reversals. The most important driver here is outstanding 25-30Y Power-Reverse Dual Currency notes, of which we estimate a sizable portion with knock-outs are centered around the 112.5-120.0 bucket. Risk reversals should then find support as demand-supply imbalances are reduced from lesser hedging requirements.

We thus recommend USD/JPY options that buy the risk reversal targeting the 6M-12M tenors. Consider a 9-month USD/JPY 109 call funded by selling a 102/91.50 RKI put for zero cost, off spot ref 104.40.

Trade 4: Lower USD-CAD beta Implied correlation between AUD/USD and AUD/CAD has remained elevated (~86% percentile), which provides sizable cheapening to AUD/USD puts by selling correlation. This relationship relates to CAD being perceived as a USD substitute, which we think will not be the case as Fed tapering spurs bond repatriation and underscores policy divergence between the two. Thus, consider a 6M AUD/USD 0.86 put with an AUD/CAD 0.83 cross knock-out indicatively for 136bps versus 190bps for the vanilla, off spot refs 0.8920 (-3.6% from strike) and 0.9580 (-13.4% from the barrier).

Empirically, since the 1983 AUD floatation AUD/CAD dips have been more constrained than AUD/USD, unsurprisingly given the broad dollar response and cyclical co-sensitivity of commodities (see highlights in chart 3). Historically, a -3.6% AUD/USD put with an -13.4% AUD/CAD KO would have been in-the-money 26.2% of the time, and knocked out 2.7% of the time.

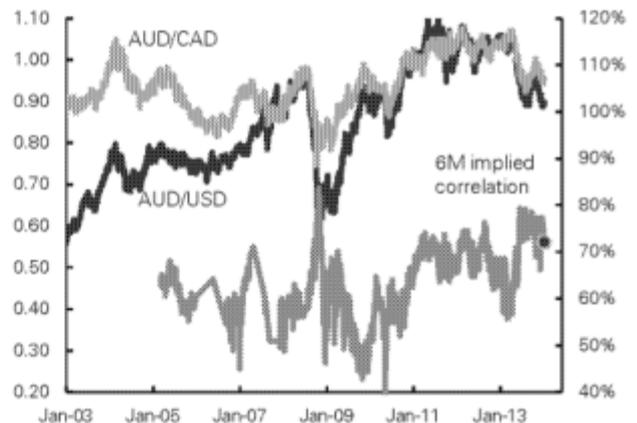
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Weekly change in spot versus risk reversal at extreme



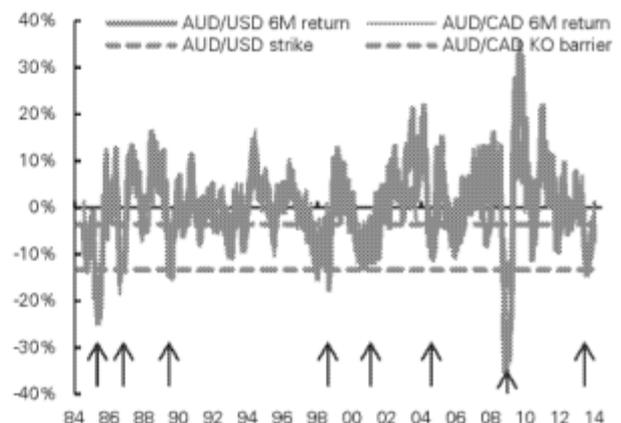
Source: BBG. $dspot/drr = \text{rolling } 3M \text{ change in weekly spot return} / \text{change in weekly } 6M \text{ risk reversal}$

Spots diverge but implied correlation near highs



Source: Deutsche Bank, Bloomberg Finance LP

When returns fall AUD/USD underperforms AUD/CAD



Source: Deutsche Bank, Bloomberg Finance LP