Theme #9: Pole dances, TRY trips

- Go long PLN and HUF, buoyed by competitive REERs and proximity to strong German demand, and stay short TRY, as reserves are insufficient to act as a buffer and where external deficits require further adjustment to restore competitiveness

Aggregated EMEA FX correlation (3m rolling correlation of daily changes) have dropped to levels only seen once post-crisis (prior to the Fed opening the door to tapering last May). The stand-out underperformer is TRY, undermined by risk spreads on both sovereign and corporate bonds having widened on domestic political instability that has already claimed the jobs of a few ministers. At the other end we have ILS and PLN outperformance, but HUF has also has performed reasonably well, largely unchanged vs the USD over the past month. More divergence with idiosyncratic factors playing a greater role is something we have argued for some time, and although disrupted by the 'taper tantrum' in Q2/Q3 2013 in particular, the trend is intact.

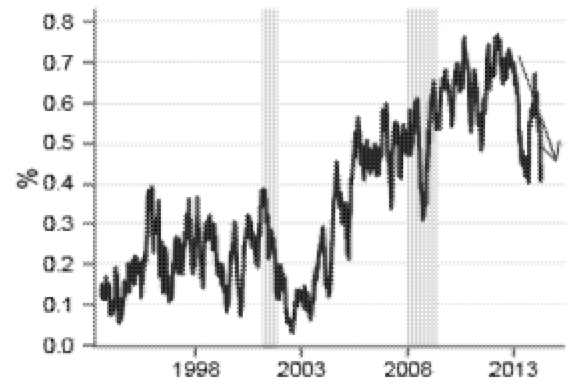
With the Fed pushing fewer (but still a lot) of dollars into the global economy, it still makes sense to avoid currencies with large C/A deficits, and/or those where indebtedness has risen substantially (be that public and/or private). However, in economies where FX weakness in 2013 was more a function of weak growth/policy rate cuts, higher yields should not be damaging as long as the rise in yields is orderly and reflects improved growth prospects. Export oriented economies with competitive real exchange rates and limited balance sheet risk should benefit from a sustained global recovery.

In EMEA this is likely to translate into more divergence between PLN & HUF (benefitting from relatively competitive REERs, a strong German economy and export led recoveries), and the ILS (where the BoP effect will maintain appreciation pressures) on the one hand, and on the other CZK (sustained CNB intervention) plus TRY & ZAR (vulnerable to a tightening of global liquidity on insufficient FX reserves). The Russian RUB meanwhile, will be stuck somewhere in between, supported by low balance sheet risk and attractive carry but undermined by the threat of lower oil prices and the lack of credible reforms.

From red-hot to stone cold

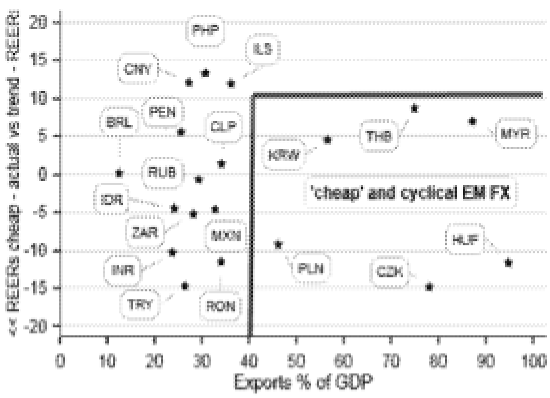
Growth is picking up. Poland will benefit not only from strong German demand but also a healthy banking system, with domestic credit now grinding higher. Any sign of demand-led inflation will make the NBP uncomfortable so Poland is likely to be one of the front-runners in this tightening cycle. Also, longer-term valuation points to 'fair-value' around 3.80, suggesting that in an environment of stronger demand the Bank is unlikely to be sensitive to zloty appreciation. *Go long PLN vs EUR, target 3.95 with a stop @ 4.30.*

Average correlation within EMEA FX (daily changes)



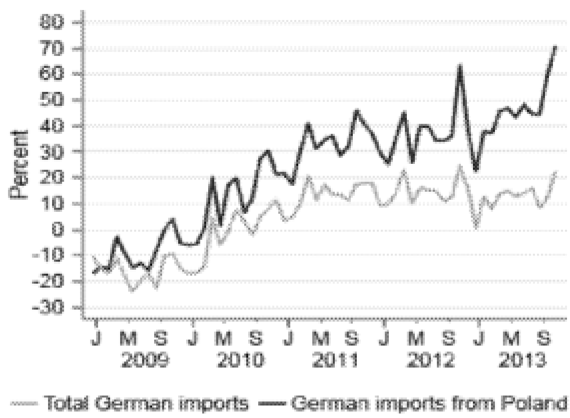
Source: Deutsche Bank, Bloomberg Finance LP

Cheap & cyclical EM FX



Source: Deutsche Bank, Bloomberg Finance LP

Polish competitiveness helping market share



Source: Deutsche Bank, Bloomberg Finance LP