



Theme #14: Volte-face – buy 6m EUR/EM-USD/EM vol spreads, sell EUR vs TRY, MXN, INR

- Options markets assume the dollar will drive price action but the euro is now the “risk off” currency
- “Euroglut” outflows into the US and EMFX reverse as risk appetite sours and carry trades squeeze
- EUR/EM crosses have been realizing well above USD/EM but implied volatilities are quite similar
- We recommend buying 6m EUR/EM – USD/EM volatility spreads in TRY, MXN, INR
- For a directional view, express our EM 2016 Outlook short EUR v. TRY, MXN and INR trade as a 4m 97.5% worst-of put, a 2/3rd discount v. vanillas

EUR is the new risk appetite barometer

Our FX strategy team has written extensively about “Euroglut” outflows into the U.S. and emerging markets (see *FX Special Report 9-Dec-14 and 1-Dec-15*). EUR increasingly adapts the hallmarks of safe haven currencies such as CHF and JPY; fixed income outflows (Figure 1) followed by sudden repatriation during positioning squeezes. Consequently, correlation between equities (a risk proxy) and EUR/USD has flipped since the Fed-driven USD rally (and ECB QE-driven EUR sell-off) last year. The EUR TWI is now *negatively* correlated to the S&P 500 while the USD TWI is *positively* correlated to equities (Figure 2).

We can also infer forward-looking market expectations of dollar-equities correlation by comparing implied volatility for USD-hedged and un-hedged international equity ETFs. In recent months (un-hedged) EFA volatility has traded 1-2% below both iShares hedged EFA (HEFA) and DB X-trackers hedged EFA (DBEF), suggesting the market expects the dollar will be *positively* correlated to global equities in the future (principally with respect to EUR, CHF and JPY).

We should expect a similar result when looking for volatility in EMFX. Since EUR/USD is negatively correlated to equities (acting as risk proxy), we would expect EUR to be negative correlated with EMFX as well, making EUR/EM more volatile than USD/EM.

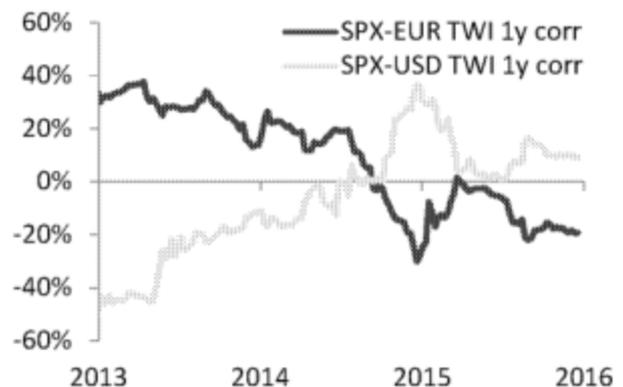
Buy EUR/EM volatility not USD/EM for an added kicker. Indeed, EUR/EM is realizing higher, but implied volatility is not reflecting this at all. Figure 3 illustrates that EUR/EM and USD/EM 6-month implied volatility is priced roughly equal for much of EMFX, and where it is not (such as INR), the premium on EUR-cross volatility relative to USD-cross volatility is too low. As a result, while USDTRY, USDMXN and USDINR exhibit typically positive volatility risk premiums, EURTRY, EURMXN and EURINR volatility premiums are negative.

Figure 1: Eurozone fixed income outflows dominate the financial account



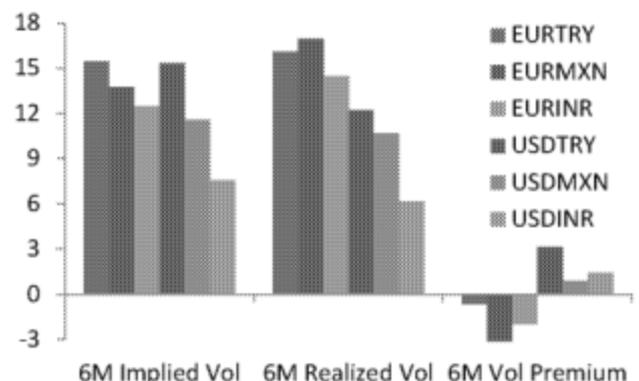
Source: Deutsche Bank, Bloomberg Finance LP.

Figure 2: Positive vol premium in USD/EM, negative vol premium in EUR/EM as flight to EUR safety not priced



Source: Deutsche Bank, Bloomberg Finance LP.

Figure 3: Positive vol premium in USD/EM, negative vol premium in EUR/EM as flight to EUR safety not priced



Source: OECD