

Deutsche Bank  
Markets Research  
Global  
Foreign Exchange  
FX Spot

Date

16 May 2013

FX Blueprint

Dashing Buck

Theme #1: Green Back: Buy USD TWI: Sell EUR/USD

Theme #2: USD/JPY to Step Up Again: Buy USD/JPY

Theme #3: Swiss Cheese Pounded: Sell GBP and CHF vs. USD and EUR

Theme #4: Solid Bloc: Sell NZD/CAD, Buy low delta AUD/USD call

Theme #5: NOK o'Clock: Buy NOK/SEK

Theme #6: No Chinese Quick Fix: Buy USD/CNH calls

Theme #7: Japanese Takeaway: Buy USD/KRW, USD/SGD, buy MYR/JPY

Theme #8: EMEA Reality Check: Buy PLN/CZK, buy EUR/HUF and USD/ZAR  
calls, buy USD/TRY put

Theme #9: Mexican Siesta: Take profit on short USD/MXN, sell EUR/BRL and  
EUR/CLP

Theme #10: Turning Up the Volume: Buy USD/GBP variance swap and  
AUD/USD variance swap

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Overview

Asia, not the US, has provided the biggest surprises of 2013 so far. Chinese FX reserve accumulation has grown at a pace not seen since 2010. Much seems to be due to speculative dollar sales, but whatever the reason, the likely rebalancing has provided support for non-dollar reserve currencies such as the euro and Australian dollar. The other surprise has been the scale of the Japan "shock" with Abenomics proving to be the most radical set of policies since the depression-era. The yen has fallen markedly; competitor nations such as Korea have seen their currencies weaken, while suppliers to Japan such as Thailand and Malaysia have seen their currencies strengthen. Through all of this the dollar has marched higher even with the market wavering over an early move to tapering by the Fed and still absent equity re-allocations to the US.

Dollar Break-Out Time

The resilience of the dollar should be taken as a signal that the dollar is in the midst of a major uptrend. Over the coming months, economic data will likely improve after a soft patch, which should keep real yields well supported. More importantly, despite continued US equity market outperformance, international investors have still favoured the Euro-area, Japan and EM Asia over the US in terms of flows. This is unlikely to continue. Chinese reserve accumulation should also slow down, not least because of measures by authorities to clamp down on speculative inflows. The euro will no doubt lose out with such a backdrop. Additionally, the ECB has re-opened discussions of easing, while the Fed is contemplating how to wind down easing. On the flow side, lower euro risk premia should see much less repatriation, and if anything a greater allocation to foreign assets by Euro-area investors. We go long the dollar trade-weighted index and short EUR/USD.

Japan Shock

Though many want to fight the trend, we continue to stick resolutely to a bearish yen view. The next three to four months should see a wave of events and announcements that will reinforce the potency of Abenomics, whether through elections, structural reforms or monetary policy. Expectations will remain one of the key channels through which Abenomics will influence the direction of the economy. The flow picture also remains negative for the yen thanks to M&A outflows and the potential for further unwinds in

past inflows to short-term Japanese instruments. We stay short the yen against the dollar.

GBP, CHF: Nowhere To Hide

Two other currencies should lose out to an unwind of safe-haven inflows: sterling and the Swiss franc. The negative sterling picture is aggravated by the fact that recent strong data will not change BoE policy, while the negative net investment income balance points to

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How We Did

Turning to how our trades performed from January's blueprint, it is clear that our weaker yen and stronger euro calls were key factors behind our overall return of +3.8%. Carry trades also performed well. Our biggest winner was long USD/JPY (up 17%) while our biggest loser was short a 1 year USD/PHP NDF (-1.5%). The trades made 3.8% on average with a hit ratio of 78%.1

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an extremely negative current account deficit dynamic.

The franc meanwhile will suffer from a resumption of portfolio outflows from Swiss-based investors. We sell both GBP and CHF (vs EUR and USD).

Rest of G10

Swedish disinflation and Norwegian household debt issues should lead to central bank biases that support a long NOK/SEK trade. Finally in G10, we like to go long CAD against the JPY and NZD on the back of Canadian growth catching up to US growth, a stabilisation in the housing market and an upturn in natural gas prices.

We are neutral on the Australian dollar, but given the recent sharp decline would consider buying AUD

upside options, which appear cheap making the riskreturn look attractive.

Asia = China+ Japan

The yen-centric Asia FX trade, short Korean won and long Malaysian ringitt, should continue to perform well.

As well as competition from Japanese companies,

Korea will likely suffer from portfolio re-allocations to Japan. Malaysia meanwhile should benefit from a pickup in bond and equity inflows after the recent election.

As for CNY, at annualized appreciation pace of 12%, we are concerned. The state of the economy does not justify that, and measures to clamp down on

speculative inflows should reduce the appreciation pressure. Moreover, a band-widening should, if anything, lead to CNY weakness. We like to sell CNY via options.

Rest of EM

Of the remaining currencies, we find the Brazilian real attractive thanks to its carry and policy support for a range in the currency. We go tactically neutral on the

Mexican peso. Big picture the currency looks attractive, but positioning is crowded.

In EMEA, we look for additional strength in the Israeli shekel after its recent sell-off on the back of a strong economy. We remain negative on the Hungarian forint and South African rand, and positive on the Turkish lira. We enter optionbased trades to express those views.

1 Past performance is not indicative of future performance.  
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Theme #1: Green Back

The dollar is the top performing currency in G10 so far this year, and not far from the top if emerging market currencies are included. Therefore, dollar strength has not been confined to just the yen (see first chart), which suggests a broader dollar uptrend is unfolding. The fact that the consensus of analysts is only looking for moderate dollar strength against the majors and weakness against the rest of G10 and EM add to the case that we are only at the early stages of dollar strength.

Equity Flows Still Not Supportive

Ironically, dollar strength has so far not been supported by foreign inflows into US equity markets, despite US outperformance. The US saw negligible equity inflows in Q1, with the Euro-area seeing by far the largest. Both Japan, and the rest of Asia also saw larger inflows (see second chart). Flows often lag performance, so one would not necessarily expect flows to immediately pick up into the US with stronger US markets, but the resilience of the dollar does augur well for a dollar uptrend.

China Wildcard

Yet the equity flow picture has not been the most surprising flow story of 2013. Instead, the significant increase in Chinese FX reserves takes that prize. Reserve accumulation has been at the highest pace since 2011, and undoubtedly has provided much support to currencies such as the euro and Australian dollar through a rebalancing effect. The backdrop of weak growth and strong credit expansion has provided an unusual mix for such a pace of accumulation. It would appear that some inflows to China have occurred through over-invoicing of exports and onshore entities taking advantage of the carry offered by borrowing in dollars and lending in Chinese rates. However, over the past week, new measures have been introduced to clamp on these practices. This should slow the pace of reserve accumulation. Moreover, the sharp decline in the USD/CNY fix over April has also likely added to inflows. USD/CNY continues to trade at the bottom of the band around the fix, which implies still significant CNY demand. However, this state-of-affairs is unlikely to continue not least because the much anticipated band widening may actually occur over the coming months, and bring to an end anticipatory inflows.

Dollar Mispricing

Stepping back, what is evident is that US equity

markets have been outperforming since 2009, but the dollar has only started to gain traction since late 2011.

The 1995 dollar turn also saw US equity  
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Figure 1: Dollar Trending Higher In 2013

65  
67  
69  
71  
73  
75  
77  
79

Fed USD TWI

USD basket vs G10 ex-JPY (equal-weighted)

Jan-11 May-11 Sep-11 Jan-12 May-12 Sep-12 Jan-13 May-13

Source: Deutsche Bank

Figure 2: Equity Flows To Everywhere But US

10  
20  
30  
40  
50  
60  
70  
80  
-20  
-10  
0

12Q1 12Q2 12Q3 12Q4 13Q1

Source: Deutsche Bank

\$bn, estimated for Q1 for Euro-area

Euro

Japan

Asia

ex-Ch

US

Figure 3: China Reserves Have Surged In 2013

100  
150  
200  
250  
300  
350  
50  
(100)  
(50)  
-

09Q1 09Q3 10Q1 10Q3 11Q1 11Q3 12Q1 12Q3 13Q1

Source: Deutsche Bank

China (\$bn)



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outperformance precede dollar strength. The swing factor for a more pronounced dollar move, though, appears to be real interest rates. Their relentless decline since late 2008 did weigh on the dollar, but the picture has started to improve as real rates appear to be turning up (see first chart on this page). Earlier tapering by the Fed would likely cause a sharper move up in real yields, but even a further delay in tapering would unlikely cause real yields to reach new lows.

Therefore, markets have entered an important new phase for the USD: real yields moving higher in tandem with stronger equity markets. Such a combination should be very supportive for the dollar. We therefore like to go long the dollar trade-weighted index.

What about the euro?

We turned bearish EUR/USD at the beginning of March, and beyond our broad bullish dollar view we see two factors as driving us towards our 1.20 end-year target. First, we see divergence in conventional policy expectations

(rates) returning. For all the unconventional measures since 2008, the remarkably consistent pricing of 2-year ahead rates paths from the Fed and ECB post Lehman is what stands out (see second chart). We think this year will mark the beginning of renewed divergence. On the Fed side, mid-2015 guidance is soon coming into view for 2-yr rates making the entire US yield curve "live". In contrast, the ECB is re-opening a discussion around negative rates and strengthening its verbal guidance on "low for long" via multi-year liquidity commitments. For how long can the market be pricing identical rates paths for the ECB and Fed over the next decade?

Second, and more importantly, we see the reduction of Eurozone risk premia as negative, not positive for the EUR. On the one hand, our models suggest there is little redenomination risk priced into the EUR anymore. This has seen the correlation with Euro peripheral bond spreads and EUR/USD drop to close to zero, and makes the potential (negative) EUR/USD reaction to a return of tail risk very asymmetric. Most importantly, the big story over the last five years has not been a lack of inflows into the Euro-area, which have remained remarkably steady. It has been domestic risk aversion. This has seen large waves of repatriation and the building of more than EUR 1trillion worth of underweights in foreign assets. Lower tail risks and a gradually improving business cycle should see a return of these outflows - so we think EUR/USD is fully

capable of participating in a USD rally, even if it lags the move lower in many other crosses.

Bilal Hafeez

George Sarav

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Figure 4: USD Drivers Turning Up

-3

-2

-1

0

1

2

3

normalised units

USD

Real yields\*

S&P:world

91 93 95 97 99 01 03 05 07 09 11 13

Source: Deutsche Bank, \* pre-1997 nominal 10y minus CPI used, rather than

TIPs

Figure 5: ECB To Diverge From Fed

0

1

2

3

4

5

6

7

US 2y2y rates

Market has been pricing identical

Fed/ECB rates path since 2008,

divergence coming

Euro 2y2y

fwd rates

05 06 07 08 09 10 11 12 13

Source: Deutsche Bank

Figure 6: Euro-Area Repatriation To End

-6

-4

-2

0

2

4

6

Cumulative debt and equity

flows, trio EUR

inflows

outflows

99 00 01 02 03 04 05 06 07 08 09 10 11 12

Source: Deutsche Bank

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Theme #2 USD/JPY to Step Up Again

After a 14 big figure rally in the fourth quarter, our January Blueprint piece was called 'Don't wait for USD/JPY to dip.' It argued that the move had great scope to run because yen trends are multiyear affairs which in the early stages tend to see few pullbacks. Another 12 big figures later, we feel the same way. We envisage spot

Japan's narrow basic balance remains under pressure continually ratcheting up in steps following the new BoJ's landmark shift to Quantitative and Qualitative Easing (QQE) in early April. Our latest forecasts are 110 by December and 120 next year. The prospect of overshoot is also very real.

Unwinds before outflows

The case that we made earlier from BoP and flow drivers is still relevant. Japan's current account may be starting to stabilize but the capital flows picture continues to deteriorate and matters more (first and second charts). Outbound M&A is accelerating judging by the take-up of JBIC loans under MOF's USD100bio cheap bridge financing facility. And massive short-term hedge trades and safe-haven inflows from the time of the European Crisis have only just begun to get unwound. The latter that probably accounts for the strong underlying bid which the spot market found after exploding higher on April 4/5. It might also imply that another leg higher in the market through, say, 102 would induce a rash of 'stop-loss' buying.

By contrast, consensus had put more focus on the prospect of fresh capital outflows, which are so far disappointing. And short-term offshore positioning dissipated accordingly: Just before the recent breach of 100 the weekly IMM report, for example, had leveraged funds' yen short at less than 40% of open interest, versus 60-80% when historically stretched. This made little sense when divergent monetary policy continues to be a source of ongoing support, and left the market susceptible to seemingly innocuous triggers like a low weekly US jobless claims number.

Regardless, on the institutional side, we have consistently pointed out that significant new Japanese real money outflows are likely to evolve only gradually, and even then for the most part will be FX hedged.

Retail investors, too, should be slow starters in terms of foreign asset demand. A key difference with America's experience during QE1 & QE2 is that Japan's relative growth prospects have improved rapidly. And the fact that local investors' starting point

is a heavy  
underweight in the domestic stock market.

Expect more!

Abenomics is a departure from past reformist agendas,  
in that it relies heavily on the lever of expectations  
(apparently in part generated by yen weakness per the  
1930s). Thus, the BoJ's latest Outlook Report

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Source: Ecwin; US Commodity futures trading commission (CFTC)

Source: Deutsche Bank

Significant short-term unwinds have yet to ensue

Source: Deutsche Bank

Offshore positions cut when spot stalled in 97-99 range

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anticipates a 'virtuous cycle among production, income and spending triggered by increases in public investment and exports.' At the risk of caricature, Hayami had been all about gritting one's teeth and holding out for the eventual benefits of (Schumpeterian) creative destruction, while Shirakawa was resigned to the structural drag from demographics. Kuroda has taken a leaf out of the Fed's much more activist playbook, raising the stakes (promising almost three times as much QE) and taking a lead in talking up the economy's reflationary prospects. Policy board members' core forecasts are that the economy will exceed its potential by a factor of 5-6 times this fiscal year (2.4-3.0% versus 'around 0.5%', albeit with the caveat that this includes frontloaded demand ahead of the April '14 consumption tax hike)!

Measures of progress will come over the summer, with investors able to gauge the reaction to: (i) Abe's grand deregulation and competition plan, to be unveiled midJune; (ii) the Tokyo metropolitan and Upper House elections, in June and July respectively; plus (iii) final social security reform and fiscal reconstruction plans in August and September. Positive domestic sentiment could well exaggerate risk-seeking outflows just as the Fed discussion about tapering down asset purchases is progressing.

Déjà vu and then some

So how does the current backdrop stack up against previous periods of significant yen weakness? We examined seven episodes since the breakdown of Bretton Woods. They were characterized by trade shocks (mid- and late-70s, late-'80s, mid-'90s); valuation overshoots and intervention (mid-'90s); capital outflows, be they deregulation-, risk seeking- or 'sell-Japan'-driven (early and late-'80s, mid-'90s, early and mid-'00s). Clearly, today shares many of these features, with the added kicker of an unprecedented monetary backdrop. This is what raises the prospect of overshoot. But that's unlikely to be an issue in the next 3-6 months.

James Malcolm, London,

Taisuke Tanaka, Tokyo,

Abe's delivery schedule

Source: Deutsche Bank

Periods of yen weakness in the 70's and early 80's

Source: Deutsche Bank

Periods of yen weakness since the late 80's

Source: Deutsche Bank



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Theme #3: Swiss Cheese Pounded

堅 Swiss investors have significant underweights in foreign assets and "safe havens" globally are turning. Sell CHF vs USD and EUR.

堅 The GBP bear story is not over, in our view: basic balance dynamics remain explosive, Carney will stay dovish and market positioning is cleaner. Sell GBP vs USD and EUR.

Don't Underestimate Swiss Investor

The market has been very focused on "safe-haven" inflows into Switzerland in recent years. While these have been big, the bigger story is the lack of outflows. Up to 2008, bond and equity flows by Swiss investors had been running at a 50bn CHF annual pace, mostly recycling savings from Switzerland's large current account surplus. The main destination has been US and European assets, accounting for more than two thirds of Swiss net foreign assets. This abruptly ended after Lehman: the Eurozone crisis, narrow rate differentials, CHF strength and very volatile equity markets all played their part. On all these fronts, we think things are changing however. Eurozone risk premia have been unwound to pre-2010 levels. Riskadjusted equity returns are booming. The Swiss franc has stabilized at extremely overvalued levels, and both European and US yields have likely bottomed. We therefore see conditions ripe for a return of the Swiss investor to international capital markets, and believe this will be a major driver behind Swiss franc weakness.

All Other Safe Havens Have Turned

Aside from domestic-led portfolio outflows, we don't think the signals from the unwind of other "safe haven" trades can be underestimated. Of all the "tail risk" trades, we see gold as holding the most similar properties to the Swiss franc: zero yielding, but perceived to hold value at times of stress. With the economy entering an environment of asset price inflation but goods price deflation, gold has proved a poor hedge, and we think the same holds for the Swiss franc. Indeed, medium-term trends between the two are similar, and combined with the huge decline in Eurozone risk premia, we see the risks as skewed towards an unwind of the more than 150bn of safehaven inflow that went into Switzerland over 2010-12.

CHF Should Participate in Dollar Turn

Finally, USD/CHF historically turns to lag turns in the dollar cycle. Back in the 1990s, it turned together with USD/JPY and USD/DEM. With our confidence on the dollar outlook building and no change from the SNB on

the back of a very benign inflation outlook, we see conditions as ripe for a breakout in both USD/CHF and EUR/CHF targeting 1.00 and 1.27 respectively over the rest of the year.

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It's Not the Inflows, But the Swiss Outflows That Matter

cumulative portfolio flows,

bn Sfr

-900

-700

-500

-300

-100

100

99

inflows

outflows

250bn

u/weight

02

05

Source: Deutsche Bank, Bloomberg Finance LP

08

11

Swiss Franc Is Last "Safe Haven" To Turn

200

400

600

800

1000

1200

1400

1600

1800

0

90 93 96 99 02 05 08 11

Source: Deutsche Bank, Bloomberg Finance LP

Gold in EUR terms (lhs)

CHF effective exchange rate (rhs)

70

80

90

100

110

120

130

CHF Is Last To Weaken Around Dollar Turns

Months since currency topped against USD in 1990s

10

20  
30  
40  
50  
60  
70  
80  
90  
0

NZD AUD CAD GBP NOK SEK DEM CHF JPY

Jun 1988: NZD/USD

hits cycle high, year

when DXY range

begins

April 1995: USD/JPY

hits cycle low, DXY

uptrend begins

Source: Deutsche Bank, Bloomberg Finance LP

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Staying Bearish GBP

We've been bearish sterling since the start of the year and stick with the view, despite the last few months' squeeze. First, the recent run of positive UK data surprises versus the US and Euro-area appears to have reached extremes. Even if the run of positive UK data continues, it is difficult not seeing a greater catch-up from the country's two main trading partners.

Second, outside of its recent potential to squeeze GBP shorts, we don't think the moderate improvement in the data outlook matters much anyway. Unlike the Fed, the BoE won't shift to less easing anytime this year, so the market can't price much in terms of relative monetary policy tightening.

In contrast, GBP

correlations with risk appetite (eg. the FTSE) have shifted to negative over the last two years. Improved risk appetite is associated with higher outflows from the UK given the extremely low level of real yields - the lowest in the world.

Third, we believe that flow, not data, will be the dominant driver behind GBP. On that front, we think it is fair to say that sterling has the worst flow dynamics in the world. Portfolio inflows remain exceptionally weak due to very negative real yields. The trade balance remains stuck in deficit due to the high share of services, the big rise in ULCs in recent years, as well as persistent negative J-curve effects. Perhaps even more worrying, the investment income balance is deteriorating rapidly. This, not trade, has been the biggest drag on the UK current account and has small potential to improve in coming months. For any EM country, this deterioration would flash warning lights on the sustainability of the external position. This is very negative in the UK and growing. On top of this, it stands in sharp contrast to the US. Even though both have current account deficits, the UK appears to be suffering from a more structural decline in the relative profitability of its foreign investments - pointing to a more permanent decline in the UK financial system's capacity to transform foreign "safe haven" inflows into higher-yielding foreign assets.

Finally, the risks are skewed towards higher "political" and "policy" premia on GBP. The continued dramatic decline in Eurozone risk premia should hurt GBP the most given that sterling has been one of the biggest beneficiaries of "safe haven" inflows from the Eurozone. On a more medium-term basis, the ongoing domestic political debate around an EU membership referendum

on top of EU initiatives towards increasing regulatory burdens on the financial sector (financial transaction tax, among others), will do little to provide a medium term uplift to UK structural competitiveness.

George Saravelos, London, [REDACTED] portfolio

UK vs Avrg US & Euro Data Surprises At Extremes

0.2  
0.4  
0.6  
0.8  
1  
-0.8  
-0.6  
-0.4  
-0.2  
0  
-1  
04

Source: Deutsche Bank

06  
08  
10  
12

UK and Canada Have Worse Basic Balance In World  
Narrow

C/A + FDI

SGD  
NOK  
TWD  
HUF  
MYR  
CNY  
SEK  
CHF  
ILS  
RUB  
PHP  
KRW  
CZK  
THB  
CLP  
BRL  
EUR  
AUD  
JPY  
IDR  
PLN  
MXN  
NZD  
TRY

USD  
GBP  
INR  
CAD  
ZAR  
Source: Bloomberg Finance LP. \*Average of 3M rolling correlations over the  
past 5 years.  
Rank of basic balance  
Broad  
C/A + FDI + Portfolio  
HUF  
SGD  
MYR  
26 CNY  
MXN  
SEK  
PHP  
TRY  
21 RUB  
THB  
KRW  
CZK  
PLN  
16 EUR  
CHF  
BRL  
USD  
AUD  
11 IDR  
ILS  
CLP  
NOK  
TWD  
6 NZD  
INR  
JPY  
CAD  
ZAR  
1  
GBP  
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Theme #4: Solid Bloc

堅 The key US data suggest CAD's external backdrop remains supportive, as do Canada's commodity prices, and fears on Canadian housing are likely overdone. We maintain our recently entered CAD/JPY long. Having recently exited our long-held bullish AUD/CAD and NZD/CAD views from our previous Blueprint, we now also go short NZD/CAD.

堅 With AUD looking to have clearly overshot to the downside we do not enter AUD/CAD shorts at this point.

Indeed we are more inclined to take advantage of the skew in AUD/USD options to buy a vanilla AUD/USD 1.01 3-month call for around 100 pips.

We have in the past noted how US data surprises tend to lead Canadian data surprises, showing the influence trends in Canada's largest trading partner have on its economy. CAD then tends to follow US data surprises. CAD has been surprisingly resilient to weakness in the broader US data flow in recent weeks - a period where our US Macro Pulse Index of data surprises has largely run in negative territory. As can be seen in Figure 1, however, the key parts of the US recovery story - the recovering housing and labour markets - have been more encouraging than the broader US data flow recently, and are providing greater support for CAD. Canadian commodity prices also remain supportive, with US natural gas prices having climbed solidly in 2013.

Even in the weakest part of the Canadian outlook - the weakening building sector - the recent news is more encouraging, with overall building permits at a 5-month high in March (albeit driven by non-residential permits). While it is by no means a bullish factor yet, it may be that market participants are too negative on how much further this sector is likely to weigh on CAD (Figure 2). Given our ongoing bearishness on JPY, we expressed this CAD bullishness by going long CAD/JPY on 9 May when it rallied through 99 (see Trade Recommendation: Long CAD/JPY, 10 May) and we maintain this long.

This improving macro backdrop for CAD is being reflected in the financial variables that drive our shortterm models of CAD crosses. Our AUD/CAD model has clearly rolled over, while our NZD/CAD model is starting to roll over as well (Figure 4). So we recently exited our long-held AUD/CAD and NZD/CAD Blueprint views (see FX Daily: Changing the Call on CAD Crosses, 6 May 2013).

Figure 1: Signals from US housing and labour market support CAD...

CAD TWI 12wk-12wk% (LHS)

10  
15  
-15  
-10  
-5  
0  
5  
97  
99  
01  
03  
05  
07  
09  
11  
13

Combined Mortgage Apps and Jobless Claims  
12wk-12wk% Pulse (RHS)

10  
15  
-15  
-10  
-5  
0  
5

Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: ... Canadian building outlook starting to turn?

10  
20  
30  
-40  
-30  
-20  
-10  
0  
Jan-03  
10  
20  
30

Canadian. Building Permits 3m3m%, (LHS)

CAD TWI 3m-3m% (RHS)

Jan-05  
Jan-07  
Jan-09  
Jan-11  
Jan-13  
-40  
-30

-20  
-10  
0

Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: NZD/CAD model is rolling over – even though spot has overshoot near-term, we target a move to 0.80

0.87  
0.85  
0.83  
0.81  
0.79  
0.77  
0.75

May 12

Aug 12

Source: Deutsche Bank, Bloomberg Finance LP

Nov 12

Feb 13

May 13

NZD/CAD

Model - uses Dairy Futures, NatGas, Crude, CRB, rate differential, USD TWI, VIX

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While both crosses have now fallen a long way relative to our models, we would now expect these models to keep trending lower. Given the respective levels of the two crosses (and our AUD view below), we prefer to go short NZD/CAD. Indeed we are now more cautious on NZD more widely, as most of the good news appears priced in following its rally in recent months (see Figure 4).

In terms of AUD, our view remains that the global monetary

environment argues against looking for anything more than short-term weakness. Reinforcing this were the Chinese monetary data for April, which showed a further pickup in M2 Money growth – this has generally been bullish for AUD in recent years. Moreover, our Chinese team remains more bullish on the Chinese growth outlook than the market consensus, looking for 8.2% growth in 2013 and 8.9% growth in 2014, against a market consensus of 8.0% growth in both years. It is notable then that other “China plays” such as Hang Seng H-shares and copper prices have started to trend higher recently, indicating a greater confidence in the outlook for Chinese demand (see Figure 5). This should soon start to bolster AUD.

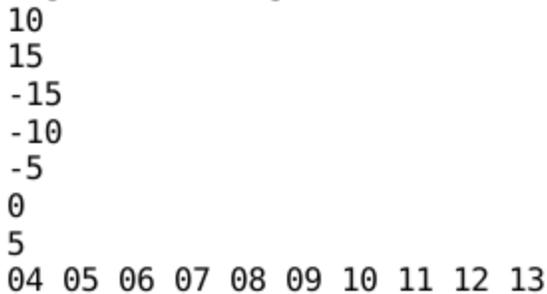
One of the other key drivers of our resilient-AUD view has been the expectation of ongoing mining-related FDI inflows (see for instance FX Daily: On-Hold RBA Lifts AUD, But FDI Inflows And G3 Policy Remain Key Supports, 5 March 2013). Despite recent negativity on the mining investment outlook, the ABS’s Q1 Capex survey suggested an increase in mining investment would be seen in 2013/14, with a lift in building and structures investment offsetting an expected decline in machinery and equipment investment. While this may prove too optimistic, it suggests mining investment is hardly about to fall off a “cliff”. In terms of what this means for AUD, even if there is little growth in mining investment, it is likely to remain at an extremely elevated level for some quarters to come. Additionally, as mining investment rotates from an import-heavy machinery and equipment focus to a local-expenditure-heavy building and structures focus, the AUD-intensity of this spending may well increase. This argues that the need for resource firms to continue to generate substantial FDI inflows will likely remain intact. As to how we prefer to express this AUD view, one relatively consistent dynamic in FX options markets is the tendency of AUD/USD options to skew towards puts on AUD/USD declines (see Figure 6). We would

take advantage of this dynamic by buying a vanilla AUD/USD 1.02 call (around 70 pips at time of writing), expecting it to resume trading in the 1.02-1.06 range that had until very recently held for most of 2013.  
John Horner, Sydney, +61 (2) 8258 2130

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Figure 4: The good news in NZ is more than fully priced



Source: Deutsche Bank, Bloomberg Finance LP

NZD TWI 3m% ch (LHS)

ANZ Survey Employment Intentions 3mth change (RHS)

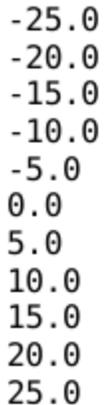
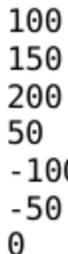
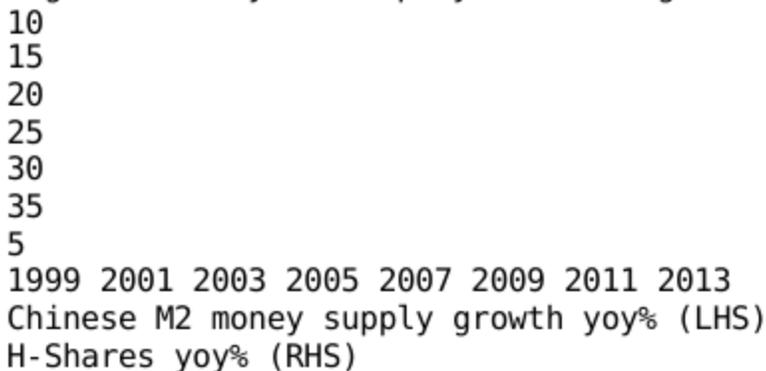


Figure 5: Many China plays are now getting a boost



Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: Taking advantage of option market dynamics to buy a vanilla AUD/USD 1.01 3-month call on this dip

0.55  
0.65  
0.75  
0.85  
0.95  
1.05  
1.15

AUD/USD (LHS)

AUD/USD 25-delta risk reversal (RHS)

-8  
-7  
-6  
-5  
-4  
-3  
-2  
-1  
0

Jan 10 Jul 10 Jan 11 Jul 11 Jan 12 Jul 12 Jan 13

Source: Deutsche Bank, Bloomberg Finance LP

16 May 2013

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Theme #5: NOK o'Clock

The Norwegian krone has weakened somewhat vs. the EUR since the last FX Blueprint on Jan 10<sup>th</sup>

, reflecting

weaker crude primarily but also a Norges Bank that has struggled to make its mind up on what the main focus of monetary policy should be, headline CPI or household debt/house prices.

The latest policy meeting would suggest household debt and house prices now have the upper hand again, although with the caveat this could change if the krone appreciates significantly. However, to be fair to Norges it is a nigh impossible job for any inflation targeting central bank to balance the dilemma of pockets of domestic overheating with external deflation. Add a solid C/A surplus and a triple-A rating and Norges Bank is stuck between a rock and a hard place.

What this means for our outlook for the NOK is that the Norges Bank's NOK TWI projections matter more than ever. Deviations of around 2-3% or more are likely to be crucial over the next couple of rate meetings.

Other factors/variables that will be monitored closely at Norges Bank are: a) total credit as % of GDP; b) house prices as % of disposable income, c) real commercial property prices; d) the share of money market funding in Norwegian financial institutions. These four variables have previously been identified as the key indicators the Bank monitors on an ongoing basis for guidance on longer-term financial stability, and also the main variables that will determine the additional capital requirements for the counter-cyclical capital buffer.

Taken together, the dilemma of balancing the risk of domestic overheating versus excessive currency appreciation and subdued spot inflation is something Norway shares with a number of EM economies and also to a lesser extent with neighboring Sweden.

However, Norway's dilemma is further reinforced by the lack of an output gap, Norway's accumulated oil wealth, booming oil & gas investments, extremely low unemployment, and large external surpluses.

The bottom line, with Norwegian monetary policy likely to continue to be a compromise over the next couple of meetings, the best Norges Bank can hope for currently is that the correction in Brent crude lower will extend and weigh the NOK down. Near-term, and dependent on crude consolidating above/around \$100/barrel, the re-assessment of the Norges policy outlook favour a higher NOK/SEK. Look for a return to the highs from

late last year. Target 1.1775, with a stop @ 11.90  
(1.1440 at the time of writing).

Source: Deutsche Bank

Source: Deutsche Bank

Figure 1: NOK I-44 slightly weaker than NB's latest  
projection

Figure 2: CPI below target, but slightly above NB's  
projected inflation path

Source: Deutsche Bank

Figure 3: Household debt is increasing again

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Meanwhile in Sweden imported deflation is dragging headline CPI further below the Riksbank's projection (in April -0.5% YoY vs the -0.2% projection). For the inflation targeting Riksbank this should mean further policy easing, and it might result in further cuts. However, as the majority on the board has made clear, they are not entirely comfortable reducing rates further in response to external disinflation when house prices are edging higher and households take on more debt. Also, further rate reductions would not necessarily support demand since the slowdown was/is due to weak sentiment and a poor external environment. Meanwhile in the real economy, data is generally a mixed bag, with a few very early indications of a turnaround. Retail sales are largely stable, and consumer sentiment is back in the positives, backed up by higher property prices and surging equities. In the manufacturing sector the PMI remains just below the 50 benchmark line, but hard industrial data has improved significantly of late, with industrial output up 0.8% on the month in March for a flat YoY reading, while the more forward looking new orders component rose a sharp 10.5% MoM and 11.2% YoY, the highest YoY outturn for 2 years.

So where does this leave the krona? On the back of the CPI report the rates market is almost fully priced for a further 25bp rate cut over the next two meetings. This to us seems about right, as even given the reluctance of the Riksbank neutrals to solely focus on the CPI, they can also not ignore headline CPI when it is running so much below target. However, at current levels (8.65) we also see limited downside in the SEK vs the EUR. In the current environment and at current policy rate levels, policy expectations can only impact on the SEK to a degree, with positive flows dynamics (C/A surplus a solid/steady 7-7.5% of GDP), attractive valuations (see DB's BEER, FEER and PPPs), and more near-term a lack of positioning (SEK a net short on dbSelect, investors have not been this short the krone for almost a year). Therefore we believe the probability of further rate reductions in the SEK is best captured in short SEK vs the NOK, where the CPI gap will continue to underpin expectations for a wider policy rate gap. Look for a return to the highs from late last year. Our initial target is 1.1775, with a stop just below 1.12. Henrik Gullberg, London, [REDACTED]

Figure 4: Inflation is running below Riksbank fcsts

Source: Deutsche Bank

Figure 5: Domestic inflation stable - imports hugely

deflationary

Source: Deutsche Bank

Figure 6: Household debt as % of disposable income

Source: Deutsche Bank

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Theme #6: No Chinese Quick Fix

We believe the risk-reward to USD/CNY has shifted in favor of topside exposure for a few reasons.

First,

Fixings have diverged from the trend in macro data  
100

the fixing has become increasingly misaligned from domestic macro data and the USD's gains against China's trade partners. China is losing competitiveness, at the very time when returns to its growth model are being tested. To us, this appears unsustainable. The motivations behind stronger fixings – whether RMB internationalization or an attempt to “catch-down” to spot – are unlikely to compel a continued disconnect from fundamentals and regional FX trends. The pace of fixing gains in April – at a 12% annualized pace – is not only unlikely to continue, but may well reverse to fulfill the policy promise of greater two-way volatility.

Second, one-way USD selling pressure onshore should begin to normalize. Authorities are clamping down on sources of speculative USD sales. Trade invoicing irregularities used to disguise capital inflows will now be scrutinized. Foreign currency lending is likely to slow, as regulators discourage imbalanced FX loan-to-deposit ratios by tying them to higher long USD NOP limits for banks. Importer buying is thus likely to return to the market. Should USD deposit rates begin to rise in response to the regulation, incentives to sell USD may begin to shift. Seasonal buying should also rise in the summer with a pick-up in MNC repatriation.

Third, the widely expected band widening is not necessarily a positive for CNY. In fact, the April 2012 band-widening was first followed by spot trading to the upper extreme of the band. We see a narrowing of the spot-fixing basis as a key precondition for the move, and are wary of a downshift in growth expectations. Thus, spot could be facing upside – not downside – pressure at the time of band-widening.

Fourth, market signals may be foreshadowing a turn. Volatility markets are becoming less complacent. CNH implied volatility has been moving higher since mid-April with realized volatility picking up sharply this month. CNH spot has begun to trade at a discount to CNY, after trading at an average premium of 125 pips in Q1. Offshore positioning in the RMB complex is stretched and strongly consensus, and is thus vulnerable to abrupt shifts in expectations.

Timing remains the key risk to our view. Policy intent for lower fixings and/or early band widening could keep

the lid on for longer. But we believe risk-reward is now more compelling for topside. We recommend going long USD/CNH via short-dated vanilla calls. Indicatively, a 3M 6.22 call costs 27bps. We also maintain our long 3M USD/CNH versus USD/CNY NDF spread trade to position for an initial move higher in spot within the bands, with a view to squaring the NDF leg at par.

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20  
40  
60  
80  
-100  
-80  
-60  
-40  
-20  
0

Jan-12 Apr-12 Jul-12 Oct-12 Jan-13 Apr-13

Source: Deutsche Bank, Bloomberg Finance LP

USD selling should normalize as regulations reduce FX lending relative to deposits onshore

100  
20  
40  
60  
80  
-40  
-20  
0

USD bn

10  
20  
30  
40

Jan-10 Jul-10 Jan-11 Jul-11 Jan-12 Jul-12 Jan-13

Net FX sales by onshore clients to banks, monthly (LHS)

New FX loans - FX deposits, monthly (RHS)

Source: Deutsche Bank, CEIC, SAFE

-30  
-20  
-10  
0

Citi China Data Surprise Index

USD/CNY Fixing (RHS, reversed)

6.24  
6.29  
6.34  
6.39  
6.19

Spot traded to the top band last time it was widened

6.00

6.10

6.20

6.30

6.40

6.50

Jun-11

Spot Max Intraday Deviation from Fix (RHS)

CNY Spot

CNY Fixing

April 2012: Intraday

trading band widened to

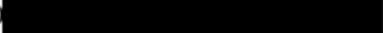
+/-1% from +/-0.5%

Dec-11

Jun-12

Source: Deutsche Bank, Bloomberg Finance LP

Sameer Goel, Singapore, 

Mallika Sachdeva, Singapore, 

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Dec-12

-2%

-1%

0%

1%

2%

3%

4%

5%

Jun-13

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Theme #7: Japanese Takeaway

堅 We expect sensitivity to the JPY and offshore portfolio allocation preferences will continue to drive Asian FX. We are long USD/KRW, USD/SGD & MYR/JPY.

Asian FX returns this year have largely been driven by varying sensitivities to the JPY. Correlations to the JPY (first chart) differentiate the relative laggards – that compete for exports and portfolio flows with Japan – from the relative leaders – that are integrated into Japanese supply chains and should benefit from

Japanese import demand, FDI, and potential QE-induced portfolio investment. With USD/JPY breaking into the triple-digit atmosphere, and a bulk of the “real” flow impact from Japanese policies yet to materialize, these divergent correlations remain the best guide to regional FX trends, in our view. In addition to the JPY, the outperformance of EM debt over EM equity fund flows has boosted debt-centric ASEAN FX over equity-centric North Asian FX. We believe this trend has legs but will become more selective.

KRW has the most to lose from JPY weakness.

Competitiveness metrics such as export similarity indices point to a trade channel vulnerability. But the real pressure point comes from the portfolio channel.

Earnings

expectation downgrades for Korean companies and upgrades in Japan are driving relative equity market performance, resulting in flows into Japan and away from Korea. Importantly, an identical trend unfolded during the JPY weakness of 2004-07 (second chart). Politicization of FX may also drive further monetary easing and FX intervention in Korea. By comparison, TWD losses should be more subdued from here given weaker export competition with Japan, stronger equity inflows and central bank USD supply. SGD is the purest USD beta in Asia. By virtue of its NEER framework, the USD TWI has consistently been the top driver of USD/SGD. Unsurprisingly then, the importance of the JPY to SGD has surged since the USD/JPY uptrend began in October. Importantly, a long USD/SGD view is predicated in principal on USD strength broadening across Singapore’s trading partners. It is thus even compatible with S\$NEER tracking near the top band, although this positioning makes the risk-reward that much more attractive.

MYR should outperform, given good inflow potential and a growing trade surplus with Japan. The status

quo election result should sponsor portfolio rebalancing towards Malaysia. Equities have considerable scope to catch up to ASEAN peers, where valuations are now unattractive. IPOs should resume in force and could attract offshore interest. Bond allocations should pick up as underweights are covered (third chart) and as Thailand considers penalizing bond market access for foreigners. Malaysia meanwhile is unlikely to consider capital controls or a line in the sand on FX.

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JPY has been a key driver of Asian FX performance

0.1  
0.2  
0.3  
0.4  
-0.4  
-0.3  
-0.2  
-0.1  
0

Latest 6M Correlation to JPY (LHS)

YTD performance vs. USD (RHS)

Winners

Losers

-5%  
-4%  
-3%  
-2%  
-1%  
0%  
1%  
2%  
3%  
4%  
5%

SGDKRW TWDCNY INR PHP IDR MYR THB

Source: Deutsche Bank, Bloomberg Finance LP

Equity flows move away from Korea and towards Japan during periods of JPY weakness

100  
20  
40  
60  
80  
-100  
-80  
-60  
-40  
-20  
0

USD bn

6m sum

10

20

30

JPY/KRW

downtrend begins

01 02 03 04 05 06 07 08 09 10 11 12 13

Japan Equity Inflows (LHS)

Korea Equity Inflows (RHS)

Source: Deutsche Bank, Bloomberg Finance LP

-30

-20

-10

0

Portfolio reallocation to drive MYR outperformance

10

15

20

-10

-5

0

5

2009

USD bn

Bond inflows (3m sum)

Malaysia

Other ASEAN (IDR, THB, PHP)

2010

2011

2012

2013

Source: Deutsche Bank, Bond flows data is collected from the respective country's official sources

Sameer Goel, Singapore, [REDACTED]

Mallika Sachdeva, Singapore, [REDACTED]

Deutsche Bank AG/London [REDACTED]

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Theme #8: EMEA Reality Check

There are a number of sub-plots and potential themes currently in EMEA FX, but rather than impacting significantly on price action, they seem to have led to paralysis, with correlation patterns versus traditional drivers having converged to near zero in many cases.

That is unlikely to last and over the next couple of months we are likely to see a mix of global themes and country-specific factors having much more of a significant impact on price action.

In EMEA, the impact of the external backdrop is potentially very mixed. The subdued external inflation environment means that economies with large negative output gaps will be less sensitive to currency weakness, and more inclined to continue to push through rate cuts, if not regardless of FX, at least as long as FX depreciation is orderly. Hungary's NBH have made it very clear that the focus is on growth, and that inflation is taking the back-seat for now. Consequently, the NBH rate cutting cycle continues unabated, with the Bank now having reduced the base rate down to an all-time low of 4.75% from 7.00%. The poor domestic backdrop, the need for further fiscal austerity in order to secure EDP exit and headline CPI at a record lows suggest rate reductions will continue, with the rates market currently pricing in around 100-125bps of further easing. Indeed, weak data, the non-domestic PPI running at a mere 3.2% YoY, coupled with global disinflation and relative currency strength also lower the bar for 50bp rate cuts (during all NBH easing cycles since the turn of the century the bank has at some point reduced rates by more than 25bps) and/or a more prolonged easing cycle.

Elsewhere, South Africa's SARB seems to be warming to the idea of rate cuts despite a relatively weak ZAR. Governor Marcus recently emphasized the importance of a free-floating exchange rate as a shock-absorber, and argued that a weaker currency would be crucial in dealing with the country's large trade and C/A deficits. She also pointed out that medium-term inflation expectations remain well anchored. These comments definitely appear more dovish than before, particularly with regard to the exchange rate and would suggest the Bank is ready/willing to accept a weaker currency as long as the sell-off does not become disorderly.

The Czech National Bank (CNB), meanwhile, falls into the category of central banks not just willing to accept but which would welcome currency weakness, in order to counter persistent disinflation.

Indeed, Governor

Singer recently reiterated his view that interest rates will stay near zero for a "very, very long" time, and

Source: Deutsche Bank

Figure 1: Dramatic differences wrt the 'growth gap' in EMEA (relative to pre-crisis trend)

Source: Deutsche Bank

Figure 2: SA C/A deterioration to lead ZAR even lower?

Source: Deutsche Bank

Figure 3: Persistent Czech disinflation/deflation

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argued that the positive effects from a weaker exchange rate on the economy were outweighing negative effects on demand. Combined with global disinflation, the Czech Republic's large negative output gap continues to advocate further policy easing, with the CNB's focus in turn likely to remain on ways of making policy more expansive.

Meanwhile global disinflation is complicating the policy outlook in much of the rest of EMEA FX. In Israel, Poland and Turkey output gaps are largely non-existent, with domestic credit growth and/or house prices edging higher. In these markets, further rate reductions would not necessarily support demand since the slowdown was/is due to weak sentiment and a poor external environment. Moreover, more rate cuts could also fuel further inflows into the domestic bond market, with foreigners already increasingly long local rates. Here central banks are instead drawn into a growing dilemma: reduce rates and risk adding to domestic imbalances/'pockets' of domestic overheating, or 'accept' that slow growth is primarily due to a poor external backdrop something monetary policy is not equipped to address.

The FX implication: In real terms, we think it is all but inevitable that these currencies will appreciate. What monetary authorities can do is to decide if most of that appreciation will come through nominal appreciation or higher domestic inflation. We maintain long core views in ILS, PLN and TRY.

Trades:

Buy a 3m EURHUF call with strike at 300 and KO at 320 for 55bps. Spot ref 293.60. Vanilla 3m call at 300 costs 1.50%.

Buy a 3m USD/TRY put, with a strike 1.79 for 0.46% of notional. Spot ref 1.81.

Maintain short USD/ILS. We are long a 3m USD/ILS put with a strike at 3.50 for 0.17% (spot ref: 3.68) from the EMEA Daily Compass on March 11

th

. Little to prevent

further grind lower to 2011 lows around 3.40, stop @ 3.73.

Target a continued gradual grind higher in PLN/CZK.

Target 6.400, stop @ 6.10.

Buy a 3m USD/ZAR call with a 9.20 strike and KO at 9.65 for 32bps. Spot ref 9.12. Vanilla 3m call at 300 costs 2.76%.

[Risks: Maximum loss for long option trades is the premium; risks detailed in FX Blueprint report]

Henrik Gullberg, London, 

Source: Deutsche Bank

Source: Deutsche Bank

Figure 6: ILS rallying ahead of C/A improvement

Figure 4: Turkey, credit leading domestic demand higher again.

Source: Deutsche Bank

Figure 5: NBP are cutting, but real rates are PLN supportive.

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Theme #9: Mexican Siesta

堅 With the reduction of global tail risks, EMFX is still attractive as a carry proposition due to elevated interest rate differentials and reduced volatility.

堅 However, differentiation could play a more prominent role as fundamental deterioration gradually spreads from the core to the periphery.

堅 In some cases, government intervention will continue to have an important influence on shortterm FX movements.

堅 We still recommend short EUR/BRL and short EUR/CLP as carry trades. While we remain constructive on MXN in the medium term we recommend tactically taking profits.

The noticeable reduction of Eurozone tail risks has helped EM currencies to become less sensitive to EUR/USD movements. With still relatively better growth perspectives, and in many cases, elevated interest rate differentials, EM currencies maintain some residual allure in this

from the combination of excess global liquidity amid a weakening global environment, in which it is becoming increasingly difficult to find a good story on fundamentals like Mexico's engaging in long-due structural reforms. An anticipated credit upgrade (by Fitch) and political signals for the continuation of the reform agenda pushed the MXN to break the critical 12 level in the last few days. Even though the structural backdrop is sound, we believe that the short-term upside potential of the MXN is now limited. The gradual materialization of the reform agenda and the inevitable recovery in the US will certainly provide some medium-term support for the currency. In the short run, however, heavy positioning and potential transitory increase in risk aversion could induce a temporary break in the appreciation trend.

Figure 1: LatAm and Asia FX on overvaluation territory environment of reduced volatility.

Nevertheless, as the deterioration of fundamentals slowly spreads from the core to the periphery, differentiation begins to play a more prominent role. Despite some overvaluation and, in some cases, deterioration in external accounts, capital inflows on the back of persistent monetary accommodation at the core should help to avoid any important correction, at least in the near term. Aggressive FX intervention could be problematic when central banks are more worried about losing competitiveness amid sputtering economic growth than the potential inflationary effects

of weaker currencies.

The BRL is a clear example of a central bank stepping in front of weakening fundamentals. In our view, the BRL will remain range bound due to official intervention, offering an attractive carry/volatility combination. The lukewarm interest rate hiking cycle, when inflation dynamics are all but comfortable, indirectly imposes greater constraints on acceptable FX depreciation. Even though the FX pass-through is relatively low in Brazil, and fundamental drivers are pointing toward further depreciation, the central bank has already signaled that it does not want to face any risks on the inflation front by promptly intervening when it considers necessary. We thus continue recommending short EUR/BRL to maintain a long BRL exposure as a carry trade (current: 2.60, entry: 2.56, target: 2.45, stop: 2.64).

In contrast, MXN is an example of positive differentiation. Mexican assets continued to benefit

-1.5%  
-1.0%  
-0.5%  
0.0%  
0.5%  
1.0%  
1.5%  
2.0%  
2.5%  
3.0%  
3.5%  
4.0%

REER Misalignment from Fair Value  
Mar-13

EMEA

Source: Deutsche Bank

Asia

Jan-13

Jul-12

LatAm

Figure 2: Still elevated interest rate differentials

0  
1  
2  
3  
4  
5  
6  
7  
8  
9

Policy Interest Rates (%)

Policy Interest Rates

US

Euro Zone

Japan

BRL CLP COP MXN PEN ZAR HUF ILS PLN RUB TRY

Source: Deutsche Bank

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Additionally, after the Central Bank of Mexico suspended the "stabilization" mechanism, we would not be surprised if a new "reserve accumulation" rule is installed if the speed of appreciation increases. While any potential negative effects in the currency will likely be short lived (barring any disappointment in the reform agenda) we have recommended tactically taking profits in our long held short USD/MXN recommendation 2

(closing: 11.96, entry: 12.68).

Investors willing to position for residual upside could benefit from still reduced volatility by entering some bullish options strategies (either 1x2 USD/MXN put spreads or knock-outs).

Andean currencies may suffer relatively more from weakening fundamentals, but we think that the downside may be limited.

In particular, we do not see much upside potential in the CLP, but the combination of elevated yield and relatively low volatility makes it an attractive carry proposition for those willing to position for the global recovery. Nevertheless, as fundamentals gradually weaken, the risk of intervention is also fading away.

The recent correction in commodity prices, especially copper, has driven the CLP away from intervention levels (perceived to be around 460), to the extent that some statements by CB president Vergara vouching for a weaker currency took the market by surprise.

Depending on its persistence, this novel shock to the terms of trade could worsen an already complicated current account balance. Additionally, economic activity seems to be entering the long awaited deceleration path. In our view, the carry trade on EUR/CLP is an attractive alternative to position for loose monetary policies at the core (current: 618, entry: 616, target: 602, stop: 626).

In Colombia, policymakers under-delivered in terms of FX market intervention after signaling that the currency was unacceptably expensive. Nevertheless, some noise remains due to proposed changes in pension funds' minimum return calculation. 3

While it is difficult to determine the potential impact of this measure (early calculations point to a range of 1bn to 5bn of USD demand), this should not have an important direct short-run impact in the COP (beyond market anticipation). With the currency trading around away from the perceived 1800 intervention threshold, we

have recommended taking profits in long USD/COP (closing:1830, entry:1819) and waiting for some potential retracement to re-enter.  
Figure 3: Capital flows help to cover growing current account deficits

-8.0%  
-6.0%  
-4.0%  
-2.0%  
0.0%  
2.0%  
4.0%  
6.0%  
8.0%

Percentage of the GDP

Portfolio Flows

FDI

Current Account

Sum

HUF RUBMXN CZK COP PEN BRL TRY CLP ILS PLN ZAR

Source: Deutsche Bank

The PEN finally suffered a meaningful correction on the back of some news regarding the potential acquisition of a stake in a private oil company by a public one and weakening external accounts. But after briefly touching 2.65, the currency recovered to the 2.60 level. Barring any external surprises, and taking into consideration the new boost to global liquidity, PEN should remain relatively anchored on the back of strong FDI flows but the change in CB intervention is evidently beginning to have the desired effect of increasing the volatility of the currency. Considering the almost non-existent carry, we recommend remaining neutral on USD/PEN.

All in all, the tide is beginning to change in LatAm FX. While some currencies still offer some attractive carry (BRL or even CLP) and other have some (medium-term) upside potential (MXN), gradually weakening fundamentals could increase the relevance of differentiation.

Mauro Roca, New York, +

Jose Vieira, New York, +

2 See Emerging Market Monthly: Flow Motion, May 10 2013.

3 The draft by the Superintendent of Pension Funds suggests it could induce pension funds to follow a minimum share of foreign assets, which is slightly above current portfolios' allocation.

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Theme #10: Turning Up the Volume

堅 Trading volumes, one of the better proxy indicators for realized volatility, have been grinding higher

堅

Increased monetary divergence and abundant global liquidity could see this trend continue further, we like long volatility option plays

Spot trading volumes picking up

Trading volumes and volatility tend to closely track each other and volumes are now on the march. Last month's average Daily Volume (ADV) traded on the EBS platform for spot transactions averaged \$128.3bln a day, or 7% higher than the previous month. Looking at the disaggregated YTD trends, it can be seen that

trading activity has been somewhat suppressed in the euro by the Cypriot banking crisis and broader Euro zone growth uncertainty, though was held up by the yen reflation trade and commodity currencies in Q1 (charts 2-4, relative trading volumes for other currencies are available on request).

Options markets telling a similar story

The options market had signaled a similar pickup in 2013. ADVs for exchange traded options from the CME for April increased by 61% YoY. Excluding yen options, which accounted for two-third of the differences in contracts traded, the largest relative difference was in GBP, more than doubling (143% YoY) since last April despite the lowered spot transactions, followed by AUD (79% YoY) and CAD (16% YoY). Although these contracts represent a small sample of the derivatives market and are corporate biased, we find that these often correlate well to volatilities (chart 5). When taken together with spot data the broader picture emerges - higher overall volumes from the historical lows of 2012, followed by realized volatility.

Monetary divergence should help

In terms of whether the volume uptrend could be sustained in 2013, it appears that this trend is increasingly finding support from monetary divergence (one of the core drivers of FX volatility, in addition to volume) in an abundant global liquidity environment. A number of factors could contribute to this: Abenomics-related investor outflows from Japan have yet to materialize,

although recent net outflows in Toshin investment is suggestive of the initial pickup. RBA's monetary stance remains closely tethered to global growth, while the rest of the dollar bloc and

Scandinavia central bank policies are linked to domestic pressures. Elsewhere in the UK, stagflation remains a prominent issue, further, it is worth noting that almost any policy response could conceivably push volumes higher given that GBP/USD spot volumes experienced one of the sharpest falls YtD within the Deutsche Bank AG/London

The bigger picture: Trading volumes and volatility

100  
150  
200  
250  
300  
50  
0  
2006 2007 2008 2009 2010 2011 2012 2013  
EBS ADV \$bn  
CVIX Index

0  
Source: EBS, Bloomberg Finance LP.

25  
20  
15  
10  
5  
EUR/USD volumes down

10  
2  
3  
4  
5  
6  
7  
8  
9  
Source: EBS, Bloomberg Finance LP.

EURUSD 2W volume  
2W realised volatility (RHS)

10  
12  
14  
16  
18  
2  
4  
6  
8  
Mar-11 Jul-11 Nov-11 Mar-12 Jul-12 Nov-12 Mar-13

But held up by yen  
10  
0

1  
2  
3  
4  
5  
6  
7  
8  
9

Source: EBS, Bloomberg Finance LP.

USDJPY 2W volume

2W realised volatility (RHS)

10

15

20

25

30

0

5

Mar-11 Jul-11 Nov-11 Mar-12 Jul-12 Nov-12 Mar-13

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G10 and hence is susceptible to rebound. Within the Eurozone, another factor to consider is the risk sensitive safe-haven unwinds (mainly from Switzerland and the UK) which could further add to this trend.

The favoured trades

In sum, a further increase in trading volumes and monetary policy divergence could see a broad-based volatility pick-up. Looking across a number of relative value trades, we recommended buying a 6M GBP/USD variance swap struck at 7.75%, and a 3M AUD/USD variance swap (9.00% strike), due to the low transaction volumes in GBP/USD and attractive historical realized volatility levels (see chart 6). Furthermore, these trades benefit from the negative spot-to-empirical volatility skew.

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GBP/USD volumes falling sharply in 2013

10

1

2

3

4

5

6

7

8

9

GBPUSD 2W volume

2W realised volatility (RHS)

10

12

14

2

4

6

8

Mar-11 Jul-11 Nov-11 Mar-12 Jul-12 Nov-12 Mar-13

Source: EBS, Bloomberg Finance LP.

Options market ADVs on the rise

10

GBPUSD 1M options volume

GBP 1M realised volatility (RHS)

8

6

4

2

0

Mar-11 Jul-11 Nov-11 Mar-12 Jul-12 Nov-12 Mar-13

Source: CME group.

10  
12  
0  
2  
4  
6  
8

AUD and GBP realised volatilities are historically cheap

1.5  
2  
0.5  
1  
-0.5  
0  
-1.5  
-1  
-2

6M realised z-score

Source: Bloomberg Finance LP. Z-score values are calculated using three years of historical data.

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EURCAD  
USDCAD  
AUDCAD  
AUDNZD  
AUDUSD  
NZDUSD  
EURUSD  
EURAUD  
USDNOK  
GBPCAD  
GBPUSD  
EURNOK  
USDCHF  
USDSEK  
EURNZD  
EURCHF  
EURSEK  
EURGBP  
AUDJPY  
CADJPY  
GBPJPY  
EURJPY  
USDJPY

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Trade Recommendation Update  
Trades from January 8

th

thth

Trade

Long USD/JPY

Long EUR vs. USD,  
JPY, GBP, CHF basket

Short GBP TWI

Long EUR/CHF

Long AUD/CAD

Long NZD/CAD

Short EUR/SEK

Short EUR/NOK

Long S&P call contingent  
on higher USD/CAD

Short 1Y USD/CNH

Short 1Y USD/PHP

Short S\$NEER

Long RUB/JPY

Long PLN/CZK

Short CAD/MXN

Short EUR/BRL

Short EUR/CLP

Short USD/PEN

3

3

4

4

5

5

6

Theme

1

2

2013 to May 14 2013

Gain/Loss

+17.07%

+5.6% (trailing 100pt stop  
introduced Jan 25 )\*

th

+3.3%

+2.54%

-0.9% (exited 7 May)\*

th

+2.8% (exited 7 May)\*

+0.52%

+0.61%

4.25%

7  
+1.6%  
7  
7  
8  
8  
9  
9  
9  
9  
-1.5%  
-0.8%  
+16.25%  
+1.18%  
+10.48%  
+4.47%  
+1.59%  
-0.61%

No. of winners: 14, No. of losers: 4, Hit Ratio 78%, Average Gain/Loss: +3.8%

\*Without risk management, long EUR vs. basket trade would have made  
+3.9%, long AUD/CAD trade -2.38% and long NZD/CAD +1.32%

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Appendix 1

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