



FX Blueprint

Thin end of the wedge

Theme #1: Holler for dollars: Buy USD vs. NZD, CHF, SGD, buy EUR/USD risk reversal

Theme #2: Play it again, san: Buy USD/JPY

Theme #3: Home Counties trump Mounties: Buy GBP/CAD

Theme #4: Swiss ██████-Out: Sell CHF/NOK

Theme #5: Dingo unchained: Buy AUD/NZD

Theme #6: SEK to score with thaw: Sell EUR/SEK, buy EUR/NOK put

Theme #7: Trend not bitter end: Follow trend in JPY and CAD

Theme #8: Balti not faulty, China still finer: Buy USD/INR put, buy USD/SGD, sell USD/CNH, sell JPY/KRW

Theme #9: Pole dances, TRY trips: Sell EUR/PLN, sell USD/ILS, sell EUR/HUF, sell EUR/RUB, buy USD/TRY

Theme #10: Pesos no prickly pair: Buy MXN vs. USD, CLP, RUB, buy CLP/COP

Theme #11: Vol to roll: Buy EUR/USD FVAs, USD/JPY vol swaps and risk reversals, AUD/USD puts

Research Team

London

Bilal Hafeez

James Malcolm

Henrik Gullberg

George Saravelos

Siddharth Kapoor

Oliver Harvey

Nicholas Weng

New York

Alan Ruskin

Daniel Brehon

Drausio Giacomelli

Guilherme Marone

Singapore

Sameer Goel

Mallika Sachdeva

Perry Kojodjojo

Sydney

Adam Boyton

Tokyo

Taisuke Tanaka

Head of FX Strategy

Bilal Hafeez





Overview

Sticking to regime change; dollar uptrend

2013 marked a fundamental regime change from the crisis-prone 2008-2012 period. The dollar's correlation to equities flipped, the euro-area avoided a crisis and the Fed announced a rolling back, rather than an expansion, of QE. If there was a locus of crisis it was in emerging markets, which felt the shock of Fed taper. This could hint that the 1990s dynamic of first half dollar weakness and developed market crises and second half dollar strength and emerging market crises could be repeating itself.

We therefore remain committed dollar bulls. If last year was all about the US long-end being re-priced on taper, 2014 will mark the re-pricing of the US short-end. December's Fed decision therefore represents only the thin end of the wedge for US interest rate normalization and its effect on markets. This should allow the USD to strengthen against the core European hold-outs to dollar strength, the euro, Swiss franc and pound. The equity flow picture should finally move in favour of the US as slow-moving capital adjusts to the new DM regime. Our favourite expression of dollar strength would be to buy it against the three most over-valued currencies in the world, the New Zealand Dollar, Swiss franc and Singaporean dollar.

Yen trend still down

While we are looking for a reversal in core European currency trends, on the yen we remain firmly in the bearish camp and look for a trend extension from last year. What adds to our confidence is that major yen turns tend to see the yen move by 43% on average, and we're nowhere near such a move yet. On fundamentals, the BoJ is also conspicuous amongst the major central banks in ramping up QE, the basic balance of payments is heavily negative and foreigners have yet to unwind their safe-haven inflows to Japan that were accumulated in the crisis years.

Rest of G10

We underestimated UK growth in 2013, but for 2014 we intend not to miss the changes in the UK economy. The starkest one will likely be the pick-up in inflation, which will only add to expectations of a more hawkish Bank of England. The pipeline for FDI into the UK also looks good. The main weakness for the pound remains the current account deficit, so as a FX trade we like to buy the pound against another current account deficit currency, the Canadian dollar. Helping the bearish CAD case is that expectations of a hawkish Bank of Canada appear overdone given the disconnect between the US and Canadian economy, the likely reversal of the surge of bond inflows seen since 2008 and a turn lower in commodity prices.

A neat way of playing the lead-lag between different segments of the market to the normalization in developed markets is to buy the Norwegian krone and sell the Swiss franc. The former saw a large unwind of post-crisis safe-haven inflows last year, while safe-haven flows to Switzerland have yet to be unwound. We should start to see this happen in 2014. Elsewhere in Europe, the Swedish krona should do well as the Swedish economy finally catches up to German and US economic strength.

Asia-Pac winners and losers

In the Asia-Pacific region, one of the largest cross moves in 2013 was AUD/NZD, but we expect a major reversal this year. Aside from attractive valuations, the rates markets will likely price a more hawkish RBA compared to an already aggressively priced RBNZ. We'd look for the Korean won to outperform the Japanese yen on an improving current account, a pick-up in global growth and a robust domestic financial system. The Singaporean dollar will struggle as valuations are stretched, household debt is elevated and the currency is closely tied to the overall dollar trend. Finally, we'd still buy CNH as the current account, inflation and likely capital inflows are supportive, though we remain wary of the carry unwind dynamics seen in the currency.

Fragile EM; strong EM

The Indian rupee is the only 'fragile five' currency we like to be long. Current account improvement, portfolio inflows after last year's reduction and beneficial policy action adds up to a bullish case. By contrast, the Turkish lira and South African rand should continue to struggle as their current account dynamics are poor. While both Indonesian rupiah and the Brazilian real also suffer from rickety current accounts and domestic dynamics, better valuations and high carry may prevent excessive weakness. Not all EM is bad. We like the Polish zloty, Israeli shekel and Mexican peso. The first on growth, the second on commodities and third on expected FDI and cyclical pick-up.

Last year's Blueprint's Trades

Our trades from the last Blueprint were mixed. Our best trade was going long MXN/BRL (+7.1%) while our worst was being short TRY/ZAR (-3.6%). Overall, 6 of the themes made money while 4 lost money. Overall, our 10 themes made a 0.47% average return.

Bilal Hafeez, London



Theme #1: Holler for dollars

- We expect the Fed and a recovery in US equity inflows to be the two main pillars of support for the dollar in 2014. Buy USD vs. NZD, CHF and SGD on cycle and extreme valuation.
- The Euro-area current account remains supportive for the euro, but tight liquidity is fully priced, the risk of negative rates is material, portfolio inflows are peaking and we are reaching the 20% FX over-valuation bound. Buy 12m EUR/USD 1.40/1.31 risk reversals for zero cost.

Don't Rely on Fed Dovishness

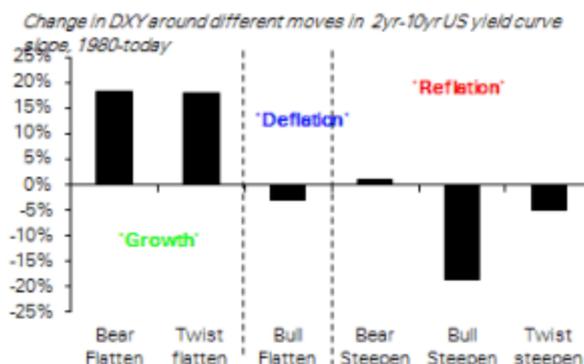
Last year was all about pricing out QE, even though tapering is just beginning. The overwhelming message is that the market front-runs major events, and that the timing of re-pricings is very unpredictable. Just as 2013 was about QE unwinds and higher long-end yields, we think this year will be about the re-pricing of "low for long" and higher short-end yields.

First, US short-end expectations are exceptionally benign. The market is not pricing the first rate hike until Q3 2015, just in line with FOMC projections, and by which time a simple linear extrapolation of the US unemployment rate takes us well below 6%. Second, the US yield curve is close to all-time steepness extremes. On the one hand, this means that the risks are skewed towards flattening, historically one of the most supportive yield curve environments (chart 1). On the other hand, the forwards are extremely high, suggesting that even if these are realized, the US dollar will climb up the carry ladder and drop-out of the bottom-3 yield ranking by year-end.

Foreigners to Come Late to the Party

The second building block to our bullish USD view is our positive outlook on growth and by extension US equity inflows. 2013 stood out for large dollar cash accumulation, on the back of UST liquidation and an adjustment of USD hedge ratios (chart 2). The year has also stood out for record outflows from US equities as Americans have invested large amounts offshore and foreigners have refused to engage in the S&P 500 rally. But looking at relative valuations, outflows have overshoot what is a relatively benign valuation picture for US stocks. Using the average P/E ratio of Hong Kong and UK stocks as a global proxy, we find that valuations are close to the medium-term average (chart 3). The odds therefore seem skewed towards higher equity inflows into the US, which combined with a flatter US curve should see an improvement in portfolio flows that was lagging this year.

Curve Flattening Very Bullish USD



Source: Deutsche Bank, IMF

UST Selling Last Year Offset By Cash and Hedging



Source: Deutsche Bank, Bloomberg Finance LP, Datastream

Equity Valuations Not Extreme, Inflows Should Recover



Source: Deutsche Bank, Bloomberg Finance LP, *we proxy world by the FTSE and Hang Seng



Hard to See EUR Story Get Any Better

The EUR was the star performer in 2013, despite a strong dollar elsewhere. The Euro-area's large current account surplus has helped, which has pushed the basic balance into positive territory and in the past has been associated with broad-based EUR-appreciation. It is for this reason that we expect the EUR to continue to hold up relatively well against many G10 FX. Looking at drivers more relevant to EUR/USD however, the positive factors that have driven strength versus the dollar have peaked.

First, interest rate differentials should turn lower over 2014. Looking across different tenors as well as bond versus implied forward yields, we find that the euro is most sensitive to short-dated forward-implied yields. Last year short-end European yields moved higher not only on the back of ECB LTRO liquidity withdrawal, but as the cross-currency basis also moved back to flat for the first time since 2008 (chart 1). For this year, the risks are skewed the other way. There is less than 200bn EUR of excess liquidity left, EONIA is back to the refi rate and cross-currency basis is flat, so there is no room left for higher short-end European yields. In contrast, the ECB retains a strong easing bias and negative rates or additional liquidity injections remain a strong possibility.

On the flow side, the best is behind us as well. Portfolio inflows into the Euro-area have been dominated by equity, but cumulative purchases are now back to trend and on a relative valuation basis Euro-area equities are at a 10-year high. On the outflows side, European offshore investment remains very pro-cyclical, so an improving cycle should lead to a pick-up in Euro-area outflows (chart 2). Add to that the peak in the current account surplus on the back of recovering domestic demand and the risk of additional ECB easing, and we like buying a 1.42p/1.34c EUR/USD risk reversal for zero cost.

(a) Other Dollar Crosses to Short

Looking outside of EUR/USD, NZD, SGD, and CHF are our top shorts. The Swiss franc is a higher beta version of EUR/USD, with valuations more stretched and greater potential for capital outflows. NZD and SGD are the most over-valued currencies in the world, having lagged all other FX in the USD appreciation that has materialized so far. We therefore like buying USD vs. NZD, CHF and SGD. This basket has a steady ~80% correlation with both the narrow and broad USD trade-weighted indices over the last ten years.

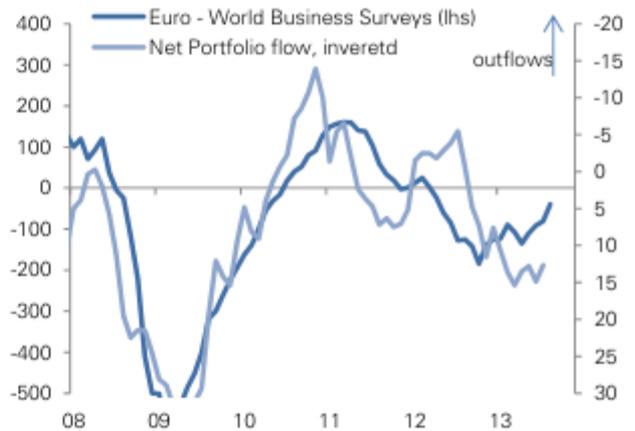
George Saravelos, London, [redacted]
 Bilal Hafeez, London, [redacted]

EUR/USD Still Tracking Rate Differentials



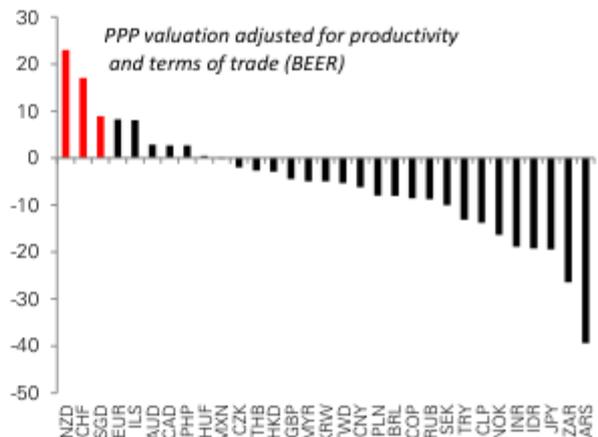
Source: Deutsche Bank, Consensus economics 1-yr ahead expectations

Portfolio Inflows Into Euro-Area Peaked



Source: Deutsche Bank, Bloomberg Finance LP

NZD, SGD, CHF Most Expensive FX in the World



Source: Deutsche Bank, Bloomberg Finance LP



Theme #2: Play it again, san

We always suspected 2013 would be special, and in this publication a year ago urged investors not to wait for a dip in USD/JPY to buy. We highlighted the ongoing deterioration in Japan's balance of payments and huge pent-up energy in risk-averse short-term capital flows post-GFC. We noted how sentiment was shifting but investors seemed overly cautious, and pointed out that trend turns are typically worth 20-25% on a first-year basis – basically what ensued. It didn't matter that we couldn't anticipate the BoJ's radical departure or mixed Fed signals on QE. The associated swings in risk appetite and positioning created some bumps in the road. But a single-minded focus and conviction ultimately paid off big time.

Last year's gain now appears to be this year's pain. The yen posted its largest percentage point loss in 34 years and the Nikkei its biggest rally since 1972. Both go into the New Year on their highs, even as 10Y JGB yields are within 5bp of their end-2012 level. Few savor the prospect of chasing or fighting such markets.

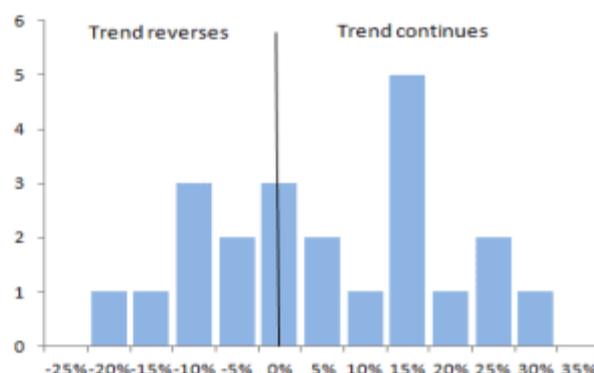
The trend is yet young

Still, outsized (10%+) moves in USD/JPY have extended in the following year twice as often as they retraced: 12 times versus 6 since 1971 (top chart).¹ We think this is a multi-year-trend, and historically such moves have cumulatively been worth 43% (log terms) with a standard deviation of 20%, typically lasting for just over three years (see chart 2). Mechanically speaking, that would take spot to 116 in December, and well through most conceptions of 'fair value.' One should not shy from forecasting such things, because overshoot is very much the norm for FX (chart 3).

Base money differentials matter, will grow

As far as the eye can see policy settings also imply it. Deputy Governor Iwata argued in October that past experience both in the US and Japan show QE works mainly via *changes* in the money stock. (Hence the importance of the BoJ's commitment to doubling the monetary base; he asserts 'the current *level* of the monetary base is irrelevant.') Time lags in transmission mean its impact – including on the yen (top chart over page) -- will build even as the initial expectations boost from 'shock and awe' ebbs. Consequently, markets need not fear the absence of further easing by the Bank if, as seems likely, the consumption tax hike in Q2 passed smoothly. Governor Kuroda has also made clear that Japan's massive money expansion will continue until the 2% core CPI target is not only achieved but deemed secure on a sustainable (medium-term) basis.

What happens in year after big* USD/JPY move?



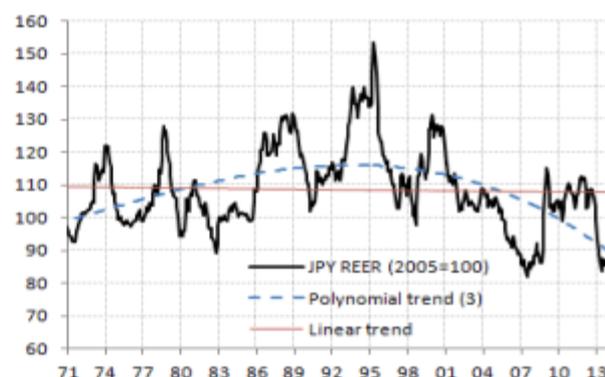
Source: Deutsche Bank, Bloomberg Finance LLP. * defined as a 10%+ absolute log change

Long-term trends in USDJPY

Date	Rate	Log chg	Months
13/01/1971	358.44		
14/03/1973	254.45	-34%	26.0
08/12/1975	306.84	19%	32.8
30/10/1978	177.05	-55%	34.7
04/11/1982	277.65	45%	48.1
25/11/1988	121.10	-83%	72.7
17/04/1990	160.20	28%	16.7
19/04/1995	79.75	-70%	60.1
11/08/1998	147.66	62%	39.7
26/11/1999	101.25	-38%	15.5
31/01/2002	135.15	29%	26.2
17/01/2005	101.69	-28%	35.6
22/06/2007	124.14	20%	29.2
31/10/2011	75.35	-50%	52.3
	Abs avg	43%	37.7
	Stdev	20%	16.7
20/12/2014	116.00	43%	38.6

Source: Deutsche Bank, Bloomberg Finance LLP

Fair value contestable, overshoot is not



Source: Deutsche Bank, Bloomberg Finance LLP

¹ xFor the Nikkei the same stats using a 20% threshold are 5 and 10, i.e., only half as many large moves continue.



External accounts highlight major vulnerability

Japan's balance of payments still promises a brisk tailwind for yen weakness. The trade account has deteriorated further, against most expectations of stabilization. This is overwhelmingly an oil and gas story, though lackluster external shipments and strengthening domestic demand are supplementary issues. Net FDI outflows a similar-sized drag that is only likely to get bigger even if the current account gradually improves. That reflects a massive cost-of-funding advantage spurring catch-up after Japanese corporates have been risk averse and lagged their competitors in overseas expansion over the last two decades. Overall it leaves Japan's 'narrow basic balance' in a pretty neutral state (middle chart).

Cross-border portfolio flows have also had little impact on the yen thus far. Foreign equity inflows seem to have been largely hedged and new bond outflows were limited to banks' offshore treasury activity. Henceforth, real money inflows to Japanese stocks should pick up, but will probably be balanced by growing Japanese outflows into foreign bonds and stocks – the latter encouraged by the new NISA scheme and more aggressive GPIF portfolio adjustment away from JGBS.

That would leave the financial account's short-term loans balance as largest swing factor again. It captures carry trades and foreign asset hedging activity and responds to risk aversion and investor's perception of long-term interest rate differentials. It is several orders of magnitude larger than other BoP components and seen in stock terms retains scope for several hundred billion dollars of yen-selling unwinds (lower chart).

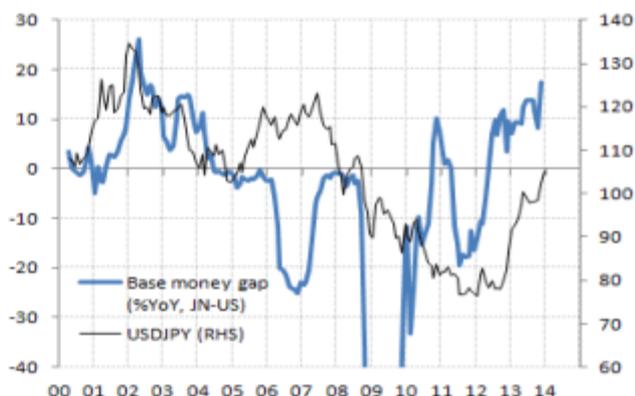
Abenostics abound

Conventional market tops are characterized by hubris in the mainstream which creates unquestioning acceptance of a 'new status quo.' By contrast, most forecasts for Japanese asset prices strike us as intensely conservative as there is tremendous skepticism that the country's long-term prospects have really been changed by the advent of Abenomics.²

Inevitably there will be bumps along the way, and nobody should expect a free lunch. But until the basic tenets of what remains a uniquely favorable backdrop of fundamentals and potential flows are challenged or overshadowed (geopolitics, anyone?), encourage investors to replay last year's template as this year's basic game plan. We expect FX-equity correlations to remain extraordinarily high and volatility to stay elevated. Our end-2014 and 2015 USD/JPY forecasts of 115 and 120 are reiterated with upside risks.

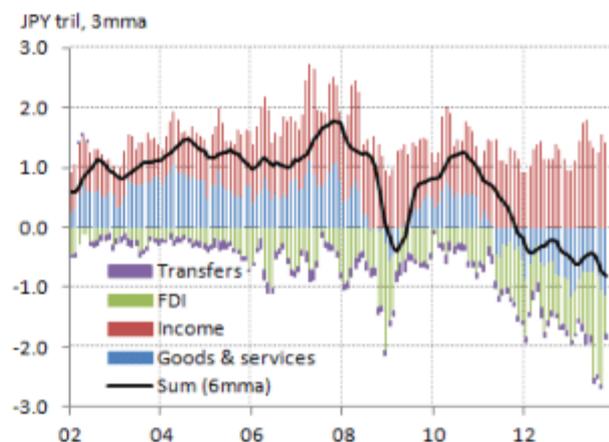
² For a convincing exposition of this assertion, see Kuroda's recent speech: https://www.boj.or.jp/en/announcements/press/koen_2013/data/ko131225a1.pdf

Relative base money growth will only point higher



Source: Deutsche Bank, Bloomberg Finance LP

Narrow basis balance still under pressure



Source: Deutsche Bank, Bloomberg Finance LP

Financial account's 'other investment balance' is key



Source: Deutsche Bank, Bloomberg Finance LP

James Malcolm, London, (+44) 20754 50884
Taisuke Tanaka, Tokyo



Theme #3: – Home Counties trump Mounties

- Inflation risks and potential FDI inflows should keep sterling supported this year, but a widening current account deficit and stronger USD will constrain gains versus the euro and dollar. We are moderately bearish EUR/GBP and GBP/USD, forecasting 80p and 1.54 by end-year respectively.
- As an outright trade we prefer buying GBP versus CAD, on which we are more bearish. It remains vulnerable to an equally-large current account deficit, QE-flow unwinds and unwinding internal imbalances.

The UK domestic demand cycle has kicked in quicker, stronger and more sustainably than anticipated. We see inflation and FDI inflows as being the major source of upside risk for GBP next year.

Inflation, not deflation to be theme in 2014

Last year was all about UK growth expectations. This year, the risk is attention turns to prices. First, even though recent inflation prints have surprised to the downside, pipeline pressure is building. Productivity is not recovering as quickly as the BoE is expecting, leading to a much faster than expected drop in the unemployment rate. In turn, wage inflation could accelerate sharply in 2014 (chart 1). Second, the starting point of inflation is much higher in the UK than the rest of G10. Any turn in the trend will focus minds much more quickly than elsewhere. With the first BoE rate hike still only priced for mid-2015 (a bit earlier than the Fed), there is plenty of potential for near-term yield support as price pressure builds.

Outside of monetary policy, FDI is another source of support. Excluding the Verizon-Vodafone deal, UK inbound ██████ has been muted by pre-crisis standards. But UK deal-flow is pro-cyclical, tracking the broad trends in equities and global ██████ transactions well. Our equity analysts are positive on both this year. Add to that the UK government’s increasing dedication to attracting foreign investment – particularly into the publicly-owned banks – (chart 2) and FDI stands out as a potential additional source of support for GBP in 2014.

Current Account Deficit Will Constrain Gains vs. EUR

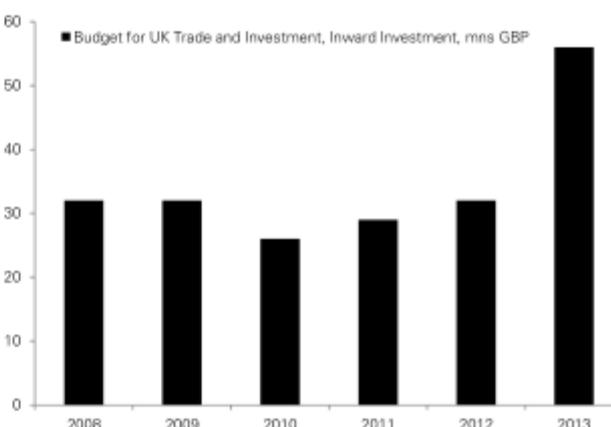
On the flipside, the UK recovery is happening for the “wrong” reasons. Domestic demand, not exports are driving the cycle. The current account deficit is deteriorating and stands in contrast to the US and Euro-area. This goes a long way to explain the lag in EUR/GBP versus cyclical indicators (chart 3). This is reflected in our conservative EUR/GBP forecasts: we see a slow grind lower to 0.80 by the end of the year, with GBP/USD revisiting the low 1.50s on the back of a strong USD.

Inflation Could Be Here Sooner Than Market Expects



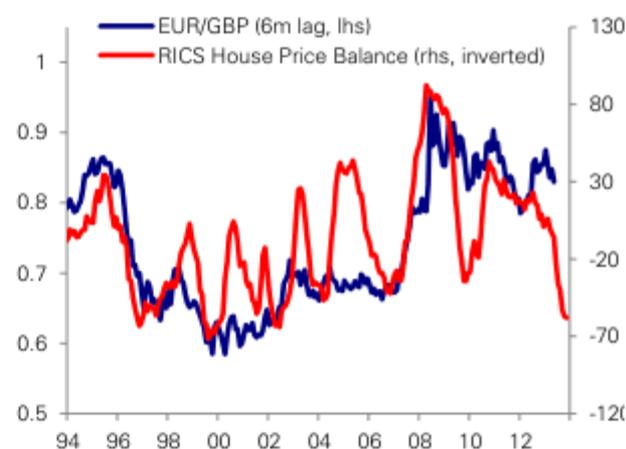
Source: Global Markets Research, IMF

FDI Upside Risk To GBP Next Year



Source: Deutsche Bank, Bloomberg Finance LLP

EUR/GBP Holding Up Better on Back of Flow



Source: Deutsche Bank, Bloomberg Finance LLP



CAD Flow Picture Very Negative

We are more bearish CAD. Speculative shorts are building, but on the portfolio flow side, the balance of payments is characterized by a large overhang of fixed income inflow positions as a by-product of Fed QE (chart 4). Canada benefitted from close to 280bn of "excess" inflows over the 2010-2013, which have plugged a sharply wider current account deficit similar in size to the UK. The UK, in contrast, has suffered from a lack of inflows in recent years (chart 4). While FDI and underweight fixed income positions have the potential to "plug" the UK deficit, the risks appear skewed the other way in Canada.

On the monetary policy side, Canada doesn't appear well placed to benefit from an improving US cycle either. Rate expectations are already running ahead of the Fed and BoE by a quarter, and given the BoC's renewed dovishness there is limited potential of these happening sooner. Indeed, the correlation between US and Canadian data surprises has dropped off sharply over the last few years, pointing to the divergent trends in local housing markets and domestic leverage. To boot, Canadian terms of trade have clearly peaked (chart 6), with the currency moderately expensive versus non-energy commodity prices and supply glut in North America oil production providing an additional headwind.

Big picture, GBP/CAD is a dollar-neutral cross, with correlations with other USD crosses all lying below 50% over 1-3 year time horizons and zero correlation with the broad USD TWI since 1995. The relative performance between UK financials and Canadian stocks does a decent job of explaining big picture turns since the early 1990s. The cross remains more than 20% below its pre-crisis average suggesting plenty of potential for upside as the respective domestic stories play out.

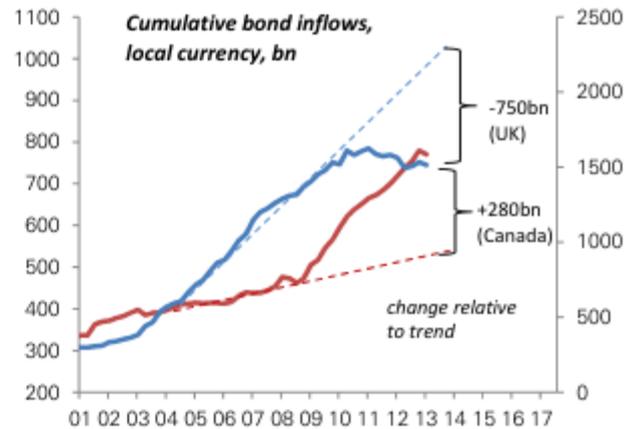
George Saravelos, London, [REDACTED]
Oliver Harvey, London, [REDACTED]

GBP/CAD a Beta Neutral Cross



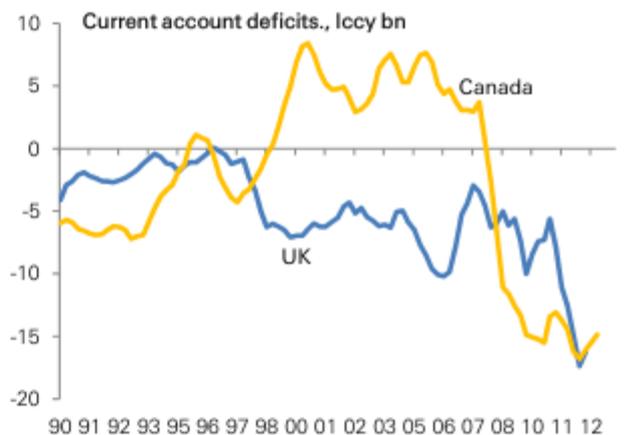
Source: Deutsche Bank

UK Inflows Could Improve, Opposite of Canada



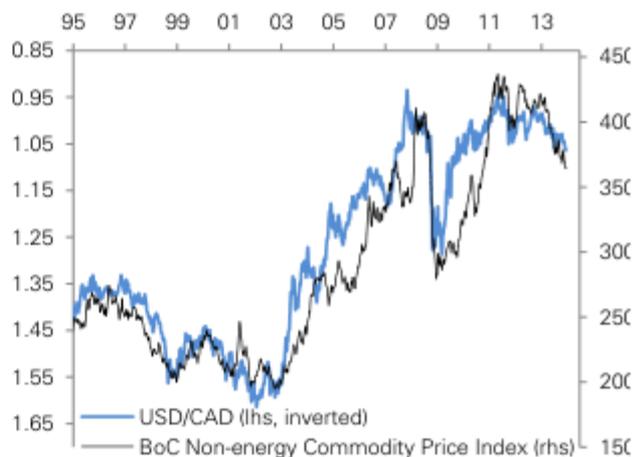
Source: Global Markets Research, IMF

GBP/CAD 'Current Account Neutral' Cross



Source: Deutsche Bank, Bloomberg Finance LLP

USD/CAD Following Commodity Prices Lower



Source: Deutsche Bank, Bloomberg Finance LLP



Theme #4: – Swiss ██████ –out

We can think of three reasons to go short CHF/NOK.

1. The relative cycle is supportive of rate differentials.

Inflation is at a much higher starting point in Norway than in Switzerland, leaving the Norges Bank much less room to manoeuvre than the SNB in the event of upside surprises to import prices or stronger European growth. Market pricing in Norway has evolved rapidly from three months ago, with the first hike now expected in Q3 2015 rather than Q1 2014, more or less in line with the Norges' own projections. NOK is also much better placed to benefit from a stronger US cycle with one of the strongest correlations to US growth, and CHF one of the weakest. One risk is house prices, which have risen precipitately in Norway over the last five years, a sharp reversal of which could weigh on domestic demand and prompt Norges' dovishness. We think the risks of this are slim, however, (see theme #6), and moderate falls will be welcomed by the central bank as skimming froth from the market.

2. Swiss safe-haven unwind should follow Norway's.

Like Switzerland, Norway experienced large-scale safe haven inflows as a consequence of the financial crisis, helping to pause customary current account surplus recycling. In the latter's case, these inflows have largely reversed, to the tune of NOK 190bn on a 2y/2y basis). This has been one of the primary recent drags on the krone, but appears to have largely run its course, in contrast to Switzerland where it has yet to begin.

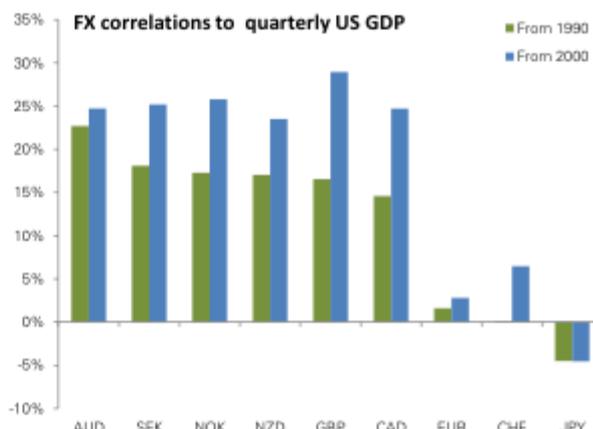
3. CHF also more vulnerable to domestic outflows.

As well as the foreign inflow, Norway and Switzerland both saw significant repatriation of domestic assets from abroad. Again, this flow has long turned in Norway but not yet in Switzerland. One possible catalyst will be stronger price pressures next year on the back of more robust growth. This should erode real returns Swiss domestics have enjoyed on already some of the most expensive assets in the world. Historically, Swiss capital flows have been counter-cyclically related to prices (chart 3). Indeed, CHF performance closely tracked changes in real yields last year. By contrast, while conventional Norwegian outflows have resumed, NOK is more protected by surplus savings being invested by the oil fund.

Along with the above, CHF/NOK appears fundamentally misaligned with traditional drivers like oil/gold. Finally, the trade benefits from being USD and EUR/USD neutral (with a 15 year correlation of 16% and -11% respectively).

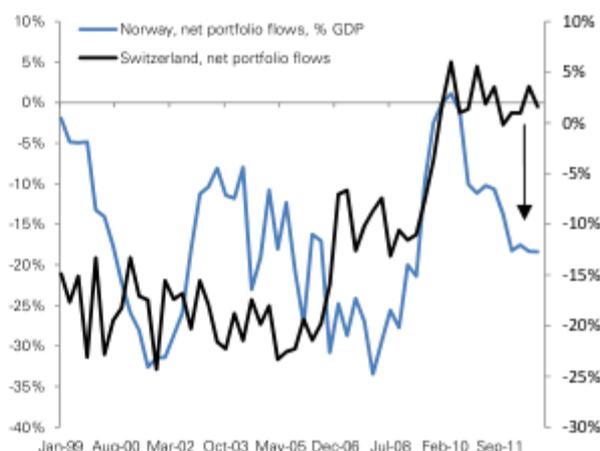
Oliver Harvey, London, ██████

NOK one of highest betas to US cycle, CHF lowest



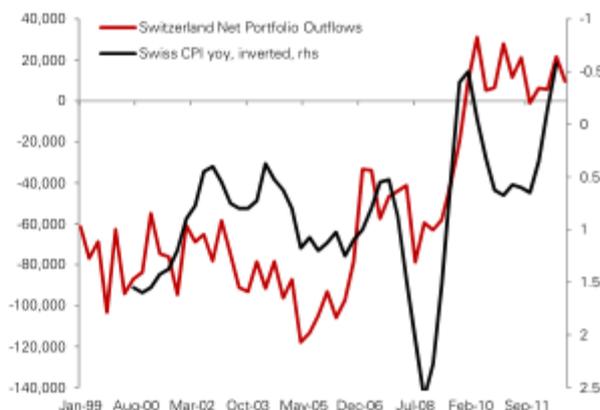
Source: Deutsche Bank, Bloomberg Finance LP

Norway flow reversal nearly done, Swiss yet to begin



Source: Deutsche Bank, Bloomberg Finance LP

More Swiss inflation means CHF weakness



Source: Deutsche Bank, Bloomberg Finance LP



Theme #5: Dingo unchained

- 2013 saw the largest fall in AUD/NZD in over 28 years. Behind the fall in the cross was a significant move in interest rate differentials.
- With the cross near record lows we think the risk / reward from here favors AUD/NZD upside. As a result we would be long AUD/NZD at current levels.

As shown in Figure 1, 2013 marked the 'worst' year for the AUD/NZD cross since at least 1986. Interestingly, in prior years when the cross has fallen over 10% the subsequent year sees a significant bounce back. The 13.5% fall in 1987 to 1.0959 was followed by a bounce of 23.5% in 1988; while the 12.7% fall in 2002 (to 1.0727) saw a 6.7% bounce in the following year. With the cross ending 2013 at 1.0850 after a 14.0% decline, history would suggest some likelihood of a significant move higher in AUD/NZD over 2014.

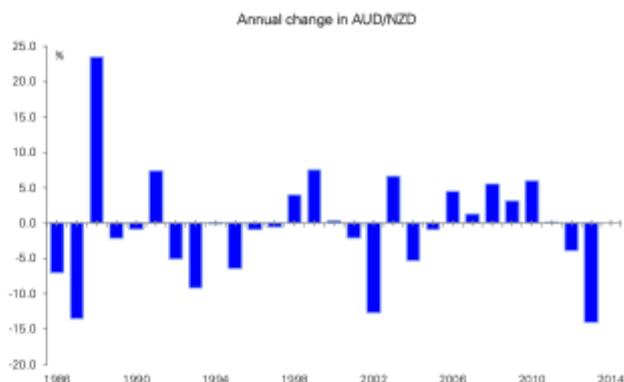
Of course there is much more to FX than history. From a more fundamental perspective we see a number of reasons to expect a move higher in the AUD/NZD cross through the course of 2014.

The first is valuation. As Figure 2 shows, the AUD/NZD cross has traditionally found a base around 1.05 (with just below here therefore likely to serve as a good level to set any stop). Our valuation metrics (as published in *Exchange Rate Perspectives*) also find NZD the most over-valued of the G10 currencies on a PPP and BEER basis. The NZD is around 33% 'expensive' on a PPP basis, versus the AUD which is 26% 'expensive'. On a BEER basis the NZD is 22% 'expensive', versus the AUD which is only 5% above 'fair-value'.

As far as 'big picture' drivers of the AUD/NZD cross are concerned, it is hard to go past interest rate differentials as shown in Figure 3. Looking a little more closely at the last few data points in that chart it also appears that AUD/NZD has 'overshot' interest rate differentials to the downside. Indeed, the current interest rate differential would appear to be more consistent with the cross trading around 1.13 versus its current level. We should not, of course, rule out interest rate differentials 'catching up' to the cross. That would require, however, markets to price even more tightening for the RBNZ, and/or easing from the RBA.

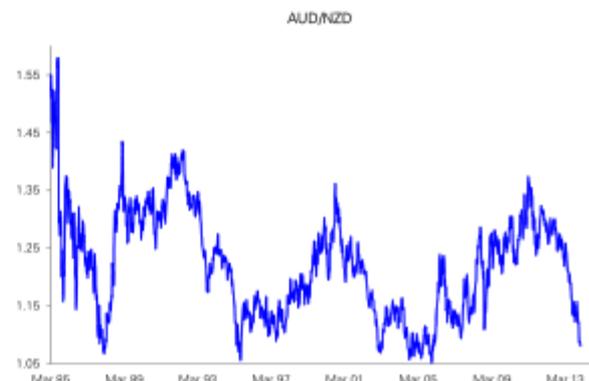
On the outlook for the kiwi central bank our central view remains that we will see 75bps of policy tightening over the course of 2014. Market pricing is a little more aggressive than that, with a little over 100bps of hikes priced for 2014. On the RBA the market is essentially priced for no change in rates in Australia over the coming year – something consistent

Figure 1: Large declines in AUD/NZD usually see bounces



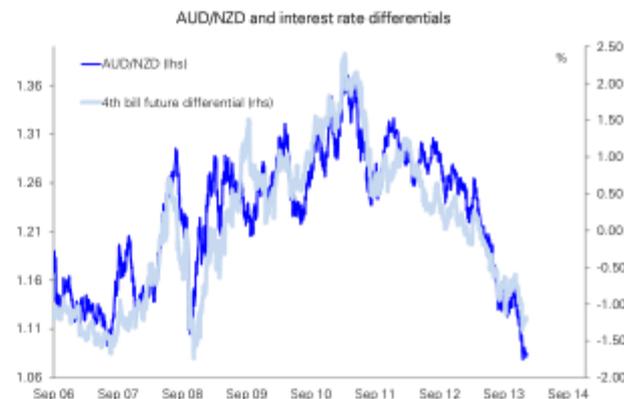
Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: The cross is also at an extreme



Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: Interest rate differentials are the key driver



Source: Deutsche Bank, Bloomberg Finance LP



with our own view. That said, the Australian rates market has a tendency to sell off considerably once it becomes clear that an easing cycle in Australia is over. (Figure 4). As to what might spark such a sell-off; an improvement in the labor market stands as one clear possibility. RBA action – and market pricing for the RBA – is often driven by conditions in the labor market. As Figure 5 shows, our tracking of 11 different monthly indicators of labor demand and sentiment suggests a pick-up in the pace of employment growth over coming months. All up, we therefore see the risks being skewed toward a narrowing of the front end interest rate differential between Australian and New Zealand, something that would be supportive of our long AUD/NZD stance.

Finally, it would be remiss of us not to consider the outlook for China when discussing any view on AUD, either against the USD or crosses. Our house view remains quite constructive on China, with GDP growth expected by DB to continue its recovery towards 8.6% in 2014. Despite the modest decline in the December PMI reading, our local economists note that the PMI's Q4 average reached 51.3, 0.5pts above the Q3 average which suggests that Q4 IP and GDP growth are unlikely to have decelerated from that seen in Q3. Looking forward, stronger external demand should see an acceleration of GDP growth over 2014. If this view on China is correct, then it should be supportive of the AUD given the tendency of the market to see the Aussie as a China proxy (see Figure 6).

We are; however, a little cautious about overplaying any impact that stronger growth in China may have on the AUD, given that Australia's key commodity export to China (iron ore) is likely to be moving into an oversupply situation this year. We should note here that while many analysts focus heavily on relative commodity prices when considering the AUD/NZD cross; we are inclined to think that the true importance of commodity prices is captured through the influence on interest rate differentials. In other words, we take the view that the impact of divergent commodity price trends is likely to have already been captured by interest rate differentials.

All up, some recovery following the sharp fall in 2013, the favorable valuation backdrop, and the risk that the interest rate differential moves in the AUD's favor over coming months has us long AUD/NZD.

Adam Boyton, Sydney, [REDACTED]

Figure 4: Once the RBA is 'done' easing, Australian rates usually (and often incorrectly) price a lot of hikes



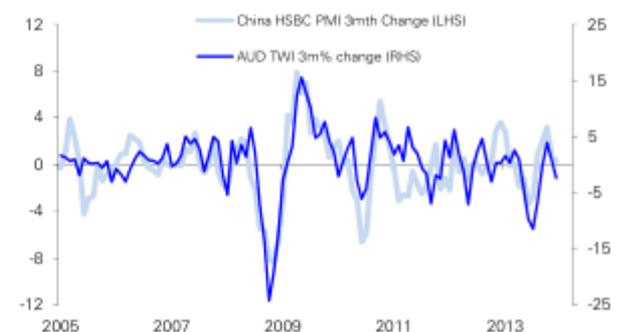
Source: Deutsche Bank, Bloomberg Finance LP

Figure 5: The labor market might be the catalyst



Source: Deutsche Bank, Bloomberg Finance LP, AIG, ANZ, NAB, DEWR, WBC-MI

Figure 6: Stronger growth in China could also help AUD



Source: Deutsche Bank, Bloomberg Finance LP



Theme #6: SEK to score with thaw

- The krona is not the main culprit of a lukewarm Swedish recovery. Rather the latter reflects a broader trend of DMs losing market share to EMs.
- But global recovery still positive for the high beta Swedish economy and SEK. Moreover, global growth is equity supportive which is bullish SEK.

Swedish growth numbers have disappointed repeatedly over the past 6-9 months, causing market participants to scale down their expectations for growth and policy normalization. This has in turn resulted in a gradual weakening of the SEK from around 8.40 vs. the EUR back in March/April last year to current levels around 8.90. Disappointing growth numbers are a reflection of subdued industrial activity, which in a small open economy like Sweden has also been weighing on consumer sentiment, job growth and domestic activity.

However, blaming the disappointing industrial activity on a strong krona is difficult when the currency is undervalued on all metrics (PPP, BEER, FEER), and the SEK REER not historically strong. Instead, the country breakdown of imports in Germany and Norway, Sweden's key export markets, shows developed markets continuing to lose market share to developing countries, suggesting the latter can now compete in major Swedish export areas like "machinery & transport equipment" where they previously have been small players. This is backed up when looking at hard data, with rising German imports mainly benefitting Central and Eastern Europe. The CE-4 market share of total German imports post-crisis has risen by 50% to around 12% of total. Meanwhile Norwegian imports are showing a similar but broader trend towards developing countries (including Asia) and away from the rest of the Nordics, Eurozone, US and UK. This of course very much goes against the popular view that DM imports might be decoupling from EM exports.

Nonetheless, whilst losing market share means an ongoing global recovery will be less of a driver of Swedish GDP growth, it will still be growth supportive, and given the degree of openness in the Swedish economy, more so than in most of the rest of G10. This is SEK positive, partly because it will mean market participants will have to re-assess the policy outlook, but more because it should translate into similar growth in corporate revenues. With Swedish stock valuations only in line with the longer-term average, this should also translate into higher equity prices. Global growth and higher equity prices are typically associated with a stronger SEK, and are factors more important than [an orderly] turnaround in the interest rate cycle in the US. Target a gradual move to 8.55 in EUR/SEK, with a stop @ 9.15. In options a3m EUR/SEK 8.65 put costs an indicative 52bp, and can be largely financed by selling a 3m EUR/SEK call with a strike around the more than 2y highs @ 9.15.

Figure 1: Albeit with a lag, the Swedish PMI is likely to follow USD and DEM PMIs higher



Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: Exports of Goods & Services, Percent of GDP



Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: SEK trade-weighted (TCW) & the US ISM



Source: Deutsche Bank, Bloomberg Finance LP



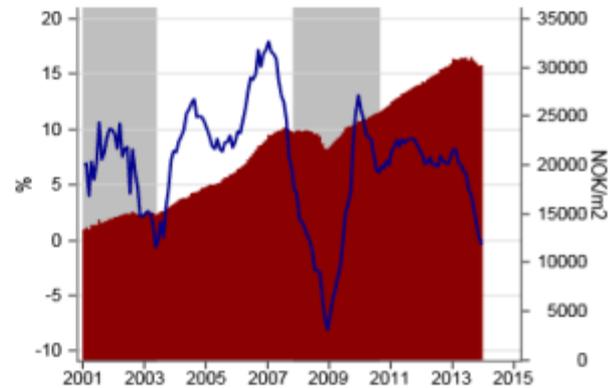
- Norges bank to continue to balance falling house prices vs. sticky CPI.
- NOK cheap, but investors wary of jumping back in unless/until Norges Bank and/or crude provide support supportive.

In Norway, the mainland economy has been growing around 2.0-2.5% YoY for most of the last couple of years, with the recent PMI and manufacturing output suggestive of continuing improvement going forward. Norges Bank's focus is balancing the declining housing market against sticky inflation at the consumer level. With house prices having slowed to largely flat on the year, representing a 3-3.5% drop from the peak in Q3 last year, and headline CPI back in line with the Bank's 2.5% target (from 3.2% YoY in August), Norges Bank is erring on the dovish side, arguing that the rise in [core] inflation is transitory. Indeed, according to the Bank's projections, core inflation is expected to drift back up over the next few months, reaching a peak just above the inflation target of 2.6% in April/May, before dropping down and remaining just below 2% up until the end of 2015. House prices meanwhile, are seen slowing further, to -2.5% to -3.0% YoY in H1 2014, before returning to positive YoY growth in early 2015.

The risk to Norges Banks's finely balanced outlook for inflation and housing is twofold. First is a scenario in which past and current FX weakness feeds through to imported inflation, thus preventing core from moderating in line with Norges forecasts. If the Bank then feels compelled to hike rates at a time when house prices already are declining, that would exacerbate the decline and not be currency supportive. An alternative risk scenario is if the house price falls feeds on themselves. With policy rates already as low as 1.50%, and with core CPI projected at or above target over the next 3-6 months, there would be limited scope for policy to provide a stopgap. While the above scenarios are not our baseline, they will continue to be a key factor in the Norges Bank's decision-making process, with monetary policy likely to be stuck between a fear of adding to the decline in house prices on one hand and sticky inflation on the other. Meanwhile crude is likely to continue to flatline in the relatively tight \$90 to \$110 range of the past few years.

Monetary policy and crude are therefore unlikely to provide much in terms of direction in the NOK. However, given recent depreciation cannot be explained by fundamentals, with the Norwegian unit arguably oversold even when taking into account the market's now very dovish outlook for Norges Bank policy and flat oil prices, we are cautiously constructive. On balance we anticipate very gradual downside in EUR/NOK from current levels. A 3m EUR/NOK put @ 8.25 costs an indicative 76bp. Alternatively, finance it by selling a 3m EUR/NOK 8.65 call.

Figure 4: Norway, Real Estate Prices, All Residential Buildings, Total & YoY



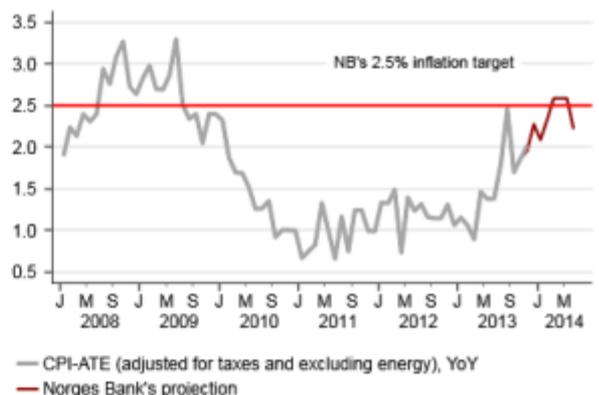
Source: Deutsche Bank, NEF

Figure 5: EUR/NOK and Crude oil



Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: Core inflation - actual and Norges Bank's projection



Source: Deutsche Bank, Bloomberg Finance LP

Henrik Gullberg, London, [REDACTED] 1947



Theme #7: Trend no bitter end

In 2007 we replicated a RBA study that claimed non-commercial “profit seekers” made money on their IMM positions at the expense of commercial “liquidity seekers”.³ The striking conclusion is that currency speculators generally know the correct direction of G5 currencies and investors can profit from knowing their positions (although these signals are less useful in practice since IMM data is lagged three days).

In a sense, money is “left on the table” by commercial foreign exchange users, and to a lesser extent by foreign bond and equity investors, which can be earned by non-commercial actors that provide liquidity to currency markets. These profit seekers collect FX risk premia in the same manner Keynes first identified when describing risk transfer in commodity markets.⁴

Profit Seekers Made Money in Every Year since 2003

By our calculations, non-commercial positions made money in every year since data was first released in 1993, mainly at the expense of commercial users (dealers also made money).⁵ In recent years profits have come from timing big EUR/USD moves (2010-11) and catching last year’s USD/JPY rise. These numbers more closely resemble pre-crisis profits than the outsize gain in 2008 (reflecting higher FX volatility) and the nearly flat 2009 period (probably due to an unexpected GBP rebound).

IS Eroded As Speculators Accumulate Positions?

Our analysis rests on the crucial assumption that profit seekers accumulate positions over the course of the week at the average price. By contrast, live trading metrics such as the Parker Index of currency manager returns show a loss since 2011 as currency volatility has overwhelmed macro trends (with the exception of USD/JPY in 2013) even as the correlation between weekly IMM and Parker returns remains positive. It is possible that intra-week volatility causes profit seekers (especially momentum traders) to “buy high and sell low” relative to VWAP and that IMM is eroded when currencies trade in a choppy range. Fortunately for investors FX volatility continues to fall and promising trends (JPY, CAD) have emerged.

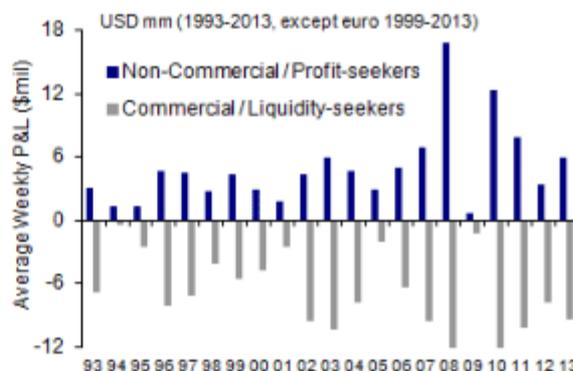
Daniel Brehon, New York

³ See Kearns and Manners (2004), “The profitability of Speculators in Currency Futures Markets”, Reserve Bank of Australia; and Bilal Hafeez (2007), “Currency Markets: Is Money Left On the Table?”

⁴ Keynes, (1930). “Treatise on Money”. London: Macmillan,

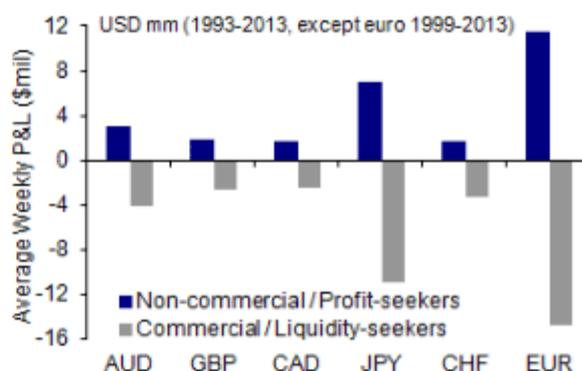
⁵ We calculate weekly by determining the notional value of positions on Tuesday and assuming longs and shorts are accumulated (or squared) at the average price over the course of the week.

Figure 1: Absolute (\$mil) of Profit-Seekers and Liquidity-Seekers Using G5 IMM Data (1993-2013)



Source: Deutsche Bank, Bloomberg Finance LLP

Figure 2: Speculators had the correct EUR positions in 2010-11 and a large JPY short in 2013



Source: Deutsche Bank, Bloomberg Finance LLP

Figure 3: The Parker Index of currency manager returns has lagged IMM in recent years despite continued positive correlation between them



Source: Deutsche Bank, Bloomberg Finance LLP



Theme #8: Balti not faulty, China yet finer

2013 saw Asian FX fracture into a North and South complex. Relative sensitivity to the yen, the EM debt bubble, and the developed world equity/growth cycle all served to discriminate the two intra-regional groups at different points during the year. Ultimately, the North emerged fairly unscathed, while the South cheapened significantly. Indeed, much of South Asia FX still faces a host of challenges from political instability (THB), offshore debt holding overhang and weak commodity prices (MYR, IDR). However we refrain here from adding to shorts against most of this group, given a mix of large valuation adjustments, expensive carry, and/or improving policy responses that is shifting the risk-reward. We concentrate instead on currencies like INR where fundamentals have improved sufficiently to go long, and on SGD, where persistent overvaluation and exposure to a broadening in USD strength out to low-yielders favors a short bias. In North Asia, we stay short USD/CNH, but are mindful of the large build up in positioning. We favor a short JPY/KRW position to express our positive view on Korean fundamentals.

The rupee has had a makeover

After spending three years as one of the world's worst performing currencies, the rupee should fare better in 2014 for three main reasons. First, India has seen large improvement in her external balances. The trade deficit, which is the only driver of the CAD, has almost halved from its peak. While gold import compression has driven most of the trade improvement and could face slippage, exports and services have also been bright spots. Second, even as India's portfolio flow dependence is falling, both debt and equity flows could see positive swings. After aggressive debt outflows between May-Nov 2013, offshore holdings have fallen to "core" levels; indeed, foreigners returned as buyers in December. With large unallocated limits, a more positive duration view, and the possibility of index inclusion and/or Euroclearability, India could attract money. The key swing factor for equities will be general elections in May. To be sure, this is a binary event; but hopes of a pro-growth stable coalition could boost inflows in the run-up to elections. Third, RBI's swap activities have been a success adding to reserves. Concerns about oil USD demand appear exaggerated, and its return to the market in November did not raise volatility. Majority of their obligations to buy USD ahead of imminent swap repayments have been met. We are long a 6M USD/INR 62 put with an RKO at 57.

SGD no longer king

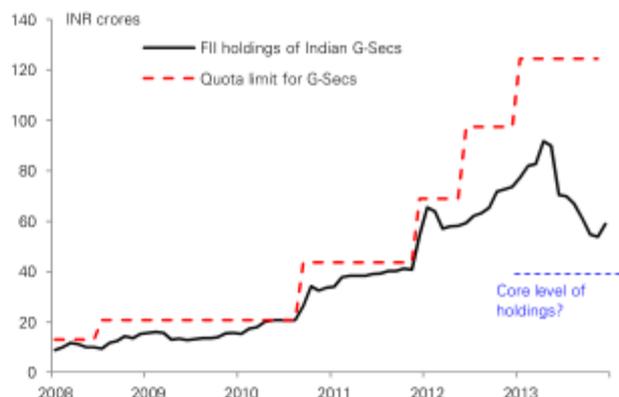
We have seen a long USD/SGD view as a good 'long-haul' trade to play for USD strength and US yield repricing. However, the lesson from 2013 was that USD/SGD took its cues more from the USD/G10 TWI than its USD/Asia peers which often behaved

Indian exports have been a bright spot in Asia



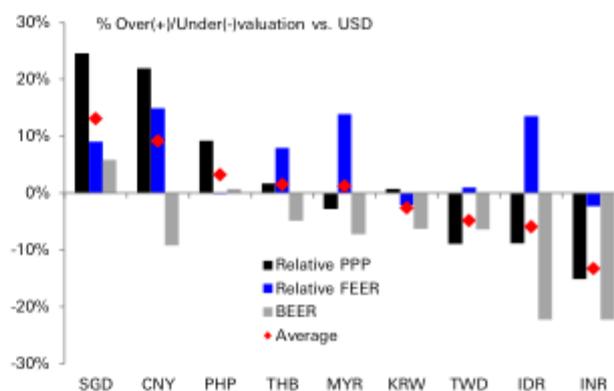
Source: Deutsche Bank, Bloomberg Finance LP

The outlook for debt flows is asymmetric in India



Source: Deutsche Bank, CDSL, SEBI

Broad consensus on SGD's overvaluation



Source: Deutsche Bank, Bloomberg Finance LP, CEIC



differently. Our view that USD strength will broaden out to G10 low-yielders like EUR, and continue to gain ground against the JPY is thus an important tailwind for USD/SGD. SGD is also one of the most overvalued currencies globally, with consensus across a broad range of models. Moreover, domestic vulnerabilities have built up in Singapore over the QE years from high household debt to bubbly property prices that leave her exposed to inevitable short-end rates normalization. We are long USD/SGD looking for a move above 1.30 this year.

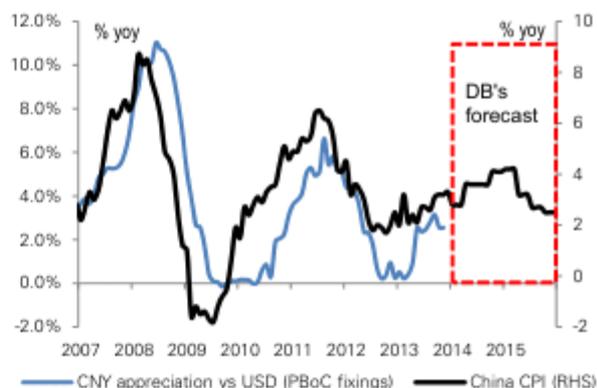
RMB appreciation remains in play

We expect RMB appreciation to persist in 2014 despite a strong USD environment. With global growth gradually recovering and Asian exports likely to catch up, we look for a healthy current account surplus for China (\$220bn, 2.2% GDP). In addition, expectations of further increases in offshore investment quotas (i.e. RQFII) on the back of capital account liberalization, should mean that portfolio inflows pick up, putting further appreciation pressure on RMB. With the appreciation trend intact, and carry potentially set to become more attractive as authorities push forward with interest rate liberalization; we are likely to see speculative flows into China persist. Inflation will be a key driver of the pace at which this appreciation is permitted by the authorities. The main risk to our view is from the sizeable nature of short USD positioning in this pair – both in the offshore and onshore markets. In the event of weaker economic data driven by tight monetary conditions and reforms, we could see a pickup in volatility. For now though, we stay short 12M USD/CNH with a target of 5.95.

JPY/KRW heading back to single-digits

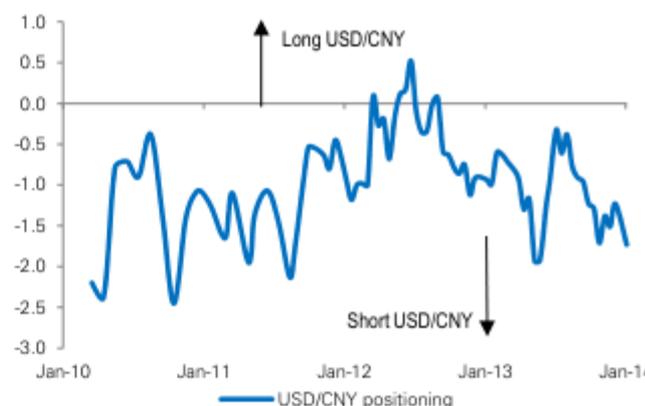
The won's fate in 2014 remains a struggle between strong underlying fundamentals, and the defensiveness of the central bank in the face of concerns about a weakening yen. The fundamental story is supported by 1) continuing improvement in the current account; 2) high leverage to the global growth/trade upturn; and 3) strength of the domestic financial system as a result of the macro prudential policies implemented post-2008. Given the strength in export orders in construction and shipping and the resulting hedging pressure, as well as the record levels of USD deposits held by Korean corporates, there is likely to be persistent pressure on the currency to appreciate. BoK on the other hand is unlikely to abandon its conservative stance on the won, given concerns about upside to exports being competed away by a cheapening yen. We have seen such concerns drive the policy response function in 2009, in mid-2012 and again last year. Given the expected strength in the broader dollar, and the BoK's reaction function, we see better risk reward to express the view of fundamental strength in KRW via JPY/KRW downside. We target a clean break of the psychological 10 level, with a near-term target of 9.75.

Inflation trajectory to guide USD/CNY fixings



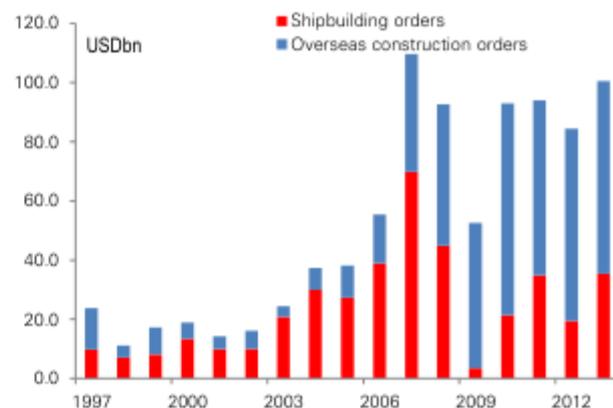
Source: Deutsche Bank, CEIC

Positioning is short USD/CNY and likely more in CNH



Source: Deutsche Bank, Reuters poll

Korean shipping and construction orders remain strong



Source: Deutsche Bank, CEIC

Mallika Sachdeva, Singapore, +65 6423 8947

Perry Kojodjogo, Hong Kong, +852 2203 6153



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

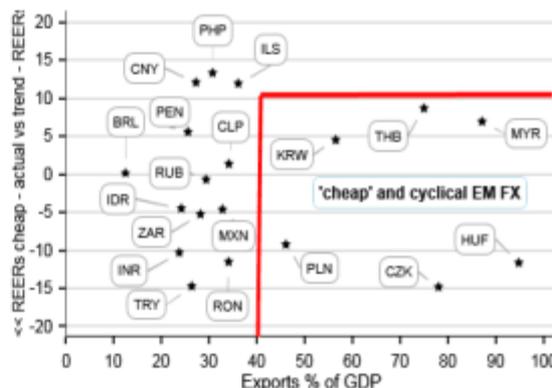
Growth is picking up. Poland will benefit not only from strong German demand but also a healthy banking system, with domestic credit now grinding higher. Any sign of demand-led inflation will make the NBP uncomfortable so Poland is likely to be one of the front-runners in this tightening cycle. Also, 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)



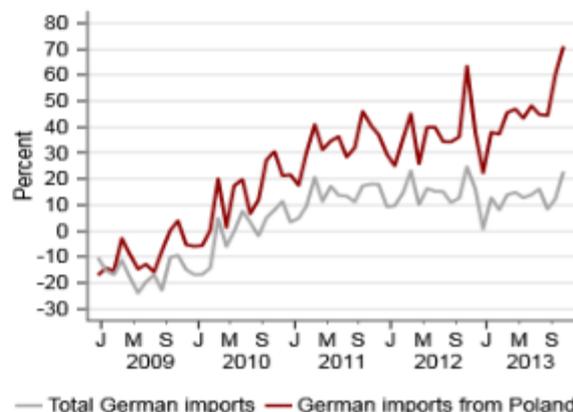
Source: Deutsche Bank, Bloomberg Finance LP

Cheap & cyclical EM FX



Source: Deutsche Bank, Bloomberg Finance LP

Polish competitiveness helping market share



Source: Deutsche Bank, Bloomberg Finance LP



History provides us with good templates of economies where oil/gas findings resulted in a significant contribution to the BoP and persistent appreciation (NLG & NOK). Also, BoI governor Flug acknowledged as much on Nov 19th when she argued that the current intervention policies are only “acting to give the business sector time to adjust to the trends derived from [long term economic] forces”. *Buy ILS vs USD, targeting 3.35 with a stop @ 3.5750.*

Having reduced rates aggressively since mid 2012, the NBH adopted a more conservative policy approach, with financial stability moving back up the agenda. Real yields remain among the most attractive globally. Retail sales are growing YoY, the PMI firmly is in expansionary territory, unemployment has fallen and the C/A balance is in surplus. *Be long HUF vs EUR, targeting 290 with a stop @ 305.*

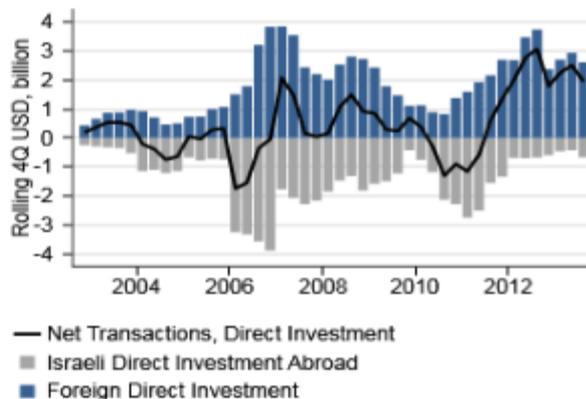
While the ruble trend has been highly negative over the past few months, favourable seasonality going into Feb/Mar and bearish positioning make us cautiously constructive around current levels. The relatively low balance sheet risk, attractive carry, CBR’s strong anti-inflationary policy stance, and a robust surplus in the goods balance are other supportive factors. *Buy RUB vs. EUR, targeting 43.10, stop @ 45.90.*

ZAR is cheap but arguably not yet sufficiently, and in the absence of any meaningful improvement in the external balances there is scope for further weakening in a rising interest rate environment. C/A fundability remains the key risk, with exports so far showing few signs of improvement from past currency weakness. Even so, there has been some response to stronger demand from abroad and with global growth continuing to improve this should be reflected in gradual rand stabilization. Key levels are: a) 10.85, where price action according to our metrics would be severely stretched and thus raise the probability of a significant snap-back, and b) 10.40, which represents the lower end of the more recent channel. *On a break of either, target a 3% move in USD/ZAR to 10.50 or 10.10 respectively.*

Turkey’s lira remains vulnerable to a tightening of global liquidity due to its sizeable C/A deficits and/or short-term external debt repayments in an environment of rising global yields. Add to that ongoing domestic political uncertainty and TRY should remain under pressure. *Stay long USD/TRY, target 2.250, stopping at 2.1350.*

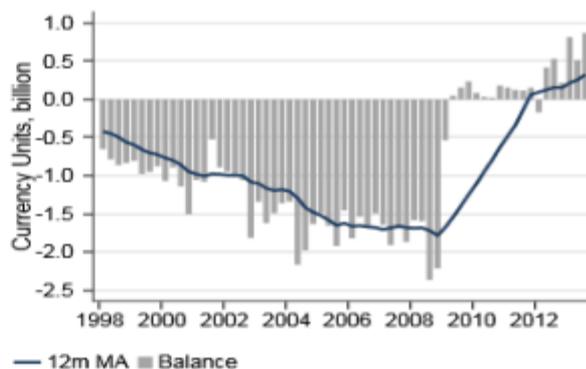
Henrik Gullberg, London, +(44) 20754 59847

Strong and persistent FDI inflows into Israel



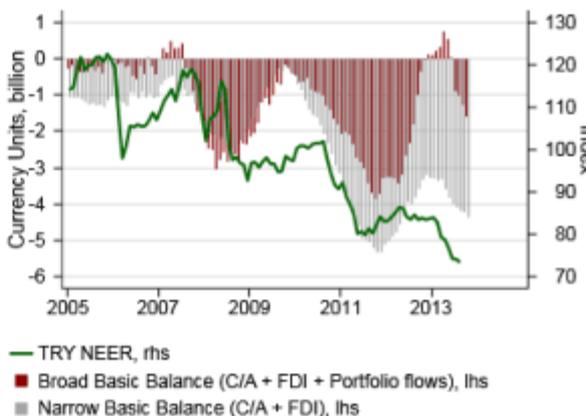
Source: Deutsche Bank, Bloomberg Finance LP

Hungary C/A in surplus and growing



Source: Deutsche Bank, Bloomberg Finance LP

Turkey’s narrow & broad basic balances (12m rolling)



Source: Deutsche Bank, Bloomberg Finance LP



Theme #10: Pesos no prickly pair

- Cyclical Lat Am FX offers value in an environment of strong US/global growth.
- Stay long MXN vs. USD, COP and RUB on back of FDI inflow pre-pricing and oil production prospects. Long CLP/COP should benefit from terms of trade and political uncertainty in the latter. Stay cautious on BRL because of structural concerns, weak fundamentals and less BCB intervention appetite.

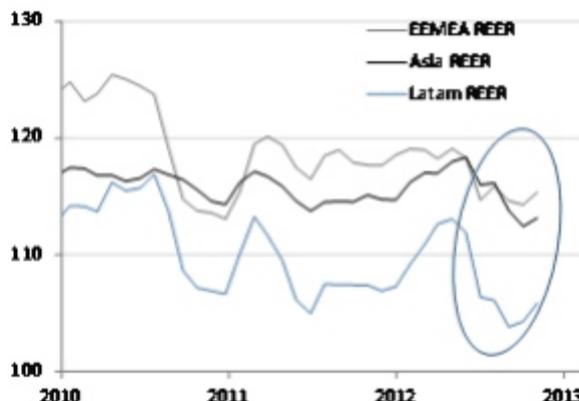
After 2013's *annus horribilis*, we anticipate Lat Am FX to offer more value over the coming months. The reaction to December's Fed tapering decision suggests markets have fully incorporated expectations of higher long-end US yields. Going forward, we expect currency performance to be closer to fundamentals and less sensitive to the re-pricing in US rates. That said, successful forward guidance, at least in the short term, is a necessary condition for Lat Am performance in 2014. Growth surprises in the US should then in principle benefit currencies with strong export exposures that have already seen considerable adjustment. From this point of view, CLP, PEN and MXN have the highest betas to the global cycle with the latter particularly well placed to benefit from an upturn in the US economy.

Despite more favorable valuations and possible upturn in some of the local economies, structural concerns and balance of payments dynamics remain headwinds for the region as whole. Where export-orientated growth is more elusive, such as in the more closed economies of Brazil and Colombia, domestic demand may not be sufficient to provide attractive rates of return for foreign investment against a backdrop of US rate normalization. At the same time, export growth will be insufficient to close current account deficits. Renewed falls in commodity prices also present a risk for COP, PEN and CLP, although our base case is that better China growth will provide a boost for the latter.

Turning to individual currencies, we remain bullish on the Mexican peso. First, the energy reform passed in December is more ambitious than expected. Licenses and production sharing contracts, rather than the originally proposed profit sharing regime, increase the potential for FDI inflows. While we do not expect the first inflows until 2015, academic research into flows and the relationship between exchange rates and commodity prices suggest that FX markets may 'pre-price' expected capital flows meaning that continued momentum over secondary legislation will be more important than deal announcements *per se*.⁶ It is worth noting that Mexico has foregone the bonanza in FDI.

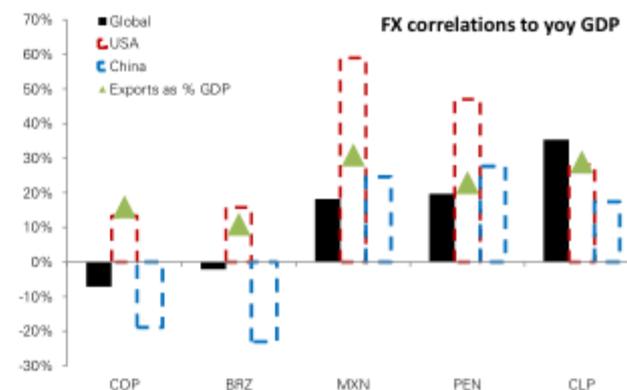
⁶ See, for example, DB Commodities Quarterly, *Trading industrial metals ratios in a rising USD environment*, Xiao Fu, June 2013.

A better starting point for valuations



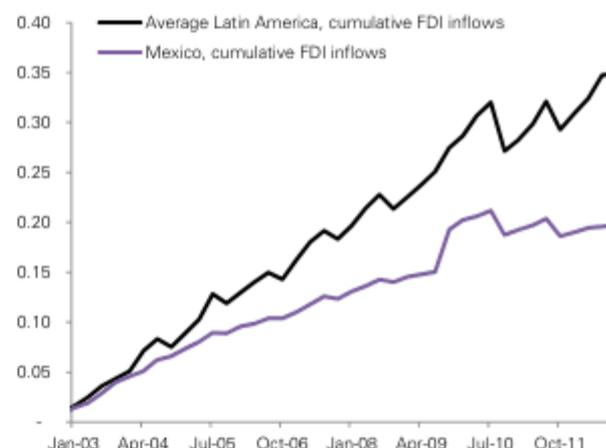
Source: Deutsche Bank

CLP to benefit most from global growth bounce



Source: Deutsche Bank

Mexico should begin to close FDI gap



Source: Deutsche Bank, Bloomberg Finance LP



enjoyed by its neighbors over the past decade, a result of onerous regulation and weak productivity growth. We anticipate that this FDI gap will begin to close as 2013's reforms bear fruit.

Second, growth is set to be sharply stronger. Our economist has noted that the main reason behind the disappointing performance of Mexican manufacturing relative to the US this year was the lack of growth in high-value sectors to which the Mexican economy has become more sensitive. We do not anticipate this dynamic to continue. At the same time, the drag caused by last year's lack of government spending will end, with the IMF showing Mexico to possess one of the most positive fiscal impulses in EM next year. We therefore like to be long MXN against USD, targeting 12.50. Given the positive outlook for oil production and FDI, we also like playing MXN strength against other oil producers, in particular COP and RUB.

In contrast, the Brazilian real will likely face another challenging year. The current account has only improved modestly in spite of significant FX adjustment and the income balance remains a concern as a decade of large scale FDI inflows are 'paid back.' Moreover, while FX reserve coverage remains ample, the BCB has signaled it will adopt a more cautious stance over FX intervention over the course of the coming six months, as the central bank's swap book grows to up to 25% of total reserves. Finally, the upcoming election is unlikely to result an improvement in positive sentiment around the government's fiscal policies. We expect USD/BRL to trade in a high (2.25-2.50) range, ending the year at 2.40.

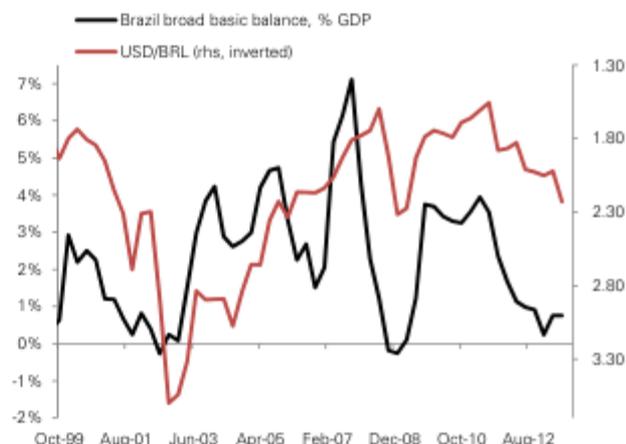
Regarding the Andeans, we foresee a difficult period for COP and a better backdrop for CLP and PEN. With respect to COP, the upcoming election year also represents a concern, with President Santos facing a strong challenge from the populist right. There are also question marks surrounding the outcome of peace negotiations with the FARC. Exports are expected to suffer as Venezuela's economic crises drags on. Combined with a muted outlook for oil prices, this suggests the COP will likely be the best short among Lat Am currencies next year. We like to play this versus a rather depressed CLP, which should benefit from a possible upturn in China and possible lower oil prices. PEN should also be helped by the uptick in growth (especially after last year's slowdown) and spillover effects from the expected increase in copper production.

Altogether we like to be long MXN vs COP and RUB, long CLP vs COP, long PEN and see BRL underperforming the forwards while possibly trading in a 2.25-2.50 range.

Guilherme Marone, New York, [REDACTED]

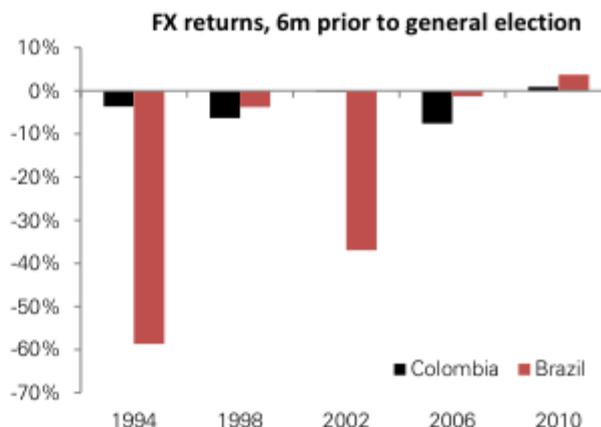
Oliver Harvey, London, [REDACTED]

Basic balance suggests still scope for BRL downside



Source: Deutsche Bank, Bloomberg Finance LP

Elections not good for BRL and COP



Source: Deutsche Bank, Bloomberg Finance LP



Theme #11: Vol to roll

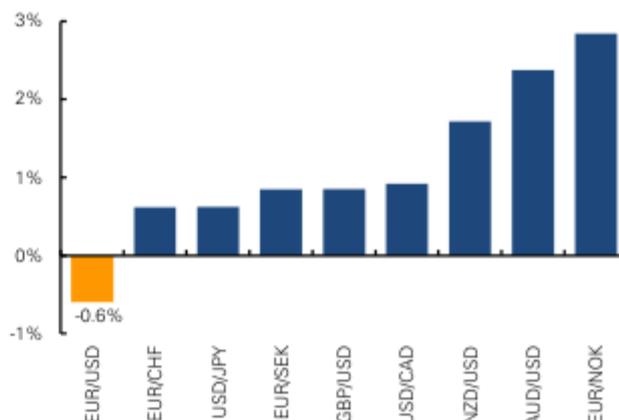
- We see relative value opportunities in vol surface distortions; specifically buying EUR/USD FVAs, USD/JPY vol swaps and risk reversals, plus AUD/USD puts cheapened with AUD/CAD KOs

Trade 1: Hedge against event-risks with EUR/USD FVAs: Despite potential catalysts such as the US fiscal impasse and EU political uncertainty, EUR/USD implied vol remained subdued in 2013, and was predominantly driven instead by rates volatility. With the USD10Y Treasury note yield expected to touch 4% on growth acceleration this year EUR/USD implieds should be supported. Correspondingly, this suggests that owning EUR/USD remains a useful blunt hedge against tail risks with significant impact on rates volatility in the US and EU. Potential catalysts include growth momentum deceleration in the US, an excessive rates rise following the tapering process forcing the Fed to backpedal, and ECB easing in Q1 on falling inflation expectations. Currently, outright long the vol swap is less attractive given implieds have been well bid since December. Instead, consider owing a 3M in 6M EUR/USD FVA at ~8.50% on the USD vega notional to exploit the flatness of the implied volatility slope (chart 2).

Trade 2: Long JPY volatility on model valuation: Another approach in analyzing volatilities relates to longer-term model valuations. On our framework, USD/JPY 1Y realized vol is estimated at 10.6% (chart 3) but could potentially trend higher. Among its core parameters are the Japanese current account (+ve beta), commodity prices (-ve beta), US core inflation (-ve beta) and the cyclically adjusted P/E ratio for US equities (+ve beta). With the falls in commodities and some eventual improvement in the current account and a higher P/E ratio as the base case for this year, risks to volatility tilt to the upside. Consider owning a 1Y vol swap, offered at ~10.70% of USD notional.

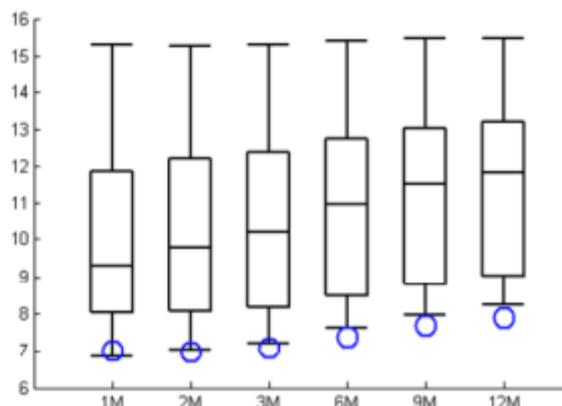
Note also that while we have been consistent advocates of AUD and CAD vol over the past year on our analysis of volumes, policy divergence and growth rebalancing these arguments are gradually becoming less attractive from a valuation perspective. Switching to long USD/JPY vol would seem to offer a better risk/reward payoff.

Changes in 3M implieds over the past year



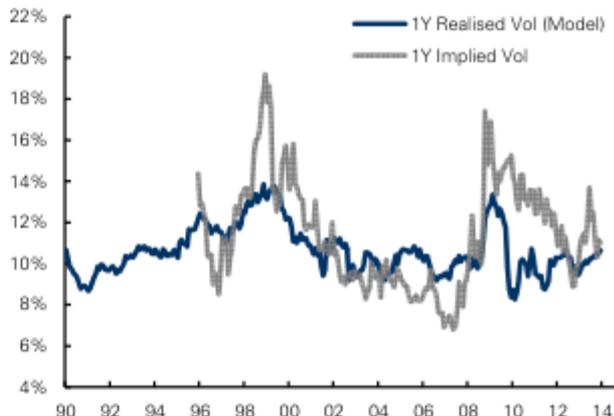
Source: Deutsche Bank, Bloomberg Finance LP

Vol slope for EUR/USD is historically flat



Source: Bloomberg Finance LP. Chart edges correspond to the 5%, 25%, 50%, 75% and 95% percentiles over the past three years, blue circles represent current values.

Modeled 1Y realized USD/JPY vol versus implied



Source: Deutsche Bank, Bloomberg Finance LP



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.

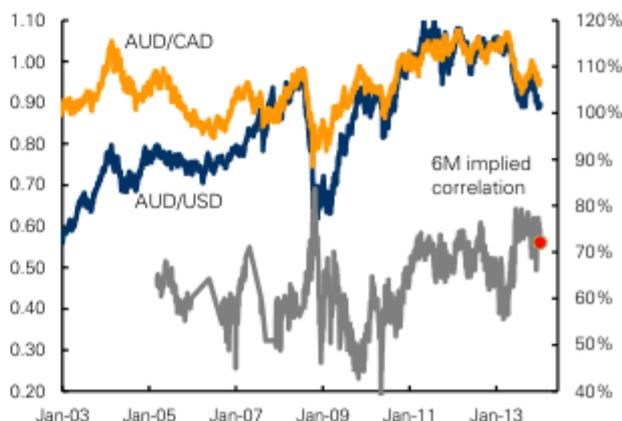
*Nicholas Weng, London, (+44) 20754 76615
James Malcolm, London, (+44) 20754 50884*

Weekly change in spot versus risk reversal at extreme



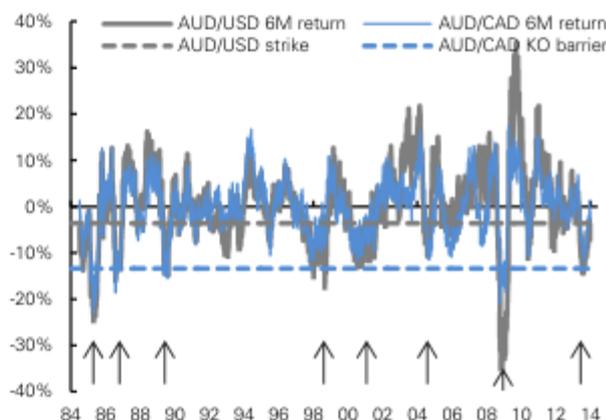
Source: BBG. dspot/drr=rolling 3M change in weekly spot return/change in weekly 6M risk reversal

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



Trade Recommendation Update

Trades from September 24- 2013 to January 8- 2014

Trade	Theme	Gain/Loss on trades	Gain/Loss on theme
Long USD TWI	1	1.14%	0.33%
Short EUR/USD	1	-0.48%	
Long USD calls vs. MYR, BRL, TRY	2	1.05%	1.05%
Long USD/JPY	3	6.3%	6.3%
Short CHF TWI	4	0.5%	
Short GBP/USD	4	-2.5%	-1%
Long AUD/NZD	5	-3.6 (-4.49%)%	-3.6%
Short EUR/NOK	6	-1.1% (-3.2%)*	
Short EUR/SEK	6	-1.6% (-2.19%)	-1.35%
Short SGD/INR	7	-1% (5%)	
Long USD/MYR calls	7	2.9%	0.95%
Long PLN/CZK	8	7%	
Long PLN/HUF	8	1.1%	
Long RUB vs. basket	8	-1.5% (-4.37%)	
Short TRY/ZAR	8	-3.6% (1.83%)	0.75%
Long MXN/BRL	9	7.14%	
Long CLP/COP	9	-2.44%	2.35%
Long EUR/USD vol swap	10	-1.3%	
Long GBP/USD vol swap	10	-0.8%	-0.8%
No. of winners:		8	6
No. of losers:		11	4
Hit Ratio		42%	60%,
Average gain/loss:		0.38%	0.47%

*Indicates ■ without risk management



Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at [REDACTED]

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Bilal Hafeez/Alan Ruskin/Henrik Gullberg/James Malcolm/Sameer Goel



Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at [REDACTED] under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at [REDACTED].

3. Country-Specific Disclosures

Australia and New Zealand: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act and New Zealand Financial Advisors Act respectively.

Brazil: The views expressed above accurately reflect personal views of the authors about the subject company(ies) and its(their) securities, including in relation to Deutsche Bank. The compensation of the equity research analyst(s) is indirectly affected by revenues deriving from the business and financial transactions of Deutsche Bank. In cases where at least one Brazil based analyst (identified by a phone number starting with +55 country code) has taken part in the preparation of this research report, the Brazil based analyst whose name appears first assumes primary responsibility for its content from a Brazilian regulatory perspective and for its compliance with CVM Instruction # 483.

EU countries: Disclosures relating to our obligations under MiFID can be found at [REDACTED]

Japan: Disclosures under the Financial Instruments and Exchange Law: Company name - Deutsche Securities Inc. Registration number - Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, Type II Financial Instruments Firms Association, The Financial Futures Association of Japan, Japan Investment Advisers Association. This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation. "Moody's", "Standard & Poor's", and "Fitch" mentioned in this report are not registered credit rating agencies in Japan unless "Japan" or "Nippon" is specifically designated in the name of the entity.

Malaysia: Deutsche Bank AG and/or its affiliate(s) may maintain positions in the securities referred to herein and may from time to time offer those securities for purchase or may have an interest to purchase such securities. Deutsche Bank may engage in transactions in a manner inconsistent with the views discussed herein.

Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.

Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates - these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.



David Folkerts-Landau
Group Chief Economist
Member of the Group Executive Committee

Guy Ashton
Global Chief Operating Officer
Research

Marcel Cassard
Global Head
FICC Research & Global Macro Economics

Richard Smith and Steve Pollard
Co-Global Heads
Equity Research

Michael Spencer
Regional Head
Asia Pacific Research

Ralf Hoffmann
Regional Head
Deutsche Bank Research, Germany

Andreas Neubauer
Regional Head
Equity Research, Germany

Steve Pollard
Regional Head
Americas Research

International Locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West, Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) [REDACTED]

Global Disclaimer

The information and opinions in this report were prepared by Deutsche Bank AG or one of its affiliates (collectively "Deutsche Bank"). The information herein is believed to be reliable and has been obtained from public sources believed to be reliable. Deutsche Bank makes no representation as to the accuracy or completeness of such information.

Deutsche Bank may engage in securities transactions, on a proprietary basis or otherwise, in a manner inconsistent with the view taken in this research report. In addition, others within Deutsche Bank, including strategists and sales staff, may take a view that is inconsistent with that taken in this research report.

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of Deutsche Bank and are subject to change without notice. Deutsche Bank has no obligation to update, modify or amend this report or to otherwise notify a recipient thereof in the event that any opinion, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. Prices and availability of financial instruments are subject to change without notice. This report is provided for informational purposes only. It is not an offer or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy. Target prices are inherently imprecise and a product of the analyst judgement.

Foreign exchange transactions carry risk and may not be appropriate for all clients. Participants in foreign exchange transactions may incur risks arising from several factors, including the following: 1) foreign exchange rates can be volatile and are subject to large fluctuations, 2) the value of currencies may be affected by numerous market factors, including world and national economic, political and regulatory events, events in equity and bond markets and changes in interest rates and 3) currencies may be subject to devaluation or government imposed exchange controls which could negatively affect the value of the currency. Clients are encouraged to make their own informed investment and/or trading decisions. Past performance is not necessarily indicative of future results. Deutsche Bank may with respect to securities covered by this report, sell to or buy from customers on a principal basis, and consider this report in deciding to trade on a proprietary basis.

Derivative transactions involve numerous risks including, among others, market, counterparty default and illiquidity risk. The appropriateness or otherwise of these products for use by investors is dependent on the investors' own circumstances including their tax position, their regulatory environment and the nature of their other assets and liabilities and as such investors should take expert legal and financial advice before entering into any transaction similar to or inspired by the contents of this publication. Trading in options involves risk and is not suitable for all investors. Prior to buying or selling an option investors must review the "Characteristics and Risks of Standardized Options," at [REDACTED]. If you are unable to access the website please contact Deutsche Bank AG at [REDACTED] for a copy of this important document.

The risk of loss in futures trading and options, foreign or domestic, can be substantial. As a result of the high degree of leverage obtainable in futures and options trading, losses may be incurred that are greater than the amount of funds initially deposited.

Unless governing law provides otherwise, all transactions should be executed through the Deutsche Bank entity in the investor's home jurisdiction. In the U.S. this report is approved and/or distributed by Deutsche Bank Securities Inc., a member of the NYSE, the NASD, NFA and SIPC. In Germany this report is approved and/or communicated by Deutsche Bank AG Frankfurt authorized by the BaFin. In the United Kingdom this report is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange and regulated by the Financial Conduct Authority for the conduct of investment business in the UK and authorized by the BaFin. This report is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. This report is distributed in Singapore by Deutsche Bank AG, Singapore Branch or Deutsche Securities Asia Limited, Singapore Branch (One Raffles Quay #18-00 South Tower Singapore 048583, +65 6423 8001), and recipients in Singapore of this report are to contact Deutsche Bank AG, Singapore Branch or Deutsche Securities Asia Limited, Singapore Branch in respect of any matters arising from, or in connection with, this report. Where this report is issued or promulgated in Singapore to a person who is not an accredited investor, expert investor or institutional investor (as defined in the applicable Singapore laws and regulations), Deutsche Bank AG, Singapore Branch or Deutsche Securities Asia Limited, Singapore Branch accepts legal responsibility to such person for the contents of this report. In Japan this report is approved and/or distributed by Deutsche Securities Inc. The information contained in this report does not constitute the provision of investment advice. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product. Deutsche Bank AG Johannesburg is incorporated in the Federal Republic of Germany (Branch Register Number in South Africa: 1998/003298/10). Additional information relative to securities, other financial products or issuers discussed in this report is available upon request. This report may not be reproduced, distributed or published by any person for any purpose without Deutsche Bank's prior written consent. Please cite source when quoting.

Copyright © 2014 Deutsche Bank AG