CitiFX Strategy Weekly

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In this week's issue:

- **G10 Focus – Reserve managers: Re-enter the dragons**
  - The diversification trade has been quiet for a year. Slower reserve inflows and a stronger USD made sitting on reserves an attractive strategy in H2 2011 and H1 2012. But this is now changing. QE3 and other G4 liquidity expansion will accelerate reserve growth, and overweight USD positions in reserve portfolios are not attractive when USD is under pressure. If reserves growth picks up, we expect reserve managers to reluctantly buy some EUR to offset rising USD reserves concentration
- **G10 Focus – Japan's political inclination towards a weaker JPY**
  - We believe the LDP will win the upcoming general election, ousting the DPJ from power. An LDP administration will be more interested than the DPJ in additional monetary easing to depreciate the JPY. This is likely regardless who wins the LDP's presidential race.
- **G10 – Wind down to the 4th quarter**
  - Markets remain modestly buoyant in the wake of OMT and QE3 but it is unclear how behind-benchmark investors will react in to quarter end and beyond. Key themes for the immediate week include upcoming Asian data, the Spanish election and looking ahead to the October ECB.
- **Asia — Laggards to catch up**
  - Asian currencies should rally in the near-term with the latest monetary easing by G3 central banks. We prefer to play the catch-up of the laggards, by going short USDCNH and long INR against KRW and SGD. We are largely neutral on Asian rates but still hold our long Korean bond position to hedge the geopolitical risk.
- **CEEMEA – Review of Hungary and Czech Republic**
  - The Hungarian central bank will continue with gradual interest rate reductions, with the next rate cut possible already next week (25 September). We have scaled back our expectations that a deal with the Troika will be struck in early 2013. Hence we see limited value in Hungarian assets now, with perhaps the exception of the belly of the curve where the spreads over swaps are about 55bps (17As).
- **Latam – Taking a breather**
  - MXN strength should resume once positioning gets cleaner. Intervention in Chile not imminent. We think there is room for points to move lower in Colombia. To watch Banxico minutes tomorrow for concerns that led to slightly hawkish stance in minutes, but Banxico unlikely to move either way in foreseeable future.

G10 Focus – Reserve managers: Re-enter the dragons

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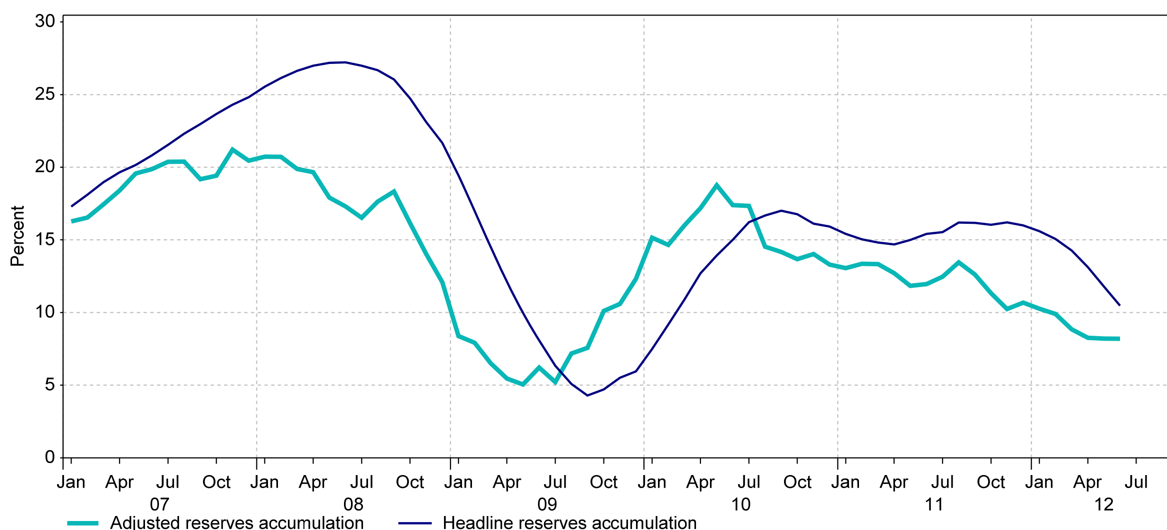
- **The diversification trade has been quiet for a year**
- **Slower reserve inflows and a stronger USD made sitting on reserves an attractive strategy in H2 2011 and H1 2012**
- **QE3 and other G4 liquidity expansion will accelerate reserve growth**
- **Overweight USD positions in reserve portfolios are not attractive when USD is under pressure**
- **If reserves growth picks up, we expect reserve managers to reluctantly buy some EUR to offset rising USD reserves concentration**

Global reserves accumulation slowed considerably over the last year, although not quite as much as the headline numbers suggest (Figure 1). The headline numbers show a decline in the y/y pace of reserves accumulation from 25% y/y in early 2008 to over 15% in early 2009 and mid-2010 to just over 10% y/y in mid 2012. However, the most recent decline in the pace of reserves accumulation also reflects the drop in value in the non-dollar component of reserves over the last year because the USD was strengthening. If we take out the impact of a stronger dollar, we find that the pace of reserves growth has slowed more steadily, but less dramatically, from 18% y/y in mid-2010 to 8% y/y now. So, some of the slowing in reserves accumulation is simply because the stronger USD has lowered the USD value of the other currencies in reserves portfolios.

Figure 1. Reserves accumulation – Headline and corrected for currency valuation (y/y)



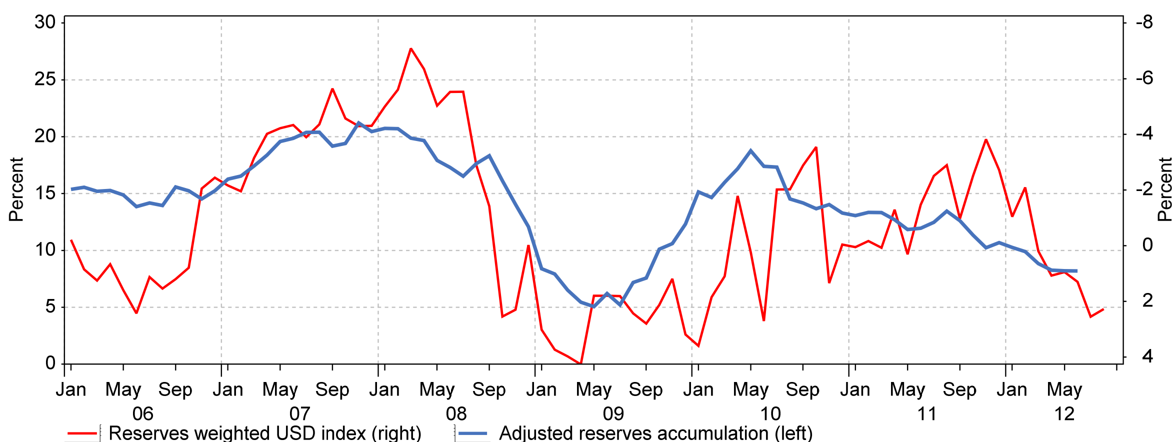
Sources: CitiFX, Reuters Ecowin
Note: We use the IMF COFER currency weights to make an approximate adjustment to remove the impact of capital gains and losses on reserves.

The three fundamental theorems of reserve accumulation

The first fundamental theorem of reserves management is that the majority of reserves are accumulated by reserves managers who do not want to accumulate reserves. Consider Figure 2, which charts global reserves accumulation, corrected for valuation, against the strength of the USD. We use this valuation-corrected accumulation because it more closely reflects buying by reserve managers, rather than capital gains or losses.

Our USD index is based on the weights of different currencies in the IMF COFER data on allocated reserves. What is clear is that reserves go up when the USD is weak versus the rest of the currencies in the reserve manager portfolio. Reserves fall or flatten out when the USD is strong. This correlation is in place because reserve managers place a higher value on competitiveness than on avoiding losses on reserves, so that when USD selling pressure threatens to weaken the dollar, they step in and buy, however unenthusiastically.

Figure 2. Reserves accumulation faster when USD is weakening, slower when strengthening (y/y)



Sources: CitiFX, Bloomberg

The second fundamental theorem is that reserve managers cannot diversify out of the currencies they accumulate. When China is buying USD hand over fist, and the SNB doing the same with EUR, they are buying currencies that no one else wants. It is unlikely that China can buy USD, and the SNB EUR, on Monday and turn around and sell these currencies on Tuesday without anyone noticing.

The reality is that if the global private sector is dumping a currency on Monday, the CB unlucky enough to be on the buying side will very likely be stuck with it on Tuesday, and certainly will have a hard time selling it against currencies that are more in demand without having a visible impact on the market. Among large reserves managers, or groups of medium sized reserve managers with common incentives, diversification is on the margin at best, not wholesale.

The third fundamental theorem is that diversification pressures are asymmetric – there is much more pressure to diversify when risk is on than when it is off. Start from the premise that in normal times reserve managers consider a 60% USD share as too high. However, when risk is off and the USD is rising, they benefit from this overweight and profit from the USD position. In

consequence, they are comfortable keeping their portfolio stable. In large part this is because, as we noted above, reserves growth is slow under these risk-off conditions, so they live in a very sustainable world of slow reserves accumulation and capital gains on their USD overweight.

Now consider what happens when risk appetite is restored. They are overweight USD, taking losses on this overweight, and seeing additional truckloads of dollars entering their reserves pile. This greatly increases their incentives to unload the USD they are accumulating, even as they discover there are no takers except at a much cheaper price. Hence, the asymmetry of our third fundamental theorem. When risk is off, the USD is rising, profits are increasing and reserves are flat, so doing little or nothing is a happy strategy. When risk is on, the USD is falling, losses are mounting and reserves are growing, doing nothing is not an option. However, diversification is painful because the reserves managers are selling when the private sector is doing the same.

Figure 3. ADXY surge as a precursor to renewed reserves accumulation

Sources: CitiFX, Bloomberg

Choosing the deep blue sea over the devil

Reserves managers are now caught in a pretty difficult position. When asked about QE and the USD, the Fed takes the view “I’m shocked, shocked to find that currency depreciation is going on in here”. Reserve managers now face mitigated, but still significant and difficult to quantify EUR risk on the one hand, and open-ended US balance sheet expansion on the other. Combined the USD and EUR are about 85% of reserve portfolios. ADXY has completed its sharpest rally since January (Figure 3), corresponding to USD weakness across the board. This leads us to suspect that there may already have been some spike in reserves. Once reserves growth is re-established, reserve managers will again be thinking of diversification strategies.

As we discussed above, diversification pressures are more acute when risk appetite is growing and the USD is weakening, so we think that reserve managers are in a familiar world where they are holding and accumulating too many dollars that they expect to go down in value. We think that as long as risk appetite is positive, the reserve manager dynamic will favour a weaker dollar, despite the euro zone policymaker ability to disappoint. Reserve manager faith in the euro is probably only partially restored, but seems likely to us that the diversification trade will emphasize

selling USD against G10 Smalls, EM and EUR as long as the euro zone does not return to a situation of acute distress. On a smaller scale the SNB may try its hand at selling a few EUR when investors are cutting shorts or building longs. The outcome is that reserve managers will favour currencies other than the G4. But given the combined weight of the EUR and USD in global currency markets, they will likely choose the EUR, unless crisis is renewed.

G10 Focus – Japan's political inclination towards a weaker JPY

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- **Prime Minister Noda is almost certain to be re-elected in the DPJ's upcoming party president election. Meanwhile, the LDP's presidential race is being contested by five candidates.**
- **We believe the LDP will win the upcoming general election, ousting the DPJ from power. An LDP administration will be more interested than the DPJ in additional monetary easing to depreciate the JPY. This is likely regardless who wins the LDP's presidential race.**
- **Ranking the five LDP candidates in terms of the strength of their position on JPY depreciation: Former Prime Minister Shinto Abe is the strongest proponent of a weaker JPY, followed by Yoshimasa Hayashi, Shigeru Ishiba, Nobuteru Ishihara, and Nobutaka Machimura.**

All eyes are on Japanese politics with the DPJ holding its leadership election tomorrow (Sept. 21) and the LDP's election just around the corner (Sept. 26). The general election, which should occur "soon" after, will likely see the LDP ousting the DPJ from its position as the leading party. Hence, while current PM Noda will almost certainly win the DPJ election, we are more interested in the outcome of the LDP election which is being contested by five candidates.

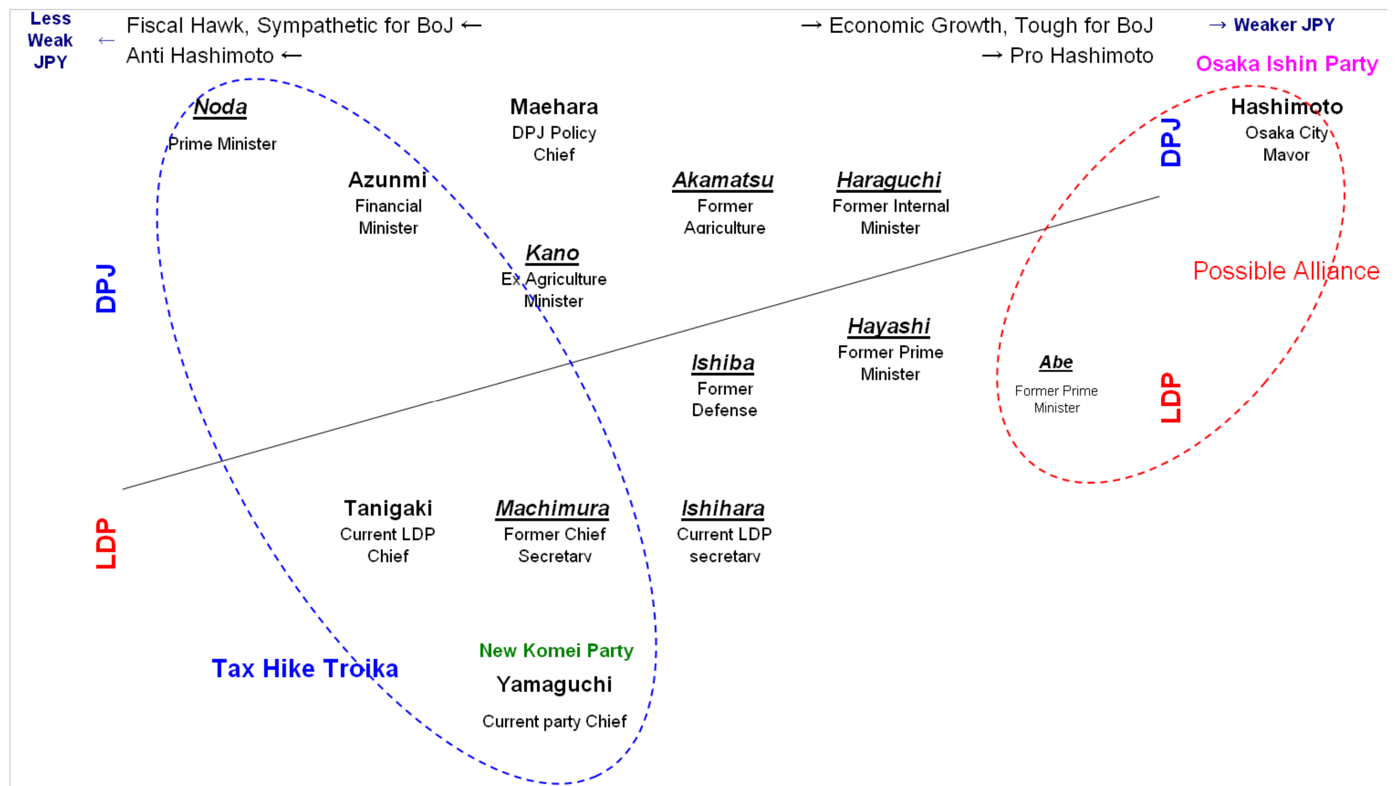
On August 31, the LDP announced its plan for revitalizing the Japanese economy. They prioritized addressing three major headwinds to Japanese economic growth: strong JPY, deflation, and the hollowing out of industry. Notably, the LDP called for a revision in BoJ law, including drastic monetary easing measures such as raising the BoJ's inflation goal to 2% and having the central bank begin purchases of foreign bonds. Clearly, the LDP plans to promote aggressive FX diplomacy and is targeting a "Heisei-era Louvre Accord." No matter who becomes the next LDP president, we are likely to see pressure on the BoJ to step up monetary easing and adopt a FX policy more conducive to JPY depreciation.

Of the five LDP candidates, we believe the former PM Shinzo Abe would be the strongest proponent of monetary easing. From the perspective of economic policy, Japanese politics is currently divided into two camps—proponents of "fiscal austerity" vs proponents of "economic growth". Both camps favor fiscal reconstruction, but the former aims to achieve that goal directly through higher taxes, while the latter aims to increase tax revenues through cutting government expenditure and fostering economic growth. This summer, the LDP and the new Komeito party united with the ruling DPJ to form a so-called "tax-hike troika" that succeeded in pushing through a consumption tax hike bill. The troika was headed by PM Noda and current LDP president Sadakazu Tanigaki, both fiscal hawks. Meanwhile, the Koizumi administration of 2001–06 would fall into the economic growth camp. Of the five LDP candidates, former PM Abe, who served as Chief Cabinet Secretary in the Koizumi administration, is most closely aligned to the economic growth camp. In other words, Abe would be most hesitant to raise taxes and most likely to demand that the BoJ strengthen its monetary easing measures.

We rank Yoshimasa Hayashi, Chairman of the Policy Research Council, second after Abe in terms of interest in JPY depreciation. His economic policy aims to

reverse the strong JPY trend by using methods as extreme as revising the floating exchange rate regime. While Hayashi does favor raising the consumption tax, unlike other candidates, he approves of Japan's participation in the Trans-Pacific Partnership (TPP) and other economic growth strategies. This aligns him relatively closely with the economic growth camp. If a Hayashi administration emerges, we believe its monetary policy will favor additional monetary easing while its FX policy will seek to depreciate JPY.

Figure 1. Japanese Political Map



Sources: MoF BoJ, Citi FX

Compared with Abe and Hayashi, former Chief Cabinet Secretary Machimura sits on the other side of the policy fence. A former bureaucrat in the Ministry of International Trade and Industry, Machimura can be considered a classical Japanese politician who has displayed a solid understanding of the fiscal and monetary policies of the Ministry of Finance and the BoJ. His economic policies are closely aligned with those of current LDP President Tanigaki, and we think he supports raising the consumption tax and other taxes.

The economic policy positions of current LDP Secretary-General Nobuteru Ishihara and former Defense Minister Shigeru Ishiba sit somewhere between the positions of Abe/Hayashi and Machimura. As LDP Secretary-General, Ishihara played a key role in the formation of the tax-hike troika that pushed through the consumption tax hike bill. We believe his current views on economic policies are closely aligned with Tanigaki's. Ishiba, meanwhile, has long been regarded as a specialist in military matters, but he has been more vociferous than the other candidates in pointing out the need for measures to halt the hollowing out of Japanese industry and to counter the ill effects of the consumption tax hike. He may also be inclined to favor greater fiscal spending and stronger monetary easing by the BoJ.

Regardless of which of these five candidates wins, we believe an LDP government would be more inclined than the current DPJ administration to pressure the BoJ into monetary easing. An LDP administration would also likely be supportive of gradual JPY depreciation, with Abe the strongest proponent, followed by Hayashi, Ishiba, Ishihara and Machimura. As of this writing, according to the Nikkei news, Abe, Ishihara and Ishiba are considered the three favorites in the LDP race. Note that unless the winning candidate receives over half of the first vote, there may be a runoff election between the top two candidates.

G10 – Wind down to the 4th quarter

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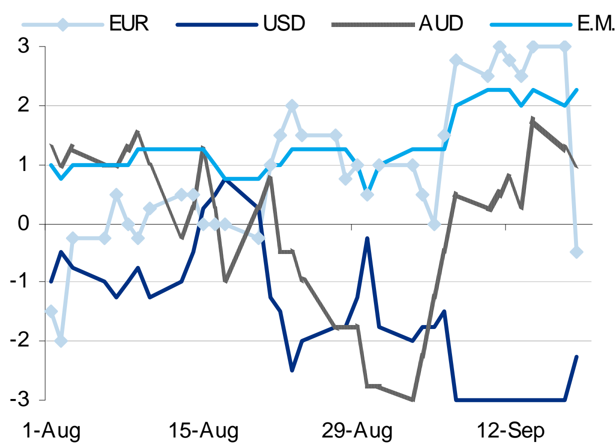
- **Markets remain modestly buoyant in the wake of OMT and QE3 but it is unclear how behind-benchmark investors will react in to quarter end and beyond.**
- **Key themes for the immediate week include upcoming Asian data, the Spanish election and looking ahead to the October ECB.**

Markets spent five all of August looking forward to the September ECB and Fed decisions. Most of the looking forward involved squaring up short-EUR trades, although mild long-EM positions were also built up. Since the ECB and FOMC, investors went outright long-EUR for a few days, although our sense is that this was strictly a short-term maneuver rather than a long-term change in view towards Europe. The question that active investors across most asset classes now face is how deal with the fact that they are hopelessly behind benchmarks. MSCI World Free is up 8.5% for Q3, while the HFRXM index of macro hedge fund manager is up just 1.3%. We suspect that investors will be reluctant to try to chase things too far, but to the extent they look for hero trades in the last week of the quarter, we think they will go back to short-EUR vs G10 small and EM trades. With that in mind, we view such trades as the most attractive position for the week ahead, as we noted in our portfolio update (G10 Portfolio Update - Legging in to G10 smalls).

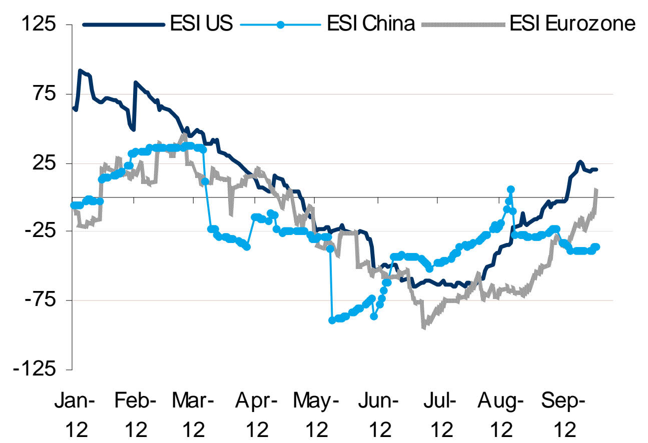
The Q3 quarter end is particularly noteworthy for Japan, where it marks financial half-year end. It has been a period of JPY strength that triggered intervention in both of the past two years. That is something FX markets will keep an eye on during a light data week. As shown in Figure 2, the preponderance of recent economic data has now turned positive (relative to pessimistic expectations) for Europe, with only Asia lagging. Given the focus on Asia, markets are likely to spend next week positioning for the Japanese quarterly Tankan survey and September Chinese PMI data, which will both be published on Sep 30/Oct 1. In Europe, the key event is likely to be the release of Spain's 2013 budget on Thursday Sep 27. In the US, the August PCE deflator is likely the most important data release, although an annual benchmark revision to the payrolls data could also move markets, particularly if it changes the employment picture enough to have political implications ahead of the first televised Presidential debate on October 3. That debate will be on the eve of the next ECB meeting, which could conceivably bring a rate cut, particularly if EURUSD is above 1.30.

Figure 1. CitiFX positioning indicators



Sources: CitiFX, Bloomberg

Figure 2. CitiFX economic surprise indices



Sources: CitiFX, Bloomberg

Asia — Laggards to catch up

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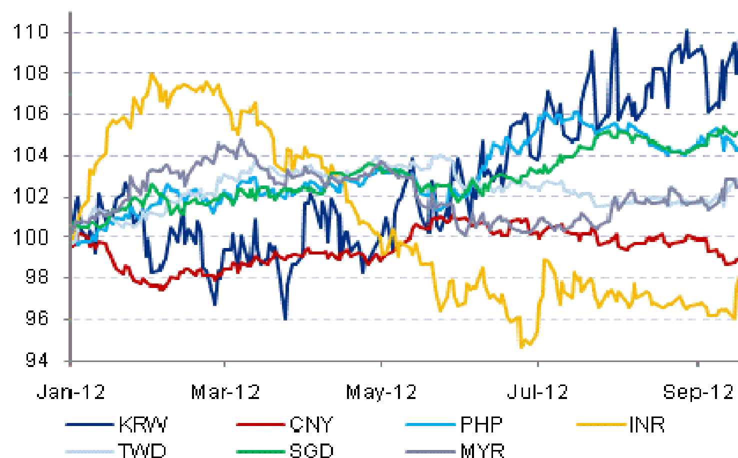
- **Asian currencies should rally in the near-term with the latest monetary easing by G3 central banks**
- **We prefer to play the catch-up of the laggards, by going short USDCNH and long INR against KRW and SGD**
- **We are largely neutral on Asian rates but still hold our long Korean bond position to hedge the geopolitical risk**

We believe the latest monetary stimulus provided by the G3 central banks should allow the risk assets to perform well for some time. Hence we added two risk-on positions to our portfolio this week: short 6m USDCNH forward and long INR against an equally weighted basket of SGD and KRW.

In our view, lower USD against Asian currencies will remain the market theme for the time being. Liquidity will still find its way into Asia, though less so than QE1/QE2 due to the weaker growth outlook. The expectation of weaker USD could also prompt exporters and foreign investors to adjust their hedges. In the medium-term, though, we suspect that USD would not weaken much, given its relative economic outperformance and political stability and that the structural rise of China/India is being called into question.

Within Asian currencies, we currently favour the laggards, namely, INR and CNY (figure 1). The rationale is that policymakers in other Asian countries, especially those with a high share of exports in the GDP, will want to see their currencies much stronger from here, if the USDCNY refuses to go lower. A few Asian currencies, such as KRW, SGD and PHP, are currently at or near their richest levels against the USD this year, where official intervention could potentially intensify. We expect such interventions to smooth the moves rather than reverse the trend, but still, to long the laggards probably provide a better risk-reward.

Figure 1. Trade Weighted Index for Asian Currencies



Source: Bloomberg, Citi; data as of September 20, 2012

In the case of China, We think the USD weakness will allow the policymakers to keep USDCNY largely stable ahead of the political transition, while pacifying the exporters with a de facto CNY depreciation on a trade-weighted basis. The unwinding of short USD positions by the corporates since Q2 has persistently weighed on CNY, but we suspect that pressure could ease into Q4. First, the perception that CNY could strengthen against the USD (at least not to depreciate) on the back of QE3 and upcoming US election could encourage the exporters to reload their hedges. Second, exporters who have been under-hedged may have to catch up as the financial year-end looms. More importantly, we think an escalation of the Sino-Japan territorial dispute could actually prompt the policymakers to keep the CNY stable or stronger, in an attempt to show might and solidarity.

For India, We believe that given the slew of positive reforms last week and the government keen on improving the sentiment further will lead to INR outperformance to other Asian peers. For detailed analysis on positive measures announced in India, please refer to INDIA: Government FUELed the fiscal reforms engine , INDIA: FDI in aviation, multi-brand retail and other sectors, PSU divestments approved and INDIA: The finance ministry is set to announce more policy measures. The government has stood tall against the threats of difficult political ally and opposition. The stance instils further confidence into the government's ability to take difficult measures. We believe the INR to outperform other peers as the turn in investor confidence will improve the capital inflows into the economy.

Our conviction for Asian rates is lower than Asian currencies. Post QE3, rate cuts have been mostly priced out with the exception of Korea. We see limited upside for the front-end rates as the growth still remains very weak. Fundamentally we are still biased to be long duration, as we doubt if the money-printing alone can effectively lift the Asian growth and the Asian rates have in general backed up quite significantly. Hence, we are still holding onto our long 2y Korean MSB position, with the view that it is just a matter of time for further BoK rate cuts. This position would also serve as risk-off hedge in light of the growing geopolitical tension between China and Japan.

However, the large dose of global monetary stimulus will inevitably make the Asian central banks want to wait for more data to assess the impact of the stimulus. Such a tendency is clearly manifested in the minutes of BoK's MPC in Sept, where they kept the policy rate unchanged. As such, it is unlikely that the Asian front-end rates can go much lower. The long-end will be function of the risk sentiment and US Treasury yields. In spite of our "risk-on" bias, we are not inclined to initiate any new long-end pay position or steepener, because we think Asian currencies are probably a better channel to express the "risk-on" view and that US Treasury yields are not moving higher either. We are currently only holding a 2s5s KRW steepener.

CEEMEA – Review of Hungary and Czech Republic

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- The Hungarian central bank will continue with gradual interest rate reductions, with the next rate cut possible already next week (25 September)
- We have scaled back our expectations that a deal with the Troika will be struck in early 2013. Hence we see limited value in Hungarian assets now, with perhaps the exception of the belly of the curve where the spreads over swaps are about 55bps (17As).

Hungary – Focus on Troika and central bank

The Hungarian central bank will continue with gradual interest rate reductions, with the next rate cut possible already next week (25 September). Our meetings in Budapest this week underscored our view that the majority at the Monetary Policy Council (MPC) favor gradual easing, as long as the risk premiums in Hungarian markets are reasonably contained.

Markets look for 100bps in rate reductions over the next 12m, which looks roughly fair now that we have scaled back our expectations that a deal with the Troika will be struck in early 2013. We had earlier thought that there would be 175bps in cuts over the next 12m on the basis of a Troika arrangement in 1Q 2013. Hence we see limited value in Hungarian assets now, with perhaps the exception of the belly of the curve where the spreads over swaps are about 55bps (17As).

The MPC is concerned about the economy and in particular about consumer spending, which has been contracting since 2008. Given this economic weakness, the majority at the MPC brushes off risks about inflation, even though inflation has been overshooting targets for a while (Figures 1 and 2). By contrast, the minority view (as expressed by the governor and his deputies) is to be more cautious and to wait for the country to sign a deal with the Troika before embarking on any interest rate reductions. A deal is believed to crush risk premiums further and prompt a HUF rally. The latter will help households indebted with foreign currency mortgages and hence justifies an easing of interest rates.

We believe that the majority of the MPC is comfortable with gradual rate cuts at the next meetings as long as EURHUF trades below 280 and bond yields and CDS spreads are stable or falling. A currency in 280-285 range probably also will be sufficient, although this is less certain (EURHUF now trades at 282-283). On the CDS front, the performance of Hungarian risk has actually been much more glaring with a 60-70bp rally in Hungarian 5y CDS since the beginning of August. The MPC’s divided views about the economy and the need for policy easing will be published as an addendum to the quarterly inflation report for the first time. This report, due out on September 27, has been produced by just the staff of the central bank in the past.

With regards the Troika, it remains unclear when or even whether a deal will eventually be signed. The government is still officially targeting October as the conclusion date for a EUR10-15bn deal, but this date looks unfeasible, because the government has not reacted yet to the proposals of the Troika that were made following its visit to the country in July. That said, the government will ensure that the dialogue with the Troika continues, albeit at a (very) slow pace, in order to keep market expectations alive of an eventual conclusion. These expectations have played a major role in lowering credit spreads and strengthening in the currency since spring.

In the next couple of days/weeks, the government is expected to provide its response to the Troika. The IMF will then send a mission to Budapest sometime after the IMF annual meetings (in the second week of October). The issues to be resolved are numerous and for sure include the elimination of the financial transaction tax on the Central Bank. Also, the macro forecasts will need to be revised down (as the 1.6% GDP growth projection for 2013 looks too high) and sectoral taxes need to be altered

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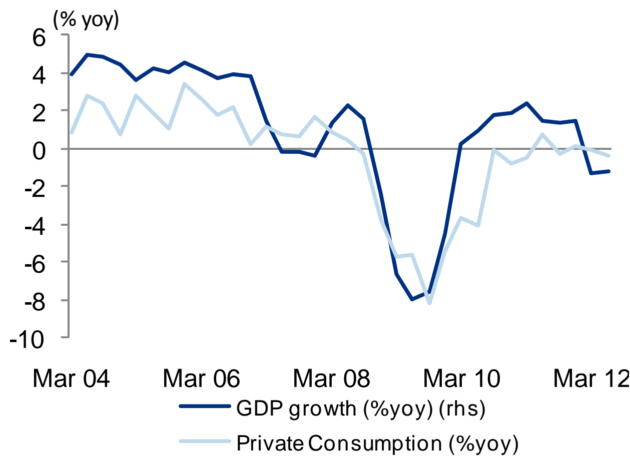
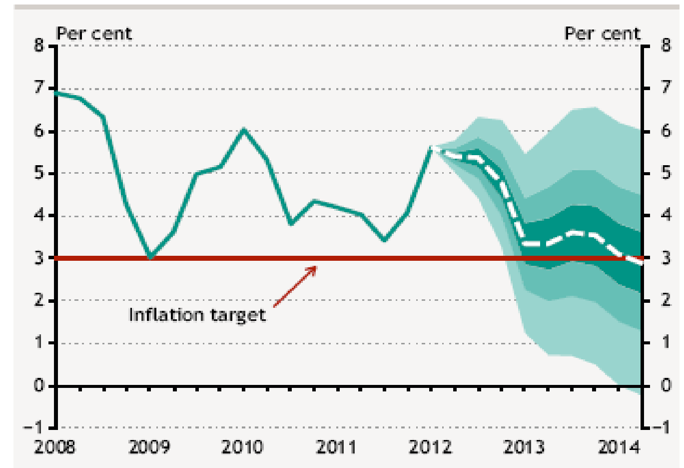
Figure 1. Hungary – Private Consumption and GDP growth



Source: Bloomberg, as of 20 September 2012

Figure 2. NBH inflation forecast – above the target until '14

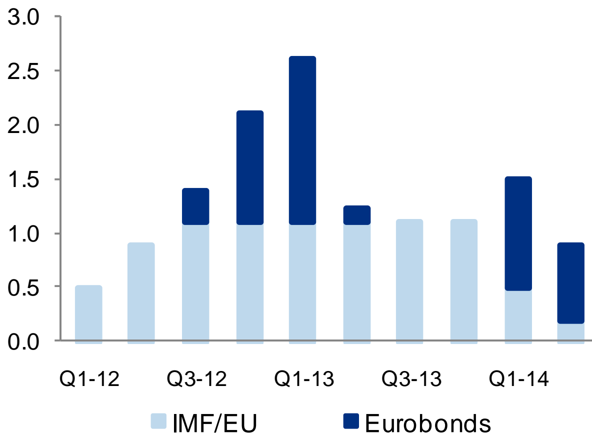


Source National Bank of Hungary, June 2012 Inflation Report

An important incentive for striking a deal with the Troika is that it improves the country's funding situation for the next few years (Figure 3). Next year, the country faces around EUR6bn in external debt repayments, after roughly EUR5bn this year. The debt office AKK has promised not to issue Eurobonds before a deal with the Troika, but we think there is a good chance that the AKK will change its mind, given the country's funding pressures and the rally in foreign currency bonds globally and in Hungary.

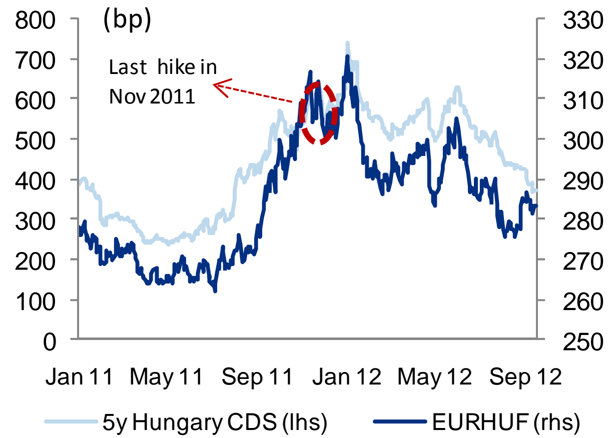
A deal with the Troika will be somewhat negative for the currency and local debt as it reduces the perceived chances of a standby arrangement with the IMF, but the alternative is that the AKK pays a premium on local debt as it tries to raise funding all locally. It has already tapped the retail sector for HUF300bn (almost EUR1bn) compared with its original plans of just HUF30bn for the year and most of the rest it will have to raise by attracting foreigners to its domestic market. Note that external debt payments are a sizable EUR2.1bn in 4Q 12 and even higher EUR2.6bn in 1Q 2013.

Figure 3. Hungary – FX debt refinancing pressure (EUR bn)



Source: Bloomberg, Citi as of 20 September 2012

Figure 4. EURHUF vs. 5y RepHun CDS



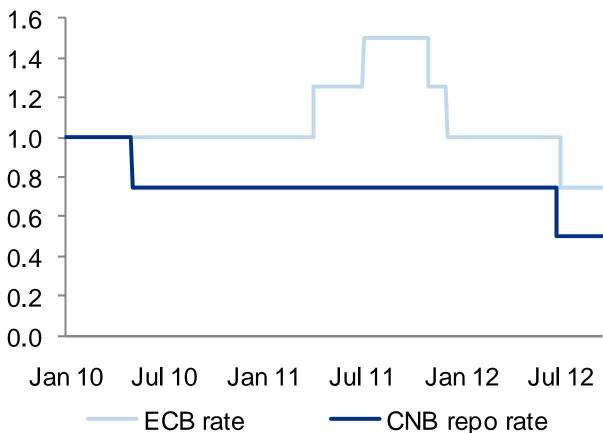
Source Bloomberg, as of 13 September 2012

Czech – The monetary policy dilemma

In our meetings with officials in Prague this week, we concluded that EURCZK likely will trade higher later this year and early next and we recommend to buy on dips, targeting 25.3. Even after this week's EURCZK rally to 24.8, EURCZK is still below the Central Bank's forecast of 25.5 for 3Q and is slightly its forecast range of 25.0-25.5 for 2012-13.

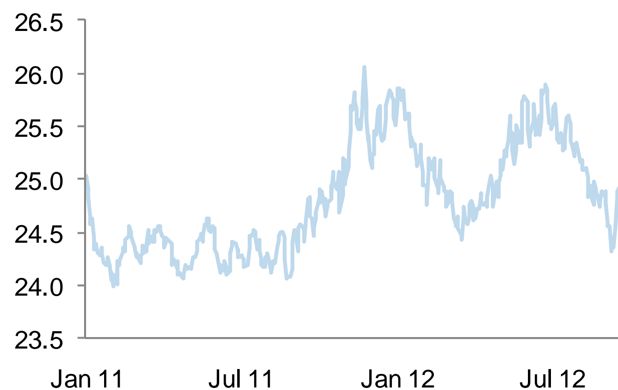
The Czech central bank (CNB) remains in easing mode, like the Hungarians and the Poles, on the back of disappointing economic performance. GDP growth printed -1% y/y in 2Q (below earlier forecasts of the central bank), as the pressure on domestic demand persists and offsets some resilience on net exports. Also, the CNB is concerned about negative real wage growth (of -1.1% y/y in Q2) – one important indicator closely followed by MPC members.

Figure 5. CNB repo rates vs. ECB rates



Source: Bloomberg, Citi as of 20 September 2012

Figure 6. EURCZK



Source Bloomberg, as of 13 September 2012

However, it has much less room for further rate cuts than Hungary and Poland, given that the repo rate is just 0.50%. Our views were confirmed that the CNB will cut the repo rate by 25bps on September 27 and that another cut of 20-25bps later this year is likely. The CNB does not want to see negative nominal interest rates because it creates some legal complications.

Any additional easing will have to come from non-standard measures or a weakening in the currency. Non-standard measures can include an easing of collateral rules for the repo facility or purchases of mortgage bonds. Collateral rules are one of the strictest in the region, but it is hard to see this easing being effective because liquidity in the banking sector is already ample. Purchases of mortgage bonds also will not be very effective given how small this market is.

Weakening of the currency will probably be the best tool for the central bank after additional repo rate cuts in case the economy continues to perform poorly. This, despite the fact that it has traditionally rarely been involved in currency interventions and export growth is holding up reasonably well.

Latam – Taking a Breather

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- **MXN strength should resume once positioning gets cleaner. Intervention in Chile not imminent. We think there is room for points to move lower in Colombia.**
- **To watch Banxico minutes tomorrow for concerns that led to slightly hawkish stance in minutes, but Banxico unlikely to move either way in foreseeable future.**

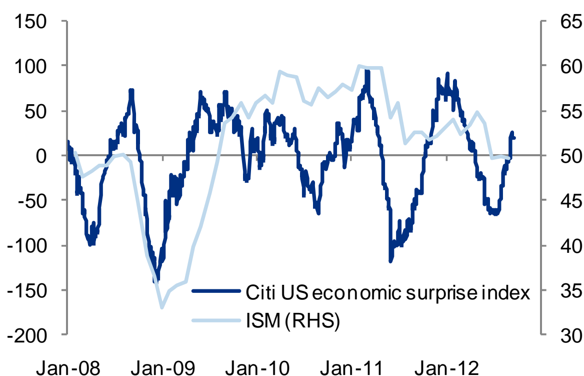
Short-term profit taking

The QE-induced rally in risk assets has somewhat faded. Although the announcement was a positive surprise to the market, the speed and magnitude of the month-to-date rally prompted some profit taking. Positioning accumulated after ECB's OMT decision limited room for a follow-through rally post-QE. Positioning in MXN is a case in point. Both CFTC data and Citi's positioning indicator show extended positioning, although both indicators have not worked very reliably as a contrarian indicator in the past, at least not immediately. MXN traded well at similar net long levels in the past. With open-ended QE in place, USD weakness should remain the theme in the near term. The nature of the rally in equities has also been supportive for MXN. Figure 1 shows that the S&P cyclicals-defensives ratio (S&P industrial sector ETF divided by utility sector ETF) has mirrored MXN strength very well. So far the ratio is not signaling any alarm yet. In addition, continued improvement in Citi's US economic surprise index bodes well for signs of US growth bottoming. (Figure 2) Once positioning gets cleaner, MXN should be the main beneficiary of the region, given close links to the US and the least intervention risk.

Figure 1. USDMXN and cyclicals-defensives ratio

Source: Citi and Bloomberg, updated September 20, 2012

Figure 2. Citi economic surprise index tends to lead ISM



Source: Citi and Bloomberg, updated September 20, 2012

We are also holding onto our long CLP position. CLP was one of the best post-QE2 performers in EM. The peso has been trading well despite China fears, and any signs of growth stabilization in China would be a tailwind for the currency. Intervention risk is admittedly non-negligible at current levels, but rhetoric so far from the central bank has not signaled pressing concern. We would note that the last two times the central bank acted only after significant pressures coming from lawmakers, with central bank president De Gregorio being invited to special sessions of Congress/Senate to discuss peso strength. Also, both intervention episodes happened as copper was trading at or above then-record highs. At this

stage with copper still off the highs and lack of clarity on Chinese growth, we don't think FX intervention is imminent.

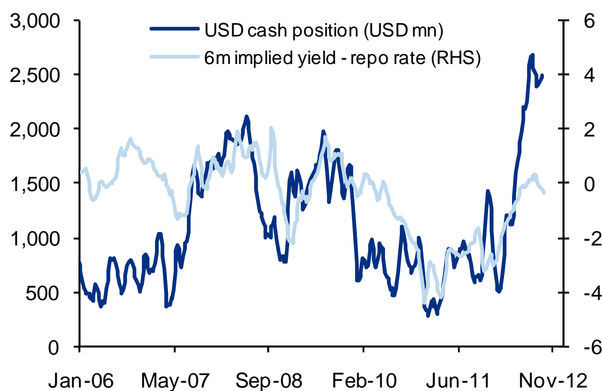
Points to move lower in Colombia

In Colombia, forward points have started to move lower. We had expected points to drop after the Ministry of Finance began buying USD last month, but strong corporate inflows have kept local USD position and forward points elevated. Figure 3 shows that USD position locally has started to decline, and forward points were dragged lower as a result. The new finance minister Cardenas signaled continued determination to keep the peso "competitive", and increased central bank buying should continue to drain USD out of the system. We think forward points have a bias to move lower still.

Banxico minutes to allow peek into slightly hawkish stance

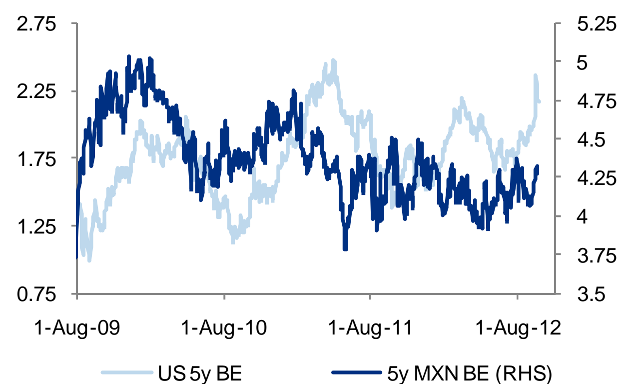
Tomorrow Banxico will release minutes from the Sep 7 meeting. The statement from that meeting struck a slightly more hawkish than expected tone. It would be interesting to read into how concerned the Board was on food inflation and its secondary effects. We believe Banxico will be on hold in the foreseeable future. Banxico qualified the "hawkish" stance by saying they would monitor monetary policy stance of other countries, especially that of the developed world. Now that the Fed has embarked on open-ended QE, the pressure for Banxico to hike should have been lessened somewhat. Regarding fears of higher inflation breakevens in the US as a result of QE possibly leading to the same phenomenon in Mexico, Figure 4 shows that the impact of US inflation breakevens on Mexico has diminished over the years. Also, there wasn't a pronounced rise in Mexico's inflation breakevens after QE2. As grain and crude prices seem to have started reversing some of the recent gains, the pressure exerted on inflation breakevens in Mexico should come down as a result.

Figure 3. COP 6-month NDF implied yield less repo rate vs. local USD position



Source: Citi and Bloomberg, updated September 20, 2012

Figure 4. Mexico and US 5y inflation breakevens



Source: Citi and Bloomberg, updated September 20, 2012

G10— Short-Term Outlook

	FX
United States	Even though significant USD weakness has yet to materialize in the wake of the launch of QE3, we remain biased for USD weakness. The currencies that look most attractive to buy against the USD on the QE3 theme include CAD, NOK and SEK. However, if China were to aggressively ease monetary policy in response to the Fed's move, AUD could join them as an attractive long due to low positioning and lots of room to run.
Eurozone	EURUSD has languished following the immediate QE3 pop. We see scope for a small squeeze higher from here but we doubt that there too many more potential EUR positives will emerge in the near future. We expect Eurozone growth will remain weak and force the ECB to accommodate further in coming months. Grexit clouds the outlook for EUR and emergence of details from the Troika's recent Athens visit could present increased headwinds for the single currency.
United Kingdom	GBP has been a source of safe haven flows from Europe all year but has compared unfavorably against the commonwealth currencies and USD along most fundamentals. The recent rally runs counter to domestic fundamentals, which remain very weak on growth, competitiveness and monetary policy axes. GBP has been moving against the USD in tandem with EUR and we expect it to continue to trade fairly closely.
Switzerland	The SNB continues to defend the peg to EUR with the utmost determination. Q2 SNB FX reserves data indicated a significant increase in the EUR holdings, suggesting either the SNB was unable or unwilling to diversify the newly acquired reserves. Reserve growth however slowed somewhat over the past few months, and EURCHF has started to move higher from its 1.20 floor. We do not expect any change in policy in the near term and would not rule out a move back lower towards 1.20.
Norway	Strong fundamentals and a comparatively less dovish central bank should support the case for stronger NOK over the medium term. Citi expects the Norges Bank to hike its base rate in Q1 2013, although the Norges Bank will likely pay close attention to the crisis inside the Eurozone and its currency. We expect NOK to remain a safe haven for European money if fear of uncontrolled EMU breakup returns to Europe.
Sweden	We remain constructive on SEK in the medium term despite recent gains pushing it to decade highs against EUR. Should the growth outlook inside the Eurozone deteriorate further, the Swedish economy could face stronger headwinds. The recent Riksbank cut was largely on the back of lower forecast exports and a stronger currency, Citi's base case is for another 25bp cut before year end and this may slow down the trend, causing SEK to underperform its neighbor NOK and other risk correlated currencies in the nearer term.
Japan	USDJPY trades close to the lowest levels of the year but we suspect the downside is limited. Finance Minister Azumi kicked off a fresh round of verbal intervention earlier in the week with this comment - "the yen's move from yesterday has been clearly speculative and we won't accept such moves…We will definitely take bold actions if needed." and the BoJ is reported to have conducted a "rate check" with several Tokyo banks immediately following the FOMC statement.
Australia	AUD continues to underperform other G10 small currencies during August due to Asia growth worries. Those worries have kept AUD from rallying alongside global equities and Australia's commodity terms of trade. Further policy steps in China could cause AUD to rally, though, as markets are likely to continue to trade it as a China proxy.
Canada	CAD continues to fluctuate with risk appetite similar to other commodity currencies and is likely to continue to track broader asset market developments. However, CAD is trading a bit strong relative to its commodity price fundamentals and it continues to rally against AUD on both risk-on and risk-off days. We view CAD as the defensive G10 small due to its resilient economy, excellent credit fundamentals and balanced external accounts.

Asia Short-Term Outlook

	Rates	FX
China	Biased to trade from the received side tactically.	Caution on CNY. Risk of further weakness.
Hong Kong	Favour receivers.	We are neutral on the HKD.
India	Exited 1y received and 1s2s steepener. Neutral now.	Tactically overweight. Long against KRW and SGD.
Indonesia	Continue to be slightly overweight bonds.	Underweight still.
Korea	Overweight 2y bonds. Preference for bonds over swaps. Hold 2s5s steepener	Underweight. Short against INR.
Malaysia	Long 1y1y receiver swaption.	Neutral.
Philippines	Overweight 10y bonds.	Underweight.
Singapore	Neutral.	Underweight. Short against INR.
Taiwan	Neutral.	Neutral
Thailand	We like front end receive with no rate cuts priced in.	Neutral.

CEEMEA Short-Term Outlook

	Rates	FX
Czech Rep	Bullish bonds. Fiscal policy is tight and inflationary pressures are absent. The country has a good credit story. Moreover, the curve is fairly steep and foreign positioning is low, making bonds less correlated to swings in Bunds.	Neutral. We believe the Koruna has now a medium range market beta relative to to other EM currencies. As downside economic surprises at the core of the Eurozone fade , the pressure on the CZK may see some short-term relief.
Hungary	Neutral bonds. There is still value in Hungarian bonds, as the credit risk premium should fall when a Troika deal is signed and the central bank will also continue to cut rates ahead of a deal as long EURHUF is less than 280. But markets have rallied much and we have turned neutral on bonds from bullish before.	Neutral. The currency is cheap on a fair value basis, but we need more positive Troika news for the currency to rally further. Overly aggressive rate cuts by the central bank can be a danger for HUF valuations.
Poland	Bullish bonds. Poland continues to have a strong credit story, as the government is tightening the budget deficit by almost 5pp in two years and it is also well ahead of its annual gross issuance. We do not necessarily see immediate interest rate reductions, but for sure, they will not be another interest rate hike, as economic growth is slowing.	Neutral. The currency is cheap on a fair value basis (that we see at around EURPLN4.0). That said, the currency's correlation with EU news remains strong, although it has definitely fallen since late June. Hence, some risk premium in the currency likely will stay.
Russia	Cautiously bullish bonds. Euroclearability for OFZs remains the key theme for local bond valuations. Given very low foreign involvement, OFZ yields have not rallied by anything like those in other emerging markets. The target date for Euroclearability is September, but delays to early 2013 are likely.	Bullish. We also like short-term plays in RUB/basket, as further RUB-denominated deals in the international markets could generate additional USD inflows. With or without Sberbank stock sales, the story in the RUB looks reasonably appealing now, as Brent above $110/bbl still suggests healthy C/A surpluses, far outstripping capital outflows.
South Africa	Bullish rates. The SARB will keep rates low for long being worried about external conditions. Also, the October WGBI inclusion is a small further factor for downside in local rates.	Bearish. The current account is deteriorating and will be over 5% of GDP.
Turkey	Cautiously bullish rates. The easing in CBT average funding rates have spurred a rally in local bonds. The major caveat in TRY rates now is the ability of local banks to keep buying front end bonds at sub-8% yield levels.	Bearish. The central bank is fine with somewhat weaker currency versus the basket and has pushed interest rates to very low levels. With EURUSD higher, Turkish exports to Europe are benefiting and imports such as energy in USD are being constraint.

Latam Short-Term Outlook

	Rates	FX
Argentina	Neutral – Real rates are too low to stop capital flight. Risks for a speeding up of the depreciation is high. The blue FX has narrowed on the back of administrative measures, but this is just a short term fix. But the soft commodity rally and better global risk appetite leave us neutral.	Neutral – Banks must inform to BCRA customer's FX transactions on a daily basis restricting the FX market even more. Jawboning the blue fx lower with accounting rules smacks of desperation. Though in short term the strong grains rally means that there is no imminent danger.
Brazil	Jan 14/Jan 15 Steepener – After change in Copom language the BCB will likely cut by 25bp at most. While the market is pricing anywhere between 150-200bp of hikes for next year, the end of an easing cycle is typically not a good time to increase duration. But we think that the market may move hikes from 2013 into 2014.	Range trading in BRL – intervention resumed as USDBRL traded closer to 2.00, suggesting that the new "floor" may be close to 2.00. But the central bank has also stepped in to sell USDs whenever spot trades close to 2.10. As such BRL may continue to range-trade. But implied volatility is too low to sell.
Chile	Long 5yr BCUs – break even inflation is low and commodity prices have been moving higher. This should continue given QE3. If we are wrong on the success of these inflationary policies, nominal rates should fall and drag real rates lower. Negative carry is now behind us after the last CPI print.	Long CLP – The Fed and ECB puts seem to be in place. CLP tends to benefit the most from QEx. And CB President Vergara suggested that intervention is not imminent. Positioning is helpful for CLP strength.
Colombia	Bias to receive 2yr XCCY swap – with the easing cycle just having started we think there is more to come. XCCY swap to outperform TES during intervention episodes.	Neutral USDCOP – COP should also benefit from a weaker USD globally, but intervention is going to contain appreciation pressures. And points are now much lower, making COP less attractive.
Mexico	Bias to receive 20yr TIIE against UST – The spread to US Treasuries should compress if G3 rates are selling off post ECB. The very back end of the curve in Mexico is the most attractive. We would not outright receive, though, given our expectations of higher rates across the board.	Long MXN – open-ended QE should support MXN, in particular at a time when growth in the US may be bottoming anyway. Furthermore, MXN does not have to contend with intervention pressures. Positioning is a negative, but it is not as extreme as in the past.
Peru	Negative bias – Bonds in Peru never sold off much with US Treasuries. As such there was little value generated over the last weeks. The 2031s are the most attractively valued bonds on the curve.	PEN to underperform – PEN remains a low beta currency and therefore is likely to underperform in a stronger global environment

Foreign Exchange Forecasts

(as of September 17, 2012)

		Market data			Forecasts			Returns***	
		spot*	3m Fwd	12m Fwd	0-3 mos	6-12 mos	long-term	3 mos rtn	12 mos rtn
G10									
Euro	EURUSD	1.31	1.30	1.31	1.32	1.15	1.25	1.2%	-12.1%
Japanese yen	USDJPY	78	78	77	78	76	80	0.4%	-1.8%
British Pound	GBPUSD	1.62	1.62	1.62	1.63	1.51	1.58	0.7%	-6.3%
Swiss Franc	USDCHF	0.93	0.93	0.93	0.91	1.04	0.96	-2.4%	12.6%
Australian Dollar	AUDUSD	1.06	1.05	1.03	1.05	0.96	0.95	0.0%	-6.5%
New Zealand Dollar	NZDUSD	0.83	0.83	0.81	0.83	0.79	0.69	0.0%	-3.0%
Canadian Dollar	USDCAD	0.97	0.97	0.98	0.95	0.98	0.97	-1.9%	0.4%
Dollar Index**	DXY	78.81	79.06	78.99	78.31	86.23	81.69	-0.9%	9.2%
G10 Crosses									
Japanese yen	EURJPY	103	101	101	103	87	100	1.6%	-13.7%
Swiss Franc	EURCHF	1.22	1.22	1.21	1.20	1.20	1.20	-1.2%	-1.0%
British Pound	EURGBP	0.81	0.81	0.81	0.81	0.76	0.79	0.5%	-6.1%
Swedish Krona	EURSEK	8.61	8.62	8.71	8.75	8.35	8.30	1.5%	-4.1%
Norwegian Krone	EURNOK	7.46	7.46	7.56	7.45	7.20	7.30	-0.1%	-4.7%
Norwegian Krone	NOKSEK	1.15	1.16	1.15	1.17	1.16	1.14	1.6%	0.7%
Australian Dollar	AUDNZD	1.27	1.27	1.26	1.27	1.22	1.38	0.0%	-3.6%
Australian Dollar	AUDJPY	83	82	79	82	73	76	0.4%	-8.2%
Asia									
Chinese Renminbi	USDCNY	6.32	6.35	6.40	6.31	6.36	6.15	-0.6%	-0.7%
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.75	7.76	7.75	0.0%	0.1%
Indonesian Rupiah	USDIDR	9520	9602	9976	9600	9850	9660	0.0%	-1.3%
Indian Rupee	USDINR	54.3	55.4	57.7	54.6	56.0	52.3	-1.4%	-2.9%
Korean Won	USDKRW	1117	1124	1136	1120	1140	1070	-0.3%	0.4%
Malaysian Ringgit	USDMYR	3.04	3.06	3.11	3.05	3.13	3.11	-0.5%	0.8%
Philippine Peso	USDPHP	41.4	41.4	41.7	41.1	43.0	40.8	-0.8%	3.2%
Singapore Dollar	USDSGD	1.22	1.22	1.22	1.24	1.27	1.24	1.5%	4.0%
Thai Baht	USDTHB	30.8	30.9	31.4	30.4	32.0	29.9	-1.7%	2.0%
Taiwan Dollar	USDTWD	29.4	29.3	29.1	29.7	30.5	28.5	1.2%	5.0%
EMEA									
Czech Koruna	EURCZK	24.3	24.4	24.4	24.7	25.9	24.5	1.1%	6.0%
Hungarian Forint	EURHUF	282	285	295	290	310	290	1.6%	5.2%
Polish Zloty	EURPLN	4.07	4.10	4.22	4.11	4.40	3.90	0.1%	4.3%
Israeli Shekel	USDILS	3.89	3.93	3.96	4.00	4.20	4.00	1.9%	6.0%
Russian Ruble	USDRUB	30.5	31.3	32.7	30.8	35.4	33.7	-1.7%	8.1%
Russian Ruble Basket		34.7	35.6	37.3	35.2	37.8	37.5	-1.1%	1.4%
Turkish Lira	USDTRY	1.80	1.82	1.89	1.80	1.92	1.85	-1.0%	1.6%
South African Rand	USDZAR	8.23	8.35	8.65	8.40	8.70	8.72	0.6%	0.5%
LATAM									
Brazilian Real	USDBRL	2.02	2.05	2.13	2.00	2.05	2.05	-2.4%	-3.9%
Chilean Peso	USDCLP	471	480	495	480	510	490	0.0%	3.0%
Mexican Peso	USDMXN	12.7	12.9	13.2	12.5	13.2	12.2	-3.1%	-0.2%
Colombian Peso	USDCOP	1791	1815	1861	1820	1850	1850	0.3%	-0.6%

Source: Citi Research and Bloomberg; *Market data including spot as of 6.09PM London time on 14 September 2012; **The DXY forecasts are implied from the forecasts of the constituent crosses; *** Returns are relative to forwards.

Source: Citi

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