

Theme #2: Hedge a Global Downturn – Buy basket of USD, MXN and HKD funded in CZK, CLP, and KRW (flat carry)

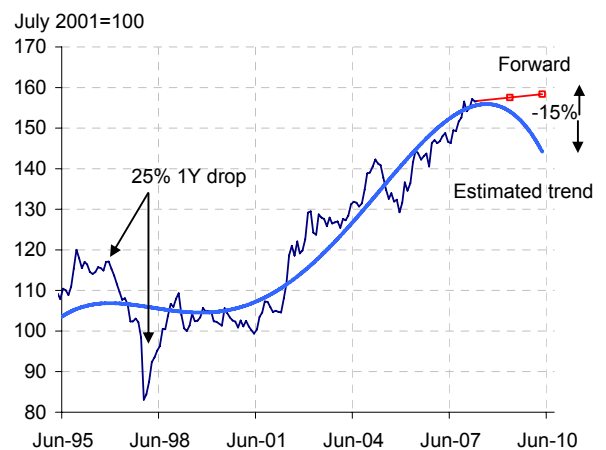
Global business and USD cycles broadly coincide and we are seeing signs of a turn in both. Precise timing is always difficult, but the environment is ripe for reversal and the classic warning signals have proliferated. New-age theories justifying the extrapolation of EM and commodity price trends have become firmly established. Inter- and intra-asset correlations are falling. And the systematic bias of forecast errors has gone from up-side to down.

The point is that once in place, a trend reversal can run a very long way; typically further than anyone at the time gives credit. Cheap, long-dated hedges are thus worth their weight in gold. Ours concentrates on being long undervalued currencies and laggards and being short those that have run furthest and have the highest sensitivities to global growth turning down. We've tried to avoid positions that imply fighting local central banks, or that would pay out only on extreme blow-ups. The resulting basket (which we advocate shorting or buying protection on) is flat carry, has run up 10% per annum since 2001, and had a dramatic 25% drawdown over the space of a year when the USD cycle last turned up and structural EM exuberance was disappointed.

- The **USD** is at historic lows and the US economic downturn starting to spread, making long-term mean reversion trades attractive here. The trade-weighted USD has fluctuated in a core +/-30% range since 1971, roughly plotting a 7-year cycle of upmoves and downmoves.
- Excluding ARS (which has ample grounds to remain cheap), **HKD** dollar is EM's cheapest currency in real terms. It has been pegged to USD since 1983, but we know authorities have considered a break in the last few years, and pressure to float is again building with domestic inflation and the shifting of Hong Kong's main growth engine to China. We believe there is a moderate chance of a depeg in the next 1-2 years and estimate HKD may appreciate by 20-30% in such a scenario. This makes an excellent risk-reward proposition in its own right as well as a hedge against further USD weakness.
- Again barring ARS, **MXN** is the only currency that has depreciated against the US dollar since mid-2001, dropping 15%. It offers a decent carry cushion now, and is generating strong investor interest as a catch-up play. Mexico's fundamental situation is also broadly positive, making it one of our strongest conviction trades in EMFX at present.

- **CZK** has risen more versus the dollar than any other currency (145%) over this current cycle. Its fundamentals and institutions have been among the strongest in CE4, drawing in much portfolio and foreign direct investment. But Czech remains a small and very open economy heavily dependent on external demand from Europe and the global transport sector.
- **CLP** outperformed other LATAM FX in recent years, and its economy is highly reliant on copper exports. The central bank recently indicated its discomfort with further CLP strength, introducing daily FX auctions through which it will accumulate USD8 billion in reserves by year-end (their current stock is less than USD18bn while Chile's current account surplus last year was less than USD6bn).
- Korea's economy is highly leveraged to global growth through its reliance on industries such as electronics, machinery, autos and shipbuilding. Moreover, thanks to the one-way appreciation trend of **KRW** in recent years, exporters have aggressively sold USD forward, and the banking sector has built large amounts of unhedged foreign currency borrowings. With external growth slowing, the current account has swung into deficit. Foreign investors have also been withdrawing their equity investments, registering net sales of USD17.5bil in local stocks so far this year. Regulators have indicated their willingness to counter rapid won depreciation, but have also signaled that a more gradual trend weakening is quite appropriate.

CLP, CZK & KRW versus USD, MXN & HKD



Source: Deutsche Bank

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