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Fixed Income Research
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FX Strategist

FX Strategy

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Sell 1yr EURMXN risk reversal

Upside surprises in US macro data have substantially reduced fears of a 'double-dip' scenario in the US and global economies. With the US September data cycle showing continued gains in labor income and retail spending, fears of a confidence-driven collapse in activity have waned. Our US economics team reports its US Q3 GDP estimate is tracking at around 2.9%qoq annualized now, far from the recessionary scenario markets feared coming out of the summer. While growth-sensitive currencies have rallied in response, option market pricing continues to reflect a great deal of risk premium for US and global growth-proxy currencies.

EURMXN implied skew pricing stands out as being rich given the reduction in tail risk associated with US growth and euro area crisis. Despite a modest retracement over the last couple of weeks, EURMXN risk reversal is trading close to its richest levels since mid 2009. With the US recession risk receding into the background, the most important source of vulnerability in the current market appears to be the euro area sovereign crisis. While the peso and other growth-sensitive currencies are, of course, vulnerable to a full-blown systemic event in Europe, the MXN can outperform in a scenario of more moderate euro stress and building ECB easing expectations, in our view. In this context, we believe EURMXN risk reversals look far too stretched and overpriced.

We recommend selling 1yr EURMXN risk reversals to exploit the rich long-end skew pricing. Specifically, we recommend buying one-year EURMXN 17.50 puts versus selling one-year 22.30 calls for zero cost (spot ref: 18.2860). The risk to the trade is potentially unlimited the further EURMXN trades above 22.30 at expiry.

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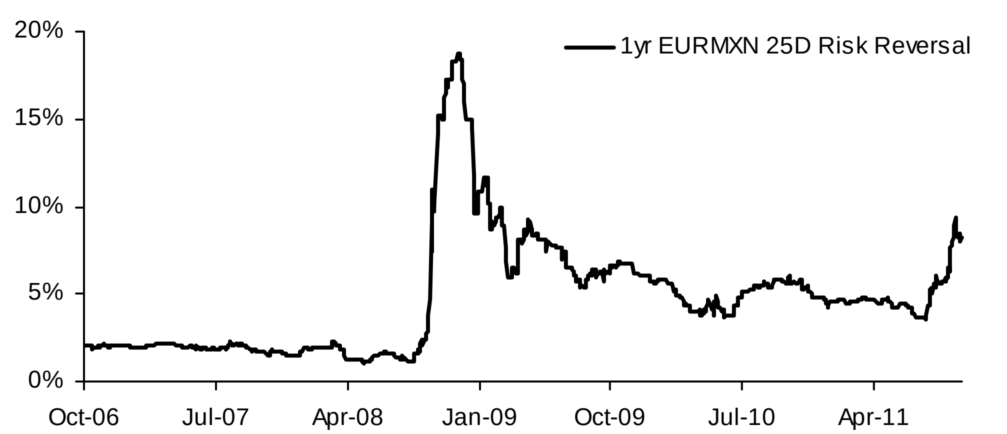
Markets in Europe have also priced in a large amount of good news with respect to the European policy process. As we noted in our *Weekly Update* last week, we see significant risk of disappointment on the policy front heading into next week's EU summit and the G20 meeting the following week, while bank recapitalization plans can also be a 'double-edge' sword for European markets in terms of equity market and asset sales impact. Growth numbers in Europe remain poor and, while ECB buying of Italian and Spanish government paper has helped reduce risks of extreme systemic events in Europe, markets are likely to continue to price substantial ECB easing.

In an environment of reduced tail risk but still significant danger from short-term European policy execution, we favor structures which benefit from a decline in pricing of US recession probability even as market participants look to rebuild euro shorts.

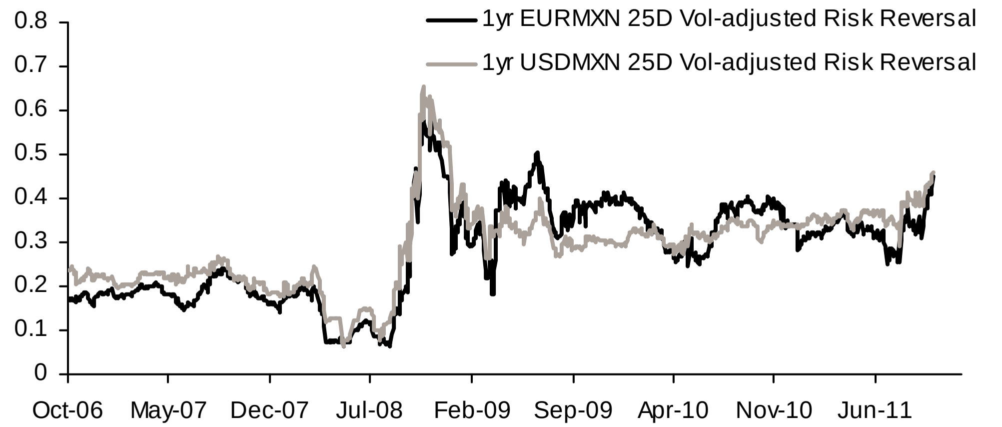
EURMXN implied skew pricing stands out as being rich given the reduction in tail risk associated with US growth and euro area crisis. Despite a modest retracement over the last couple of weeks, Exhibit 1 shows that EURMXN risk reversal is trading close to its richest levels since mid 2009. The one-year 25-delta to ATM implied vol ratio for EURMXN is currently close to 45%. In fact, EURMXN riskies are trading close to USDMXN riskies on a vol-adjusted basis (see Exhibit 2). With the US recession risk receding into the background, the most important source of vulnerability in the current market appears to be the euro area sovereign crisis. While the peso and other growth-sensitive currencies are, of course, vulnerable to a full-blown systemic event in Europe, the MXN can outperform in a scenario of more moderate euro stress and building ECB easing expectations, in our view. In this context, we believe EURMXN risk reversals look far too stretched and overpriced.

Exhibit 1: EURMXN risk reversals close to richest levels since mid 2009



Source: Credit Suisse Locus

Exhibit 2: Vol-adjusted EURMXN skews pricing in as much risk aversion as USDMXN risk reversals



Source: Credit Suisse Locus

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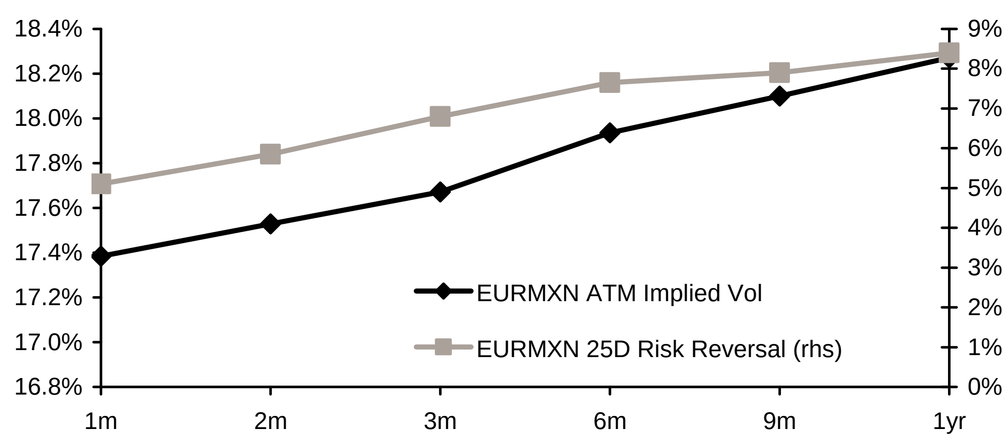
The steep term structure of implied volatility and risk reversal allows the structure to decay positively (see Exhibit 3). For example, assuming unchanged spot, forwards and implied vol surface, the structure would be worth 0.40% EUR in six months' time.

Exhibit 3: Steep implied vol and RR term structure allow positive decay



Source: Credit Suisse Locus

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