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FX Strategist

FX Strategy

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Brazil: Bullish BRL RKO

We recommend a bullish two-month USDBRL put struck at 1.70, with a reverse knock-out at 1.64. The cost of the trade is 0.4% of the USD notional or about half of the cost of the vanilla put; the leverage is 9.1x of the cost (the spot reference is 1.7135). The loss on the RKO is limited to the premium, and the main risk, in our view, is hitting the RKO barrier, even if the overall premise of the trade proves to be sound. The maximum payout is achieved if the USDBRL ends up just above the lower 1.64 strike at maturity. Investors can lower the probability of being knocked out by lowering the KO barrier, at the expense of the lower leverage factor.

The RKO (or alternatively put-spread structure) tends to be attractive when the government and the central bank (BCB) are trying to contain rapid currency appreciation. The premise for the trade is that there is a certain level of the USDBRL exchange rate that the BCB is trying to "defend." Given the recent rhetoric by public officials and today's introduction of further measures to reduce availability of dollars on shore, we think it is a good time to test waters with a RKO. In particular, we believe the 1.70 level for BRL could be where the BCB may draw the line. The second precondition of the trade, a supportive global environment, is also falling into place, in our view.

To be sure, we are not suggesting that any particular level of the exchange rate is an absolute target. After all, market speculation has been that the CB defended 1.75, 1.70, 1.65, and 1.60 levels prior to the sell-off in September of last year. However, compared to the summer of 2011, interest rates in Brazil are lower, and PRE-CDI forwards imply significant further reduction in Selic rate by June. At the same time the slowdown of the economy is likely to make the government even less tolerant of currency appreciation than last year. Therefore, we think that a structure that would benefit from the Real staying not far from the current level has a good probability to work over the next couple of months.

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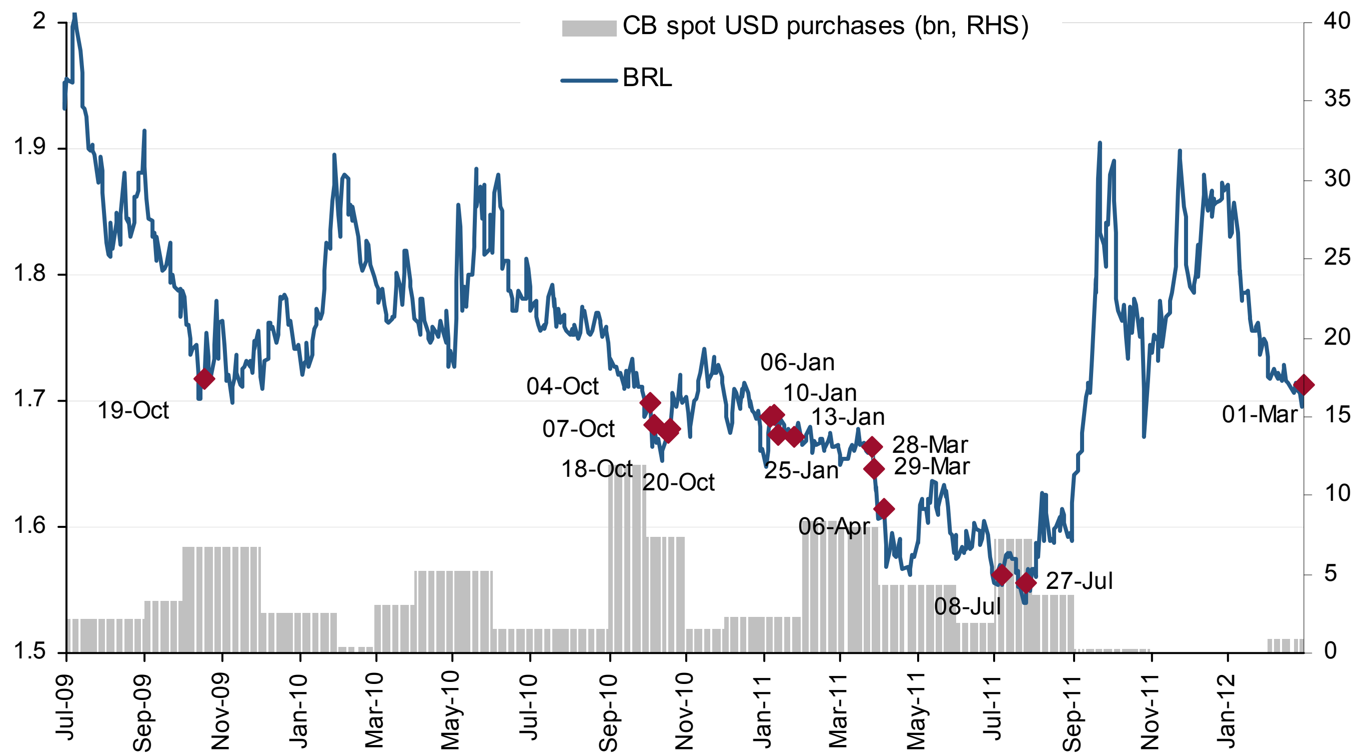
Government is concerned with the level of the Real

Several government officials have voiced concern about the strength of the Brazilian Real, over the past several weeks. Today the government acted upon these concerns, increasing the maturity of FX-denominated loans by domestic institutions (from two to three years) subject to the 6% IOF tax. The central bank has also been active in the spot and derivative markets. We believe additional measures could be considered, including further capital controls and FX intervention.

Exhibit 1: The chronology of FX measures and USD purchases aimed to slow down BRL appreciation

BRL/USD exchange rate. Monthly data for USD dollar purchases on the right axis (USD bn). Dates correspond to the measures outlined in the following table.



Source: Credit Suisse, Central Bank

Brazil has implemented a variety of measures aimed at slowing down Real appreciation in the last few years. Exhibits 1 and 2 outline the chronology of regulatory changes restricting foreign and domestic financial institutions' engagement in carry trade strategies (i.e., funding long BRL positioning in low-yielding currencies such as USD or EUR) in both the cash and derivatives markets. The measures came in bits and pieces over the last two years and fall into the following general categories:

- IOF tax on foreign portfolio inflows (6% for fixed-income inflows). The measures were introduced between October 2009 and October 2010
- Reserve requirements on banks' short dollar positions introduced between January and July 2011
- IOF tax on short-term (now up to three years) foreign loans by domestic institutions introduced between March 2011 and March 2012
- IOF tax on increases in short dollar position in derivatives established in July 2011

We think these measures have helped reduce the scope and speed of Real appreciation. The introduction of the IOF tax on foreign purchases of fixed income securities succeeded in reducing portfolio inflows substantially. Reserve requirements have decreased banks' ability to intermediate between client FX flows and the central bank, while the introduction of a tax on foreign short-term borrowing helped to prevent corporates from engaging in FX carry strategies. Finally, the introduction of the 1% levy on derivative transactions has reduced local banks' capacity to arbitrage on-shore and off-shore FX markets and to underwrite synthetic BRL-based instruments.

The latest measure (extension of maturity of FX loans subject to the IOF tax) has an important symbolic significance, in our view: The government is getting uncomfortable with the current level of the exchange rate and is likely to ramp up FX intervention further.

Exhibit 2: Measures introduced by the government since 2009 in order to prevent appreciation of the Real

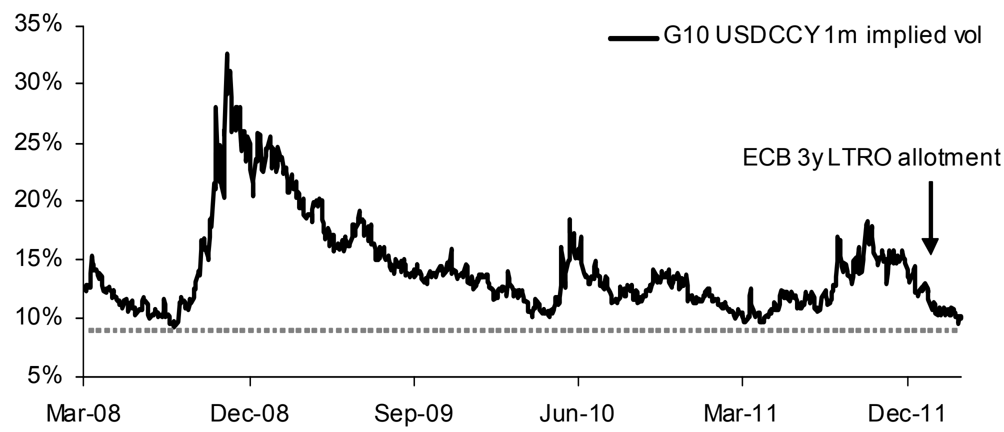
Date	Measure
19-Oct-09	Increase in financial transactions tax (IOF) rate on inflows for equities and fixed-income investments from 0% to 2%.
4-Oct-10	Increase in financial transactions tax (IOF) rate on inflows for fixed-income investments from 2% to 4%. Inflows to investments in equities 4-Oct-10 remained subject to 2% rate.
7-Oct-10	Simultaneous FX operations for foreigners that transfer their investments from the equities, futures and commodities exchange to other investments in the financial and capital markets, such as fixed-income securities.
18-Oct-10	New increase in IOF tax rate on inflows for the purchase of fixed-income securities, from 4% to 6%.
20-Oct-10	The Brazilian Monetary Council (CMN) established two resolutions limiting foreigners' transactions in the domestic market: - Resolution No. 3914: prohibits borrows, swaps, and loans of securities and gold between institutions in Brazil and non-resident investors. - Resolution No. 3915: requires the settlement of simultaneous FX contracts, subject to IOF, for all internal migration of funds in BRL by non-resident foreign investors for coverage of initial or additional margin deposits.
6-Jan-11	The central bank imposed reserve requirements on banks' short dollar positions. The reserve requirement will be charged on 60% of the short positions in dollars that exceed the lower of $3 billion and the arithmetic average of the institution's Tier-1 capital. It will be deposited with the central bank in local currency and will not be remunerated.
10-Jan-11	Bylaws allow Sovereign Fund to operate in the FX market.
13-Jan-11	Central Bank resumed operations with reserve swap contracts, taking long FX positions in the derivatives markets.
25-Jan-11	Central Bank of Brazil resumes term auction facilities in the FX market.
28-Mar-11	Government raises IOF rate on credit card transactions abroad, from 2.38% to 6.38%.
29-Mar-11	Government imposes IOF of 6% on banks and companies' international loans with maturities less than 360 days.
6-Apr-11	Government extended the maximum maturity of external loans subject to 6% IOF from 360 to 720 days.
8-Jul-11	Reduction in the limit for reserve requirements on banks' short position in dollars.
	Minimum deposit will be charged on 60% of short dollar positions that exceed the lesser of $1bn and the bank's regulatory capital. Deposit must still be made in cash, and no remuneration will accrue.
27-Jul-11	The government imposed a Tax on Financial Transactions (IOF) levy of 1% on increases in short positions in financial derivatives whose settlement value has been affected by FX rate changes. The levy will apply only to net short positions above $10 million.
	The legal framework for the levy of the IOF on the derivatives market has been established. The Brazilian Monetary Council (CMN) may raise the IOF rate to up to 25% on the value of the operations in the derivatives market.
1-Mar-12	The IOF tax of 6% on foreign loans is extended to maturities of up to three years (extending from two years adopted on 6-April-11).

Source: Credit Suisse

The outlook for high-yielding EM currencies has turned more favorable

Since the allotment of the ECB's first three-year LTRO on 21 December, FX-implied volatility has collapsed to pre-Lehman lows (Exhibit 3). Central banks in G10 have turned increasingly dovish in the past two months, with easing measures in the UK, in Japan, and in Europe. Finally, activity data in the US and in the euro area core have surprised to the upside, contributing to a general rebound in risk appetite. All of these factors have historically correlated with strong BRL performance.

Exhibit 3: FX volatility has collapsed since the ECB's LTRO allotment



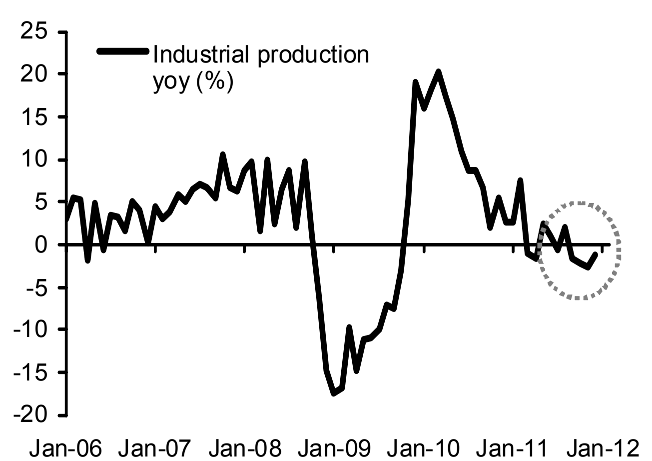
Source: Credit Suisse

We believe that authorities will be less tolerant of BRL strength this time

We note that domestic economic conditions have changed considerably, compared to the last round of intervention in early 2011, and that this change is likely to underscore a more stringent approach towards currency strength.

Recent official rhetoric suggests the government attributes industrial production underperformance on excessive BRL strength. Industrial production has contracted for the better part of the past six months, failing to capitalize on the recent pick-up in global activity indicators (our global PMI indicator has returned north of the 50 mark in December 2011). Additionally, the pick-up in commodity prices experienced in late Q4 failed to offset the decline in semi-manufactured products (see Exhibit 5). Our economists project a $22bn balance for 2012, down from $29.8bn in 2011. Further BRL gains would increase the risk of a more serious deterioration in growth.

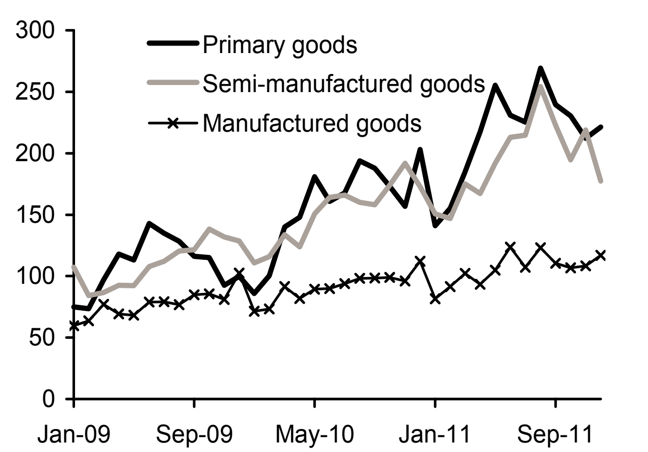
Exhibit 4: Industrial production has underperformed in late 2011



Source: Credit Suisse

Exhibit 5: BRL strength is taking a toll on non-commodity exports

Export component indices, December 2008=100



Source: Credit Suisse

The monetary policy stance has shifted to dovish. The weak domestic data and the convergence of inflation towards the central bank's inflation target have helped the Copom maintain the dovish stance it adopted in October 2011, when it started to cut rates. In early 2011, the last period of steady central bank intervention in the FX market, the central bank was in the midst of a tightening cycle. As a stronger currency would result in tighter financial conditions, it is likely that the Copom will be more in favor of measures aimed at curbing BRL strength than in previous occasions.

To sum up, the threat of a stronger BRL has become more urgent. This creates, in our view, an incentive for authorities to ramp up measures against BRL strength. From a market perspective, this makes the threat of intervention considerably more credible. We maintain a three-month USDBRL target of 1.75.

The main risk to this view is that the factors driving EM appreciation have become stronger. If we look at H1 2011 as a reference time period in which authorities intervened heavily against BRL strength, we note that it featured higher implied vol levels and tighter monetary policy in G10. As such we believe that USDBRL might temporarily undershoot our three-month target.

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