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FX Strategy

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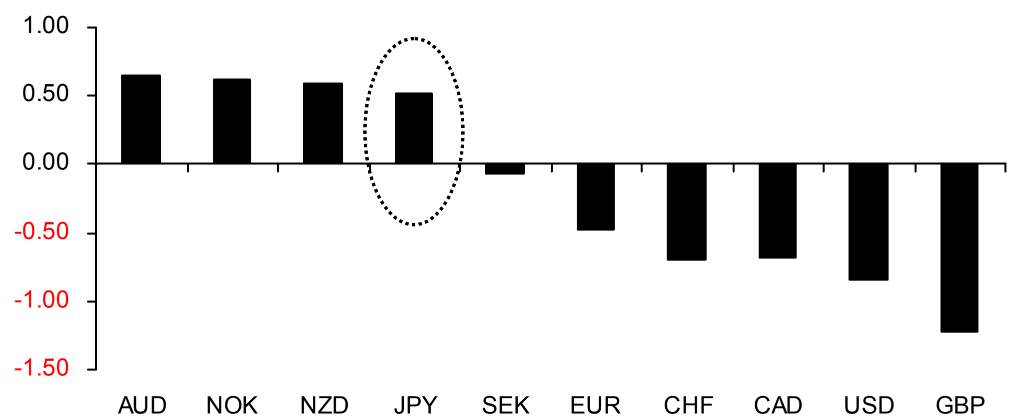
Positioning for JPY outperformance versus the CHF

- The JPY is likely to continue to benefit in 2012 from policy convergence and risk aversion. With most G10 central banks likely to be in or close to policy easing mode, pressure on rate differentials to converge towards Japan-like levels is likely to persist.
- In contrast, we think the franc overvaluation argues in favor of the Swiss National Bank maintaining the EURCHF floor unchanged at 1.20 well into 2012 and possibly longer. Given the negative-implied CHF rates and our expectation for the SNB to maintain the EURCHF floor, we like being short CHFJPY.
- We recommend buying three-month CHFJPY put butterflies to express our bearish CHFJPY view. Specifically, we suggest buying three-month CHFJPY 78.50 and 71.50 put options versus selling twice the notional of three-month CHFJPY 75.00 puts. The structure is offered at 0.52% of the single-leg CHF notional (spot ref: 82.20). The trade offers a maximum potential leverage of 8.9x premium if spot trades down to our three-month target of 75.00 at maturity. The maximum loss on the trade is limited to the upfront premium.
- As an alternative expression of a bearish CHFJPY view, investors can buy a USDCHF higher, USDJPY lower dual digital option. The positive implied USDCHF/USDJPY correlation provides significant savings on the structure relative to the individual digital options. A three-month dual digital with strikes 2.25% OTMS is offered at 10.00% of the USD payout. The maximum downside is limited to the upfront 10% premium.

The JPY is likely to continue to benefit in 2012 from policy convergence and risk aversion. With most G10 central banks likely to be in or close to policy easing mode, pressure on rate differentials to converge towards Japan-like levels is likely to persist. Faced with elevated uncertainty in global financial markets, an unattractive array of developed economy yields and the very elevated real yields at home, Japan's current account recycling is likely to remain insufficient and there will likely be persistent repatriation pressure on the stock of foreign assets. Japanese T-bill rates are 1.1% above core inflation, whereas US T-bills are 2.2% below core inflation – a 3.3% real yield gap in favor of Japan. Similarly, the five-year inflation-protected JGB yield is +0.52%, compared to -0.87% in the US – a 1.37% gap in favor of Japan.

Exhibit 1: JPY: the "Real Yield" advantage

5y real yield (inflation-linked bond where available)



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Intervention remains an important constraint on JPY appreciation, particularly with Japan now running a trade deficit and thus experiencing reduced net corporate hedging demand for the JPY. However, we do not expect the Bank of Japan to establish a definitive floor in USDJPY. Importantly, unlike the CHF, the JPY is not yet expensive from a fundamental equilibrium perspective. USDJPY would not reach one standard deviation cheap to our fair value framework until 69.

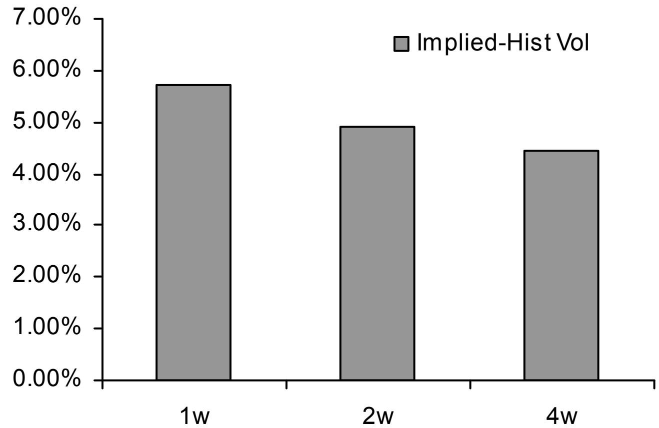
In contrast, we think the franc overvaluation argues in favor of the Swiss National Bank maintaining the EURCHF floor unchanged at 1.20 well into 2012 and possibly longer. Setting an FX floor is medium- to long-term policy, and credibility and consistency are crucial in this aspect. Fine-tuning the EURCHF floor could backfire. We note that the last time the SNB imposed a floor on DEMCHF above 80 (late 1970s), the floor held for two years. Given the negative-implied CHF rates and our expectation for the SNB to maintain the EURCHF floor, we like being short CHFJPY. As illustrated in Exhibit 1, the 5yr CHF real rate is currently 1.22% below the real yield in Japan.

We recommend buying three-month CHFJPY put butterflies to express our bearish CHFJPY view. Specifically, we suggest buying three-month CHFJPY 78.50 and 71.50 put options versus selling twice the notional of three-month CHFJPY 75.00 puts. The structure is offered at 0.52% of the single-leg CHF notional (spot ref: 82.20), close to a 60% discount to the 78.50 vanilla put option. The trade offers a maximum potential leverage of 8.9x premium if spot trades down to our three-month target of 75.00 at maturity. The maximum loss on the trade is limited to the upfront premium.

The recommended structure takes advantage of the rich CHFJPY vol pricing. Even though CHFJPY vols have cheapened from mid to late November highs, Exhibit 2 shows that implied vols continue to look very elevated compared to realized volatility. At the same time, Exhibit 3 shows that spot/vol correlation for the cross has been close to zero.

Exhibit 2: CHFJPY gamma looks overpriced

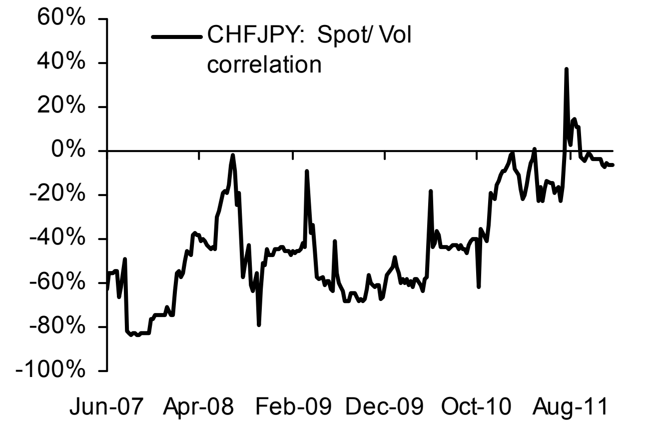
Historical vols based on 30-minute tick based vols



Source: Credit Suisse Locus

Exhibit 3: CHFJPY spot/ vol correlation is close to zero

6m rolling correlation of weekly changes



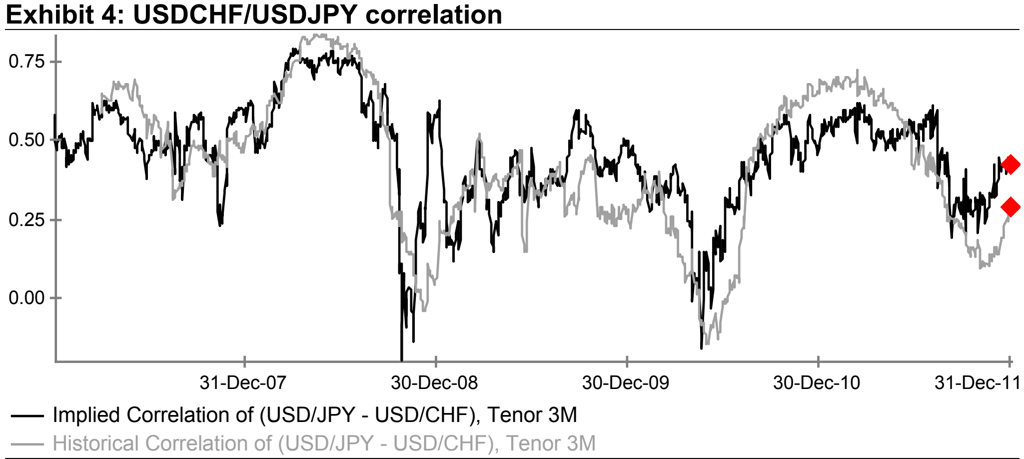
Source: Credit Suisse

As an alternative expression of a bearish CHFJPY view, investors can buy a three-month USDCHF higher, USDJPY lower dual digital option. The positive implied USDCHF/USDJPY correlation provides significant savings on the structure relative to the individual digital options. As shown in Exhibit 4, the three-month implied USDCHF/ USDJPY correlation is trading at post Sep intervention highs and looks rich relative to the delivered correlation. Trade details are as follows:

Trade:	Dual Digital Option
Tenor:	Three months
Strikes:	USDCHF above 0.9540 (2.25% OTMS)
	USDJPY below 75.05 (2.25% OTMS)
Payment Terms:	If USDCHF spot is above 0.9540 and USDJPY spot is below 75.05, the payout will be delivered to the option buyer
	If either USDCHF is below its strike or USDJPY is above its strike, there will be no payout.
Spot References:	0.9330; 76.78
Individual Offers:	USDJPY 29%, USDCHF 36%
Upfront Premium:	10% of USD payout... 10:1 payout ratio.

The risk to the trade is limited to the upfront premium of 10% .

Exhibit 4: USDCHF/USDJPY correlation



Source: Credit Suisse Locus

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