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Fixed Income Research
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FX Strategist

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Sell Forward Volatility in Emerging Markets

- The improved global growth outlook and more importantly the receding risk of a euro zone funding crisis following the ECB's December LTRO announcement have been a turning point for risk assets and various stress indicators across different markets. The easing in funding conditions has allowed a sharp decline in market pricing of near-term tail risk and as a result, a sharp decline in front end implied vols and re-steepening of the vol term structure across the currency universe.

- G10 FX implied vols have cheapened significantly and are trading close to the post Lehman lows. However, emerging market FX vols are still lagging and have scope to decline further with a recovery in risk appetite. At the same time, while front end vols have come off significantly from early December highs, long-end vols have been stickier resulting in sharp steepening of the term structure of volatility. This is generally more pronounced in some emerging market pairs.

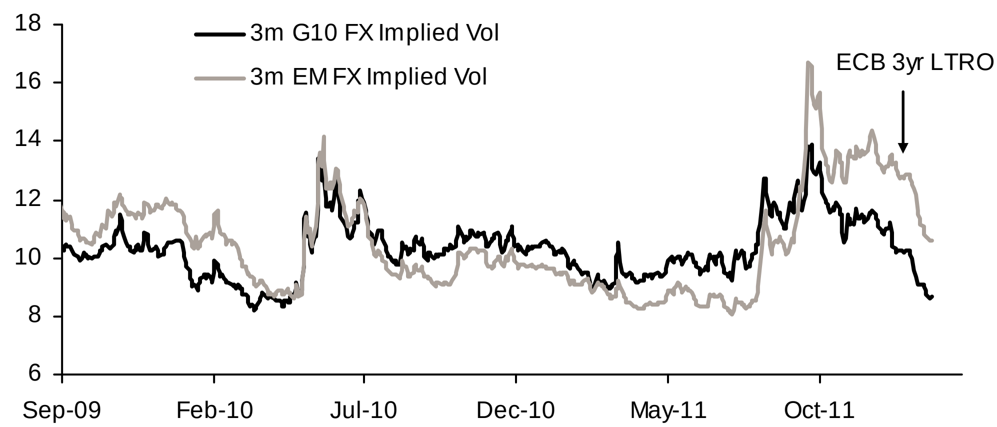
- Among the liquid EM currency pairs, ZAR and BRL currently stand out with the steepest curves. The 6m-1yr sector of the EURZAR curve looks particularly steep, making it one of the most attractive pairs to sell volatility on a forward basis followed by EURBRL.

- We recommend selling 6m in 6m EURZAR and EURBRL FVA (forward volatility agreement) to take advantage of the steepness of the two curves and express a bearish view on volatility.

The improved global growth outlook and more importantly the receding risk of a euro zone funding crisis following the ECB's December LTRO announcement have been a turning point for risk assets and various stress indicators across different markets. The easing in funding conditions has allowed a sharp decline in market pricing of near-term tail risk and as a result, a sharp decline in front end implied vols and re-steepening of the vol term structure across the currency universe.

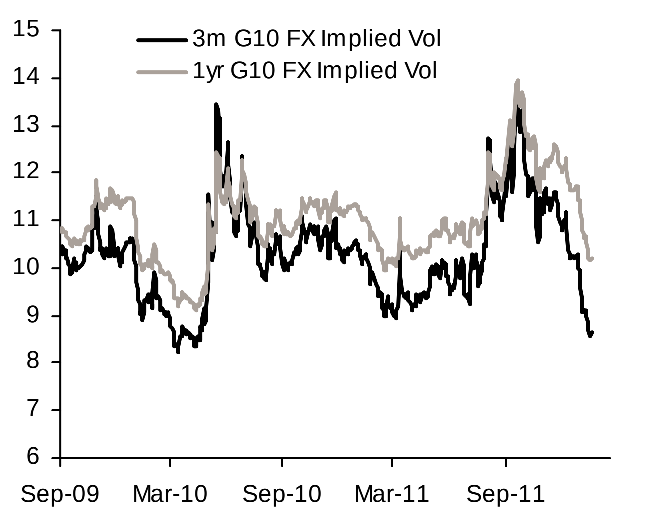
G10 FX implied vols have cheapened significantly and are trading close to the post Lehman lows. However, emerging market FX vols are still lagging and have scope to decline further with a recovery in risk appetite (see Exhibit 1). At the same time, while front end vols have come off significantly from early December highs, long-end vols have been stickier resulting in sharp steepening of the term structure of volatility (Exhibit 2 and Exhibit 3). This is generally more pronounced in some emerging market pairs. Based on our global strategist's view for a continued recovery in risk appetite combined with our expectation for EM FX outperformance, we think the risk premium and term premium built into emerging market FX vol curves should fall.

Exhibit 1: G10 FX vols at post Lehman lows, but EM vols still lagging



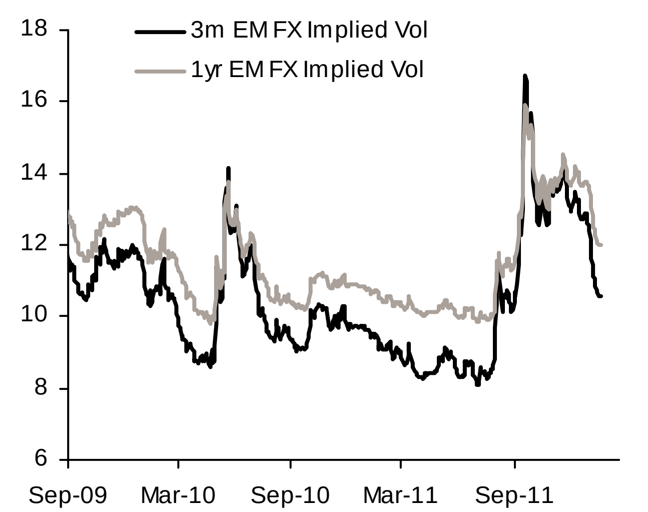
Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 2: Back-end vols have been stickier...



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 3: ... particularly in some emerging markets



Source: Credit Suisse

Among the liquid EM currency pairs, ZAR and BRL currently stand out with the steepest curves (see Exhibit 4 and Exhibit 5). The 6m-1yr sector of the EURZAR curve looks particularly steep, making it one of the most attractive pairs to sell volatility on a forward basis followed by EURBRL.

Exhibit 4: EURZAR and EURBRL stand out with the steepest vol curves…

Implied Volatility	3m	6m	1y	6m-3m	1y-6m
FX EUR/ZAR	13.70	14.90	16.75	1.20	1.85
FX EUR/BRL	12.36	13.50	15.00	1.14	1.50
FX EUR/KRW	10.79	11.77	12.88	0.98	1.11
FX EUR/MXN	12.66	13.38	14.25	0.71	0.87
FX EUR/TRY	11.45	12.65	13.50	1.20	0.85
FX EUR/ILS	9.05	9.90	10.50	0.85	0.60
FX EUR/INR	11.17	11.53	11.88	0.36	0.35
FX EUR/SGD	9.22	9.77	10.09	0.55	0.32

Source: Credit Suisse Locus

Exhibit 5: ...steeper than vs. USD-based EM pairs

Implied Volatility	3m	6m	1y	6m-3m	1y-6m
FX USD/KRW	11.40	12.65	13.90	1.25	1.25
FX USD/BRL	14.70	15.90	17.10	1.20	1.20
FX USD/ZAR	16.85	17.75	18.80	0.90	1.05
FX USD/TRY	12.65	14.00	15.00	1.35	1.00
FX USD/MXN	13.85	14.75	15.60	0.90	0.85
FX USD/SGD	7.60	8.00	8.50	0.40	0.50
FX USD/ILS	9.25	9.65	10.00	0.40	0.35
FX USD/INR	10.90	11.10	11.40	0.20	0.30

Source: Credit Suisse Locus

We recommend selling 6m in 6m EURZAR and EURBRL FVA (forward volatility agreement) to take advantage of the steepness of the two curves and express a bearish view on volatility.

6m in 6m EURZAR FVA: 17.40% – 19.10%

6m EURZAR (mid-mkt): 14.90%

1yr EURZAR (mid-mkt): 16.75%

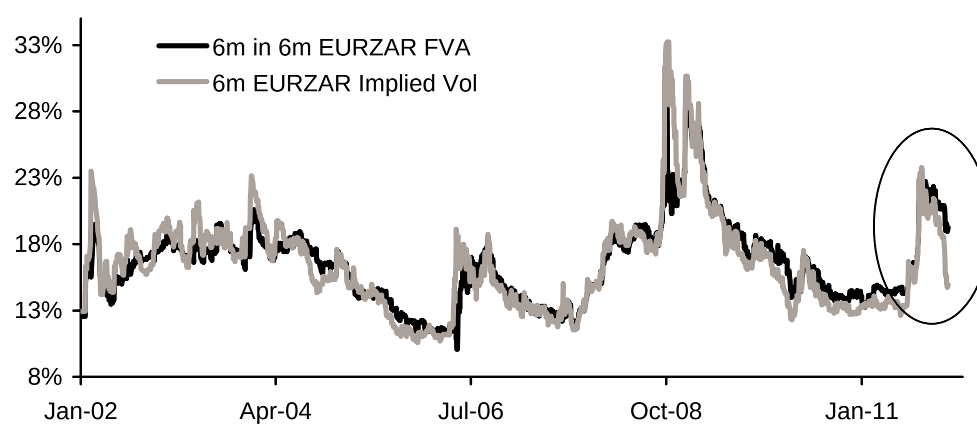
6m in 6m EURBRL FVA: 14.70% - 17.10%

6m EURBRL (mid-mkt): 13.50%

1yr EURBRL (mid-mkt): 15.00%

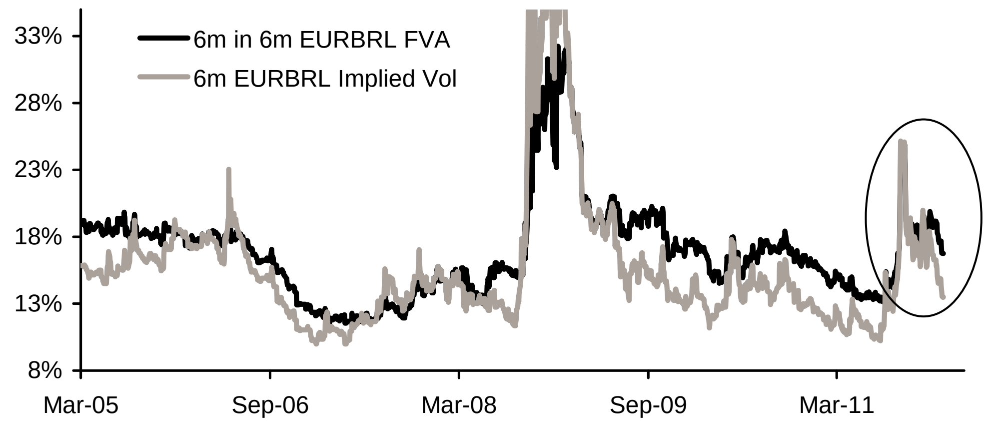
The risk to the trade is potentially unlimited if implied vols at the end of the forward tenor are higher than the pre-set level at which the investor sells the FVA.

Exhibit 6: EURZAR 6m in 6m FVA



Source: Credit Suisse Locus

Exhibit 7: EURBRL 6m in 6m FVA



Source: Credit Suisse Locus

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