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Investment Strategy Bulletin

EM currencies: Historically cheap on the charts – but not in our eyes

Investment Solutions

15 April 2020

- In March, we turned outright bearish on the GBI-EM currency benchmark following the plunge in energy prices caused by the OPEC-Plus impasse.
- While EM currencies may appear extremely cheap "on the charts" and could experience a technical bounce, they are broadly in line with fair valuations when considering the new normal for energy prices.
- This leaves scope for several EM currencies to undershoot on worse news, such as a potential sharp rise in Covid virus cases in some EM countries. Currencies with limited fiscal policy space, such as the ZAR, BRL, and COP, will also be particularly vulnerable.
- While the GBI-EM FX will remain under pressure, we believe the CNY and some Asian currencies (such as TWD and KRW) will be better placed to recover in H2.

A promising start to 2020 lost to Covid-19 and the oil shock

After being punished from 2018 to 2019 by the US-China trade war, we believed at the end of 2019 that EM currencies as a group were looking undervalued, and could benefit from a thawing in trade tensions as well as a likely modest recovery in global trade volumes. Timing-wise, H1 20 was set to be a better period for EMFX, with the lagged impact of Chinese stimulus likely to filter through. However, two major drivers shifted the landscape.

First, it was the Covid-19 outbreak. In January, the virus was seen as having more of an "idiosyncratic" or localised impact. In fact, while Asian equities had come under pressure, global equities were holding up quite well. Similarly, while currencies of countries dependent on Chinese-related tourism and/or supply chains were under pressure (like the THB, SGD, and KRW), other currencies within Asia (CNY, INR, PHP) as well as some outside Asia (the MXN) were performing quite nicely. However, in mid-February, when evidence began growing that the virus was spreading outside Asia to other countries and specifically initially within Europe, the EMFX sell-off broadened from a local to a global event.

Second, adding insult to injury was the collapse of OPEC-Plus, and an outright price war between Saudi Arabia and Russia that saw energy prices plummet. This further weighed on several major liquid EM currencies that are linked either to energy prices or more broadly to commodity prices. Thus, in the month since the collapse in talks between Saudi Arabia and Russia, currencies like the IDR, BRL, ZAR, and MXN have clocked losses of between 12% and 17%. The most recent announcement to begin reducing 10-15 million barrels-per-day (mn bpd) of production by OPEC-Plus and key Western energy producers is commendable, but it is unlikely to prevent energy prices from further downside risks given the higher levels of demand destruction (anywhere between 15 and 35 mn bpd), especially with supply cuts likely to take effect from May.

Hence, while we believe that energy prices will eventually settle closer to USD 40 per barrel by the end of the year, downside risks from current levels cannot be ruled out on a three-month view.

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Data as of 15 April 2020 unless otherwise stated.

EMFX: Optically cheap, but actually not so in the light of "low-for-longer" oil prices

Not all EM countries are energy exporters; some large countries in Asia and CEEMEA (like Turkey and most of CEE) are actually energy importers. Still, when aggregated by weights allotted to EM bond benchmarks such as the GBI-EM, we find that resultant terms of trade indices are highly correlated to energy prices (chart 1). Once we normalise for longer-term fundamentals, we find that EMFX as an asset class (here we use the GBI-EM FX index) has gone from appearing 8% undervalued at the start of the year to suddenly being fairly priced for the given oil price level (chart 2).

In our eyes, then, and despite the crushing declines already seen in EMFX over the past two months, EM currencies do not seem to represent value at current levels. While they may be "technically" oversold and could bounce back in coming weeks, the bar for further weakness is still quite low. Currencies are more likely to first become undervalued as markets may price in rising premia linked to either Covid-19 or the resultant policy responses to the crisis that will exacerbate imbalances in several countries.

Some countries like Russia and Colombia are highly vulnerable to energy prices both from a current account perspective (as they are net energy exporters) as well as through their reliance on oil activity to generate a significant proportion of their fiscal revenue. Others, such as Mexico and Indonesia, are actually net importers of energy, and their trade balances should theoretically benefit from lower oil. However, at the same time, oil forms an important part of their fiscal revenue, and softer oil prices could influence FX by undermining their fiscal positions.

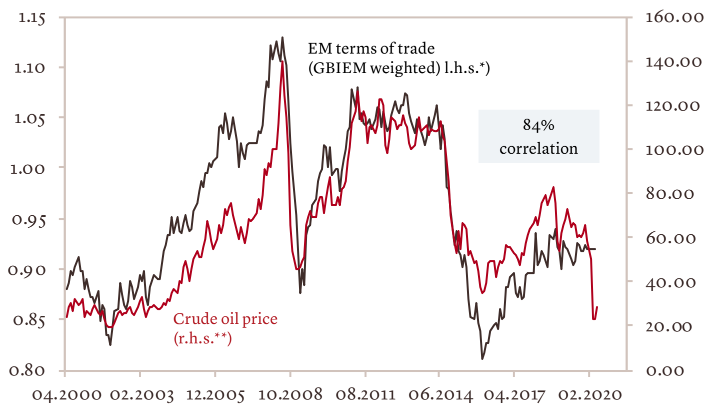
EM authorities will likely be content to use FX as a pressure valve in this growth shock

In 2013, when EM countries suffered from a sharp upward shock to US yields and financing tightened, several of them either raised rates or used aggressive intervention to defend their currencies. However, those were different times: for the bulk of emerging market countries, inflation at the time was running above most policy inflation target levels, monetary policy was lax, and growth was performing quite well or even running hot in several places. This led to EM authorities throwing the "kitchen sink" at their depreciating currencies in order to stabilise them. The hope was also that higher real rates would increase savings, slow investment, and thereby improve the current account positions.

The situation now is different: for most EM, inflation is running well below inflation target levels, external balances are in better shape, and growth is weaker. Indeed, a weighted average growth rate of the BRIICS economies ex China (i.e. Brazil, Russia, India, Indonesia, and South Africa) is projected to decline to 1.6% YoY for 2020 according to the median of private sector economist forecasts. These forecasts likely face further downside risks given the fluidity of the situation. For example, plugging in the latest forecasts from the International Institute of Finance point to an outright contraction of 2.2% yoy, far worse than the 0% growth achieved in 2009. This contrasts with 3.5% YoY for 2019, and will be the lowest level of growth since 2009, in the aftermath of the great financial crisis. Moreover, unlike the last slow growth phase of 2015-16, inflation is also much lower (chart 3).

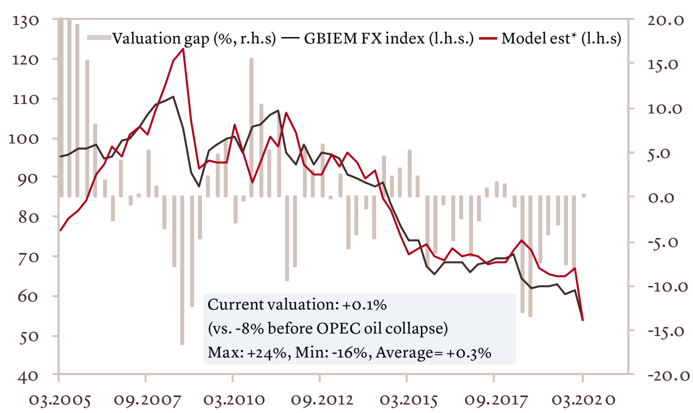
Accordingly, we are not in an environment where authorities will act aggressively to defend currencies. In fact, with inflation below target and the world facing a disinflationary shock, weaker currencies will be tolerated increasingly. This applies also to countries in a much better position to intervene, such as Russia. While Russia stands out for having a strong sovereign balance sheet, large FX reserves, and a budget surplus, we do not believe this can stop its currency from modest further weakening. It should be noted here that while Russia has a substantial war chest of FX reserves, it is unlikely to aggressively intervene to defend the RUB as it did in 2014,

1. Lower energy prices will hit GBI-EM country terms of trade



* left hand scale, ** right hand scale
Sources: Bloomberg, CPB Netherlands Bureau for Economic Policy Analysis, Lombard Odier

2. Given low oil prices, GBI-EM FX is fairly valued, and may face downside risks going forward



* based on EM-US GDP differential, govt debt/GDP and energy prices
Sources: Bloomberg, Lombard Odier

simply because Russia now operates a “free-float” rather than a managed FX regime.

Next drivers will be EM markets becoming increasingly sensitive to Covid, and…

On 14 April, we began monitoring twelve EM countries across Asia, LatAm and CEEMEA, supplementing our existing tracking of DM and North Asia (see here). While there are signs of infection rates peaking for the most affected countries in the Western world, the virus curve is beginning to move up in large parts of EM. Several EM countries are still recording 10%-plus daily growth rates: India, Indonesia, Mexico, Brazil, Colombia, Turkey, and Russia. We find that currently, Turkey, Russia, and Chile are showing the highest levels of confirmed cases per unit of population, and Turkey is showing by far the highest number of deaths per unit of population (nine deaths per million people).

However, there is concern over data quality in many EM economies. For example, Mexico’s Ministry of Health has suggested that the total number of confirmed cases could be as high as 26K compared to the WHO’s reported figure of 4.2K. This is worrisome given that Mexico’s response to the crisis has been more timid than peers’. Overall, there is a substantial risk that the numbers will move higher for these EM countries in the coming weeks, which should add downside risks to local EM asset markets. Of concern also is medical infrastructure that is weaker in many emerging markets. For instance, Turkey – which is quickly emerging as a Covid hotspot – has just over two nurses per 1,000 population only, much lower than Italy’s seven.

… policy-makers’ ability to support the economy through the shock

Over time, assuming most countries engage in lockdowns to contain the virus, markets will be looking towards sufficient support measures from the authorities, on both the monetary and the fiscal fronts. In aggregate, BRIICS ex-China do appear to have further monetary space: the weighted average policy rate for BRIICS ex-China stands at 4.75% currently, some way above inflation that now stands at 3.85%.

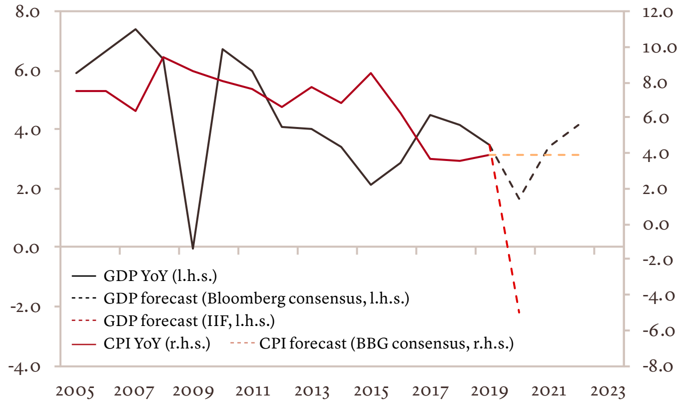
That said, fiscal policy is somewhat more constrained, with the weighted budget balance set to widen to above 4% of GDP this year. Countries like South Africa, Colombia, and Brazil will find it increasingly difficult to engage in sufficient fiscal stimulus given already elevated debt levels and wide budget deficits. These currencies will face an added layer of fiscal risk as well. Interestingly, two of the countries – Colombia and Brazil – are studying QE-like measures, i.e. buying government and/or private securities in the primary markets.

Action plan

In client portfolios, we have turned underweight in EM local and hard currency debt over the past month. While the GBI-EM FX index appears cheap on the charts, it is fairly valued given the new low-for-longer outlook for energy prices, and may undershoot. On the other hand, we believe the Chinese yuan and select North Asian currencies are likely to outperform in the second half of the year. These countries benefit from declining energy prices and appear to have managed to contain the virus well, which should lead to an earlier recovery. Moreover, unlike the GBI-EM FX, we find the CNY to be undervalued (chart 4), having become cheap through the trade war over 2018-19. We maintain a short USDCNH position in client portfolios.

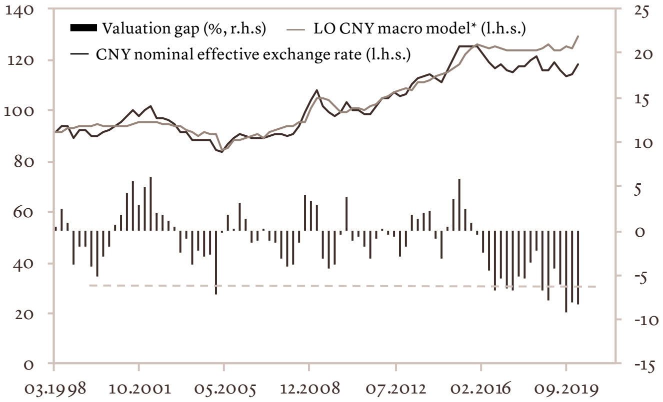
Kiran Kowshik, Global EMFX Strategist
Vasileios Gkionakis, Head of FX Strategy

3. Consensus forecasts BRIICS-ex-China GDP to grow at slowest pace since 2009, with inflation remaining at low levels



Sources: Bloomberg, International Institute of Finance (IIF), Lombard Odier

4. We prefer parts of North Asia, and especially the undervalued CNY



* Lombard Odier CNY macromodel based on productivity growth differentials, degree of openness and terms of trade
Sources: Bloomberg, Lombard Odier

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