

EM FX: Tied to tapering!

Fed forward guidance is key

Nordea Research, 18 December 2013

- 50:50 odds of tapering today
- We expect the FOMC decision to be received with calmness, but...
- ... a hawkish surprise would put pressure on EM FX
- Looking ahead, Fed forward guidance is key to EM resilience
- Growth and external imbalances will continue to divide EM FX

Taper, taper, taper...

Today, all eyes are on the Fed's policy decision at 20.00 CET. We believe that there is close to a 50% chance that the Fed will begin tapering its asset purchases. If tapering is not announced today, it will likely be so at the 28-29 January meeting. Furthermore, we expect a small, cautious step, with the Fed reducing the pace of its bond purchases by around USD 10bn. For more on our views on the Fed, see [50:50 odds of Fed tapering next week](#).

Since the Fed hinted in May that it might step down its asset buying programme, Emerging Markets (EM) currencies have roughly been moving in tandem with US yields (Chart 1). Higher US yields have on average translated into weaker EM currencies. On fears that global liquidity would dry up, international investors initiated a massive sell-off in EM assets in May. But now the market finally appears to accept that tapering does not mean tightening (Chart 2), and as a result portfolio flows to EM have picked up again, particularly to those EMs that initially suffered the largest decline such as Turkey and India.

Chart 1. EM FX tied to US 10Y yields

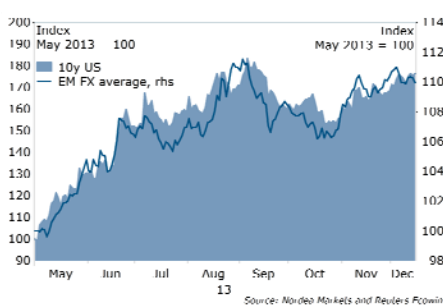
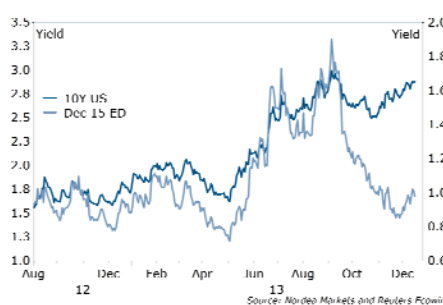


Chart 2. Fed forward guidance



What will happen to the EM currencies in the days ahead? Well, if the Fed decides to postpone tapering until 2014, we expect to see a minor relief rally in most EM currencies, while a decision to taper will likely put short-term weakening pressure on the most vulnerable currencies such as the BRL, the TRY, the IDR and the ZAR.

However, whether the Fed decides to taper today or wait for next month is not a major game changer, implying that we will not see FX movements similar to those in August, where some EM currencies weakened 20%. It's merely an issue of timing. Tapering in itself has been priced in.

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Fed forward guidance is key to EM resilience

It is a well-known phenomenon that once the US starts tightening its monetary policy stance, financial crises are bound to hit EMs – or is it? Empirics as well as intuition are actually quite inconsistent. On the one hand, higher US interest rates may reduce the attractiveness of investing in EMs as yield differentials narrow. On the other hand, if rising interest rates reflect a stronger US economy, this will generally have positive spill-over effects on economic activity in EMs, thus making them a more attractive destination for investment.

EMs will suffer if US interest rates decouple from US cyclical drivers.

One conclusion to draw from this is that higher US interest rates need to be in line with US cyclical drives in order for EMs to benefit – and this is why forward guidance is so important. As long as rates and recovery go hand in hand, some EMs have the potential to catch a ride on the US cyclical upturn.

Chart 3. EM FX against USD

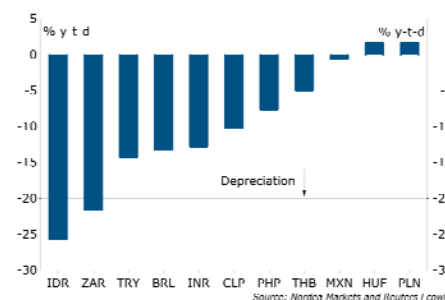


Chart 4. Efforts to stem FX pressure

	Rate hike	Rate cut	Liquidity measures	FX swaps	FX intervention	Roll capital inflows
Brazil	X			X	X	X
Mexico		X				
India	X		X	X	X	X
Indonesia	X		X	X	X	X
Thailand		X			X	
South Africa						
Turkey			X	X	X	
Russia			X	X		
Romania		X	X	X		
Poland		X	X	X	X	
Hungary		X	X	X		

Divergence in the EM universe

Looking ahead, two themes will likely divide EM currencies into winners and losers, namely growth and external imbalances. The latter is almost self-evident, recapturing the August sell-off where large C/A deficit economies took the hardest hit. As global liquidity tightens, funding large external imbalances will inevitably become more difficult. In this respect, the TRY and ZAR are some of the most vulnerable EM currencies, while the Indian authorities have taken actions to trim the C/A deficit, which will likely support the INR (Chart 4).

In terms of growth, EMs have already experienced some divergence. Most notably is the divergence between Brazil and Mexico. Just as Mexico is emerging from recession-like conditions, Brazil is running out of steam and might be heading for a prolonged period of slow economic growth as structural problems remain unresolved.

Willingness to reform will play a crucial role in the EM universe going into 2014, as many realise that they are in fact caught in a structural slowdown, unable to truly benefit from the cyclical upturn in the US. Unfortunately, elections in many EMs will likely stall the reform progress.

Chart 5. BRL moves in tandem with US 10Y

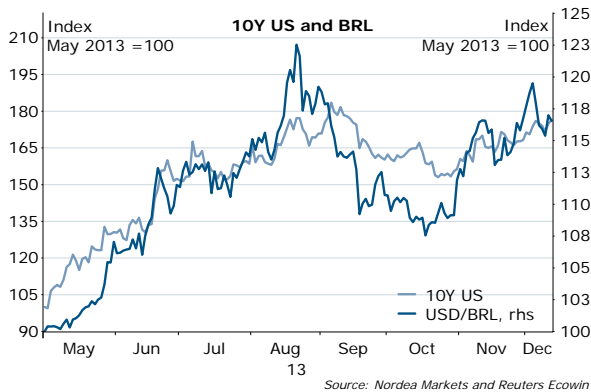


Chart 6. INR, on the other hand, has decoupled

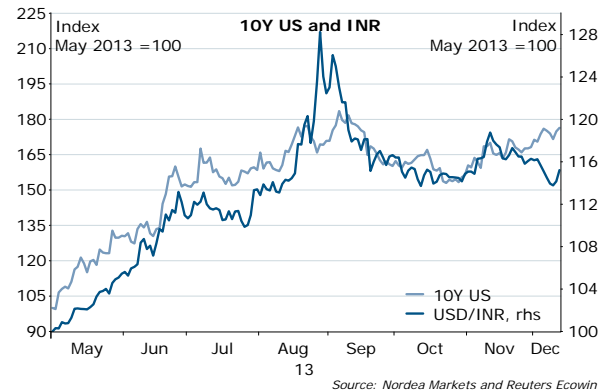


Chart 7. To some extent, so has MXN

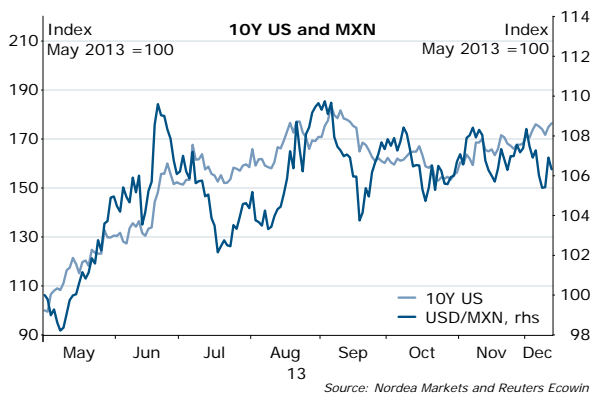


Chart 8. TRY remains closely tied to US 10Y

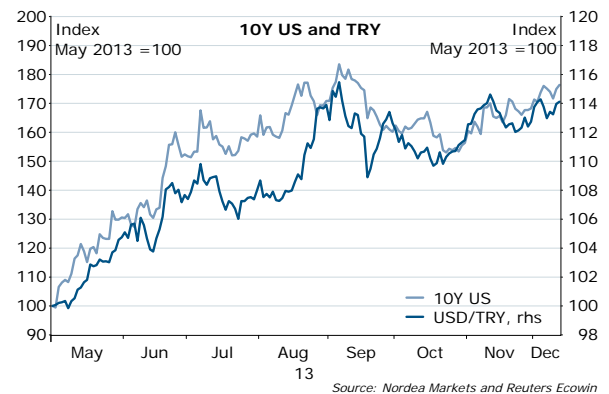


Chart 9. So does ZAR

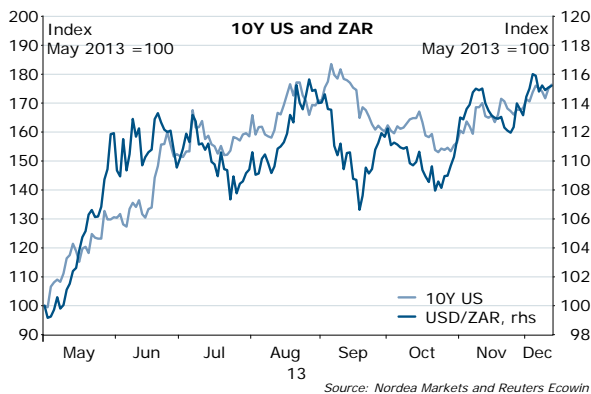
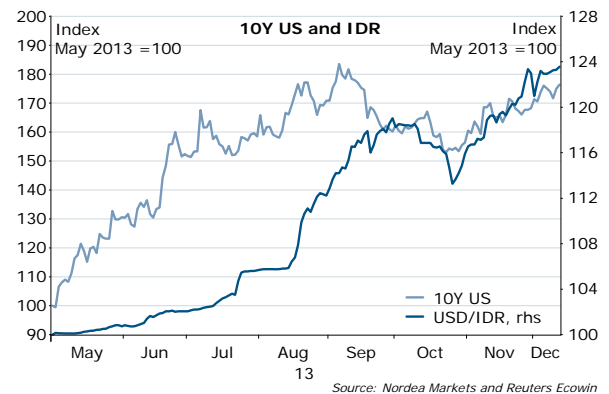


Chart 10. IDR seems determinate



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