EM FX

Doing the rounds

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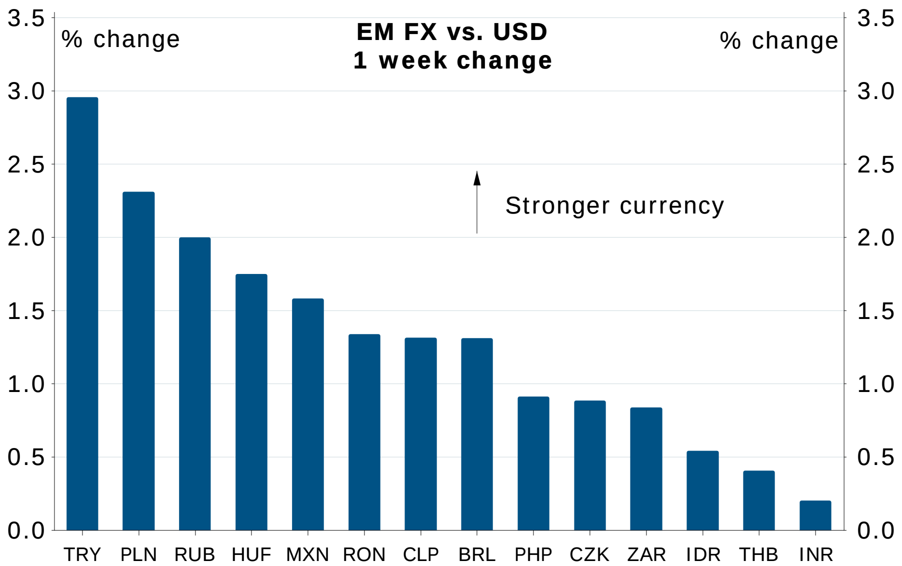
- Near-term relief amid a stream of positive news
- … despite a devaluation in Kazakhstan
- Is it time to break the last EM pegs?
- So far, three phases of EM sell-offs – we are not done yet!
- Potential near-term triggers: EM political risk

Temporary relief

After a storm comes a calm – the storm being the January sell-off and the calm being now. A steady stream of positive news has translated into some much needed relief for pressured Emerging Market currencies. Especially, the Turkish lira has staged quite a comeback. It is, however, still windy in some EMs with deep domestic problems such as Kazakhstan where the authorities earlier this week decided to devalue the tenge in an attempt to restore external competitiveness, see KZT: Kazakhstan devalued tenge, history repeats itself.

We see near-term risks of a renewed EM sell-off as elections in several EM countries could disrupt the current calm sentiment. First up is Turkey, where local elections are set for 30 March. With an already fragile political situation amid the corruption scandal from December 2013, we suspect that sentiment could once again turn against the Turkish lira, and potentially spread to other EM FX as well, such as the South African rand.

Chart 1: The February calm after the January storm



Source: Nordea Markets and Reuters Ecowin

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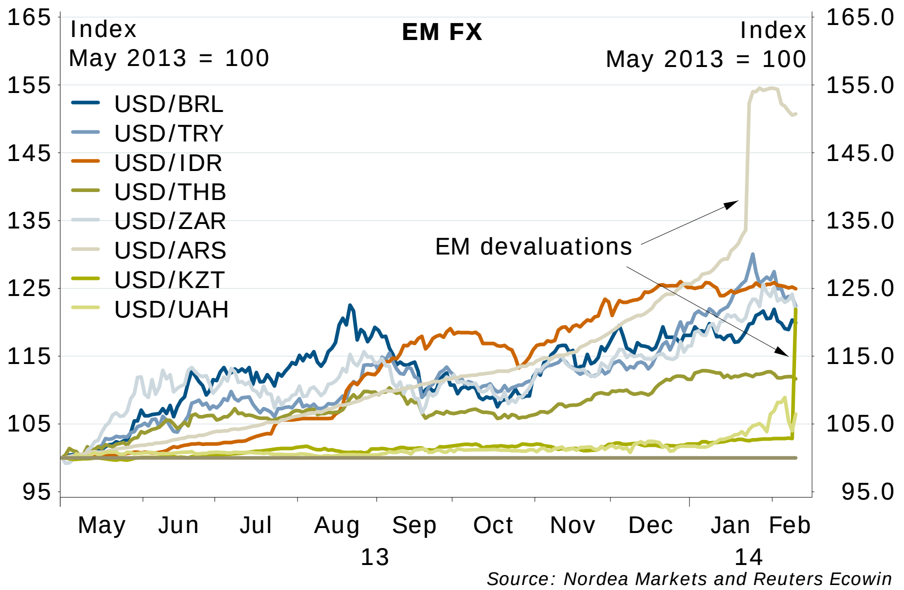
Break of pegs?

The short answer is no.

Devaluations and pegs are back on the table

So far, the EM FX universe has seen one broken peg and one devaluation. The broken peg is the Argentine peso-peg, which was left on 23 January, while the devaluation was delivered on 11 February by the Kazakhstan central bank. Despite the relatively short time span between the two FX events, they are not closely interlinked as they differ widely in terms of *trigger* and *risk of contagion*.

Chart 2: Two effective devaluations in the EM universe



The tenge was pressured by Fed's tapering – the peso by bad domestic policies

Regarding the trigger, the National Bank of Kazakhstan quoted rising pressure from the Fed tapering and the resulting weakening of the EM currencies – including the Russian rouble – as the main reason for devaluing. In contrast, the trigger was not external in the case of Argentina. Instead, it was the inevitable outcome of mismanaged macroeconomic policies. For several years the Argentine government has been monetizing a public deficit, fuelling one of the world's highest inflation rates; this combined with strict FX controls led to a parallel currency market where the peso trades at a discount of 60-70% to the official exchange rate. Therefore, letting the peso float was a desperate (or smart – time will show) strategy to stop the bleeding of scarce FX reserves. In short, the trigger was (to some extent) external in the case of Kazakhstan, while internal for Argentina.

Little risk of contagion from Argentina

This is also why we see *little risk of contagion in the case of Argentina*. That being said, the Argentine depreciation does pose a downside risk to Brazil's already sluggish growth in 2014 (we expect below 2%). Argentina is Brazil's third largest trading partner and negative spill-overs will likely go through the industrial sector as 76% of Brazil's exports to Argentina are high-cost manufactured goods, which require extended supply chains.

Chart 3: Brazil's trade with Argentina

Source: Nordea Markets and Reuters Ecowin

KZT devaluation may spread to other EMs

On the other hand, the Kazakhstan devaluation has the potential to spread to other EM currencies, as it is a competitive devaluation. Especially, the Ukraine hryvnia could come under even more pressure. Basically, if the relatively stronger central bank of Kazakhstan has come to the conclusion that a competitive devaluation was needed – it should not be too long before the Ukraine central bank reaches the same conclusion. However, Ukraine first needs to appoint a new Prime Minister. See also Ukraine: Increased risks for devaluation and default.

Sell-off phases

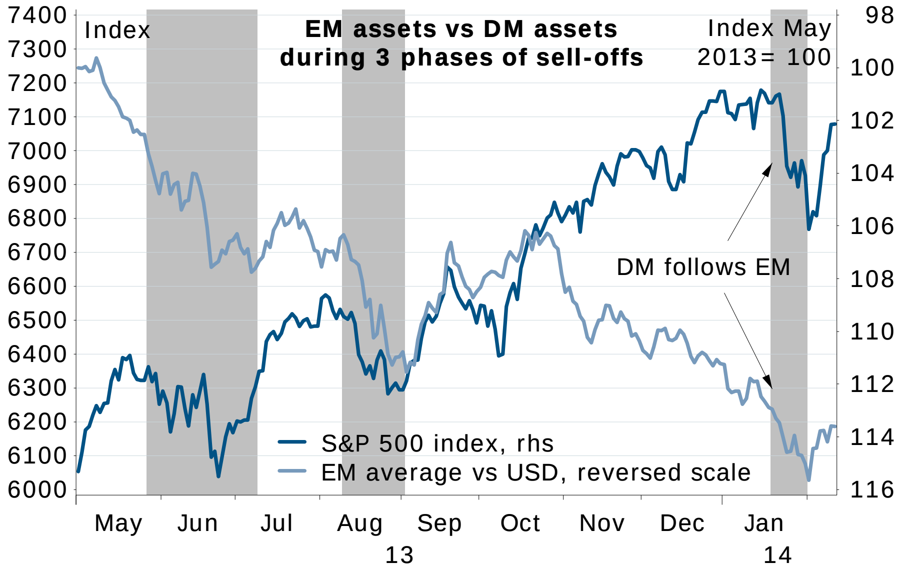
Since last summer – when the Fed first hinted at tapering – the world has witnessed three distinct phases of EM sell-offs:

- Phase 1: *"Indiscrimination" sell-off* in June 2013 triggered by fear of the Fed's tapering of its asset purchases and a hard landing in China.
- Phase 2: *"Good versus bad" sell-off* in August 2013, where we saw some discrimination among EM countries running current account surpluses and deficits.
- Phase 3: *"Quick and dirty" sell-off* in January 2014 with continued discrimination between EM countries where more countries was added to the group of "bad" EMs.

EM FX has gone a lot of the way…

Interestingly, the time span of each sell-off phase has shortened, indicating that the need for correction becomes smaller and smaller as many EM currencies are approaching more reasonable levels compared to before May 2013.

Chart 4: The 3 phases of EM sell-offs



Source: Nordea Markets and Reuters Ecowin

Still a need for adjustment in EM FX

Also, during all three sell-off phases there was a pronounced positive correlation between the S&P 500 and the EM FX indicator, suggesting that the sell-off does not just affect EM countries, but also the developed world. However, the trend still points to a negative correlation between the two asset classes, where EM FX has in general weakened, while the S&P 500 has continued to increase.

No “new normal” – just repeating past trends

Zooming out on Chart 4, it should be fairly clear that a negative correlation between EM FX and the S&P 500 has previously prevailed for extended periods of time (see Chart 5). During the era of financial crises in the EM universe – from 1994 to 2001 – there was a clear and rather consistent negative correlation between EM FX and the S&P 500. This was followed by a prolonged period of positive correlation driven first by a strong positive sentiment (2002-08) and then a negative sentiment (2008-10), taking both “asset” classes in the same direction.

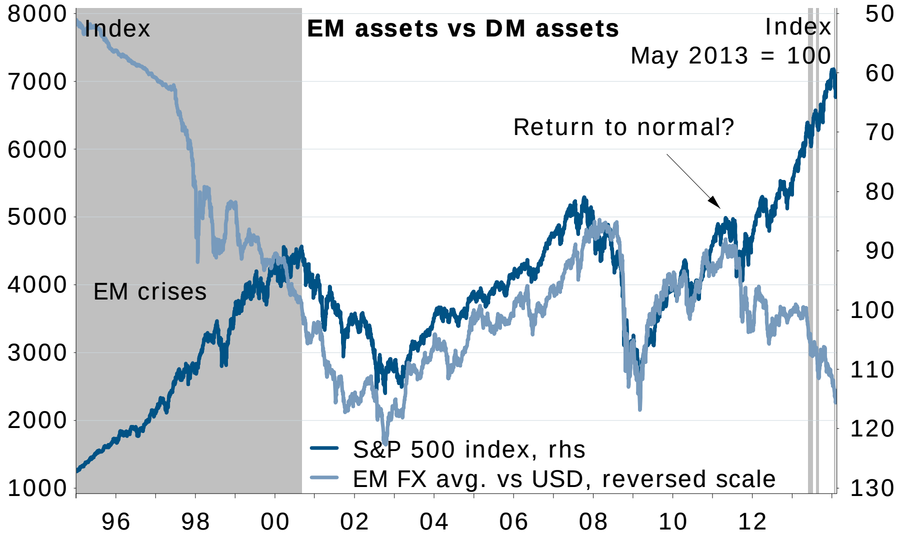
Around 2011 something changed and divergence became a theme once again, indicating that EM countries are returning to an old normal – not a “new normal”.

Divergence driven by China, commodities and interest rates

The positive sentiment between 2002 and 2008 was largely driven by China’s growth miracle, higher commodity prices and low interest rates. Since then growth in China has slowed, commodity prices have fallen and interest rates are more likely than not to rise. This type of environment is unlikely to be EM supportive and we will likely continue to see the need for an adjustment in the EM FX universe.

After a storm comes a calm – and after that calm, there will be another storm.

Chart 5: The bigger picture – divergence, convergence, divergence



Source: Nordea Markets and Reuters Ecowin