Marketexpress

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Emerging market currencies face renewed pressure

The outlook for emerging market debt (EMD) is two-sided. On the one hand, the global liquidity environment remains benign, thanks to low developed-market bond yields and a limited risk of rising yields, particularly in Europe and Japan. On the other hand, EM endogenous factors remain weak, as growth continues to struggle and reforms are still unconvincing.

Global liquidity still very supportive

The liquidity environment for EMD has remained supportive in the past few months. Even in the past weeks, when US bond yields rose by around 40 basis points, the search for yield remained strong. Hard-currency debt (EMD HC) benefited, as did high yield credits in developed markets. As US bond yields rose and market expectations for the first Fed rate hike moved from autumn to summer, hard-currency debt clearly outperformed local-currency debt. A lot of this outperformance can be explained by the rebound of the oil price since the last week of January, as EMD HC had suffered relatively strongly from the sharp drop in oil prices. But the deteriorating prospects for EM currencies have also played a role.

EM growth momentum has deteriorated

Two things have changed in the past few weeks. Firstly, EM growth momentum has deteriorated sharply. Our own EM growth momentum indicator has declined sharply in the past weeks, after being stable at the neutral mark for several months. Of the 18 markets in the index, only Thailand, Chile and Mexico have a positive growth momentum now. The other 15 are negative or neutral. The worst momentum can be found in China, Indonesia and Russia.

EM central banks in easing mode

Secondly, monetary easing in the emerging world has become more pronounced, with recent interest rate cuts by Indonesia and Turkey. Twelve of the main 16 emerging economies are now on an easing path. This is the result of weak growth and falling inflation, and because policy makers want weaker exchange rates to compensate for lower raw material prices and/or lost competitiveness. Lower raw material prices continue to put pressure on many emerging economies, particularly the fundamentally weak ones. This explains why in the past weeks Nigeria stopped defending its currency and Azerbaijan decided to devalue its currency (by 33%!) for the first time since 1999.

Volatility in EM currencies has increased

The combination of weaker growth and overconfident central banks is a bad one for EM currencies, which have become more and more volatile recently. The fear that we have had for years now - that EM exchange rates eventually will have to depreciate much more to fully reflect deteriorated EM fundamentals - is becoming more relevant.

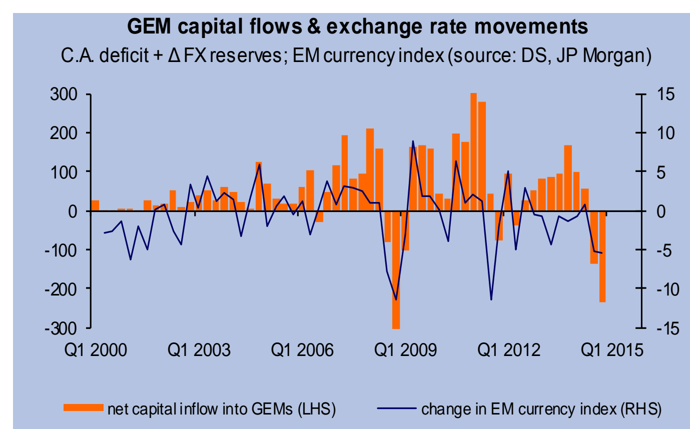
Central banks should be more cautious

In our view, EM central banks are counting too much on carry-trade-related hot money inflows. With the first Fed rate hike now only half a year away – this is what the Fed fund futures have priced in – countries like Turkey and Indonesia, with their high current account deficits and fragile domestic banking systems, should be more cautious. Especially since recent capital flows to the emerging world have already been weak (see graph).

Currency depreciation is a risky strategy

Policy makers see no end to the growth slowdown. At the same time, inflation is declining. This probably makes them think that more currency depreciation is desirable, instead of a risk.

Capital flows have deteriorated amid currency depreciation



Source: Thomson Reuters Datastream, J.P. Morgan (February 2015)

Instead of reforming and creating the conditions for future growth, policy makers choose for the easy way out, i.e. to stimulate growth through a more competitive currency. This is a risky strategy, because lowering the carry means that EM currencies are more vulnerable in case the global liquidity environment deteriorates.

Policy makers should focus more on reforms

Besides, the outlook for global trade remains bleak because of the multi-year deleveraging process in the developed world and the structural growth slowdown in China. For EM policy makers, it would make more sense to focus on creating better conditions for domestic demand growth. The export sector is unlikely to become the strong growth engine that it was in the years 2002-2010. For now, only Mexico and India have carried out reforms that have improved the prospects for domestic demand growth. Perhaps Indonesia is moving in the same direction. The fiscal adjustments in Brazil and South Africa in the past few months are encouraging, but remain minimal. More market pressure is required before real reforms will come through.

Chinese policy easing not very effective

In China, the policy easing of the past quarters is not really working. Therefore, more stimulus is probably on its way. Already last Saturday, the Chinese central bank announced another 25 basis points rate cut. We expect more central government fiscal spending, more quasi-government spending through the public development banks, more monetary easing, reserve requirement ratio cuts and more currency depreciation. Given the large structural problems that are not really being solved (the misallocation of capital, overcapacity in large parts of the industrial sector, the explosive rise in debt-to-GDP) and the large capital outflows of the past quarters, we think that the policy easing will continue to be relatively ineffective and not enough to stabilise economic growth.

The main things to watch in the coming weeks are the Chinese economic data after the New Year holiday and the possible policy easing coming from Beijing. On the 5th of March, the National People's Congress will start. The Chinese government is likely to reduce its annual GDP growth target from 7.5% to 7.0%. ING Investment Management's GDP growth forecast for 2015 remains at 6.3%. For 2016 we forecast a growth rate of 5.3%.

MSCI Regional Indices (EUR)		%
	20 - 27 Feb	YTD
MSCI World	1.67	12.21
MSCI Europe	2.61	14.68
MSCI Emerging Markets	1.97	11.91
MSCI US	1.11	10.97
MSCI Japan	2.34	17.11
MSCI Developed Asia ex Japan	1.99	12.77
MSCI Sector Indices (EUR)		**%**
	20 - 27 Feb	YTD
MSCI World Energy	0.17	7.62
MSCI World Materials	1.88	16.06
MSCI World Industrials	1.20	12.43
MSCI World Consumer Discretionary	1.93	14.92
MSCI World Consumer Staples	2.83	13.48
MSCI World Health Care	2.14	15.39
MSCI World Financials	1.54	9.25
MSCI World Information Technology	1.34	12.69
MSCI World Telecom Services	2.43	14.34
MSCI World Utilities	1.50	5.18
Bond & Credit Yields		**%**
	27 Feb	20 Feb
10-yr Bund (Germany)	0.32	0.37
10-yr Treasury (US)	2.01	2.14
US Investment Grade Credits	2.93	3.03
Euro Investment Grade Credits	0.74	0.80
Global High Yield	6.12	6.28
EMD Hard Currency	5.54	5.65
Asian Debt Composite	4.52	4.64
FX & Commodities		
	27 Feb	20 Feb
EUR/USD	1.124	1.1298
Crude Oil (WTI Spot, USD)	49.84	49.95
DJ UBS Commodity index	208.34	206.91
Economic Releases (1 - 6 Mar)		
	Date	Consensus
China PMI Manufacturing (Feb)	1 Mar	49.9
US ISM Manufacturing (Feb)	2 Mar	53.2
Eurozone CPI/Core CPI (Feb, y-o-y)	2 Mar	-0.4%/0.5%
US ISM Non-Manufacturing (Feb)	4 Mar	56.5
Eurozone ECB meeting	5 Mar	0.05%
US Non-Farm Payrolls/Unemployment Rate (Feb)	6 Mar	240K/5.6%

Sources: Thomson Datastream, Bloomberg. YTD data until 27 Feb 2015

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