QNB Economics
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Are EM currencies out of the woods?

It is not all doom and gloom for the global economy in 2019. Emerging markets (EM), particularly on the realm of foreign exchange rates (FX), are expected to perform better than last year, despite negative global headlines such as weak cyclical data, volatility in sentiment and limited upside for commodity prices. In fact, major EM currencies have stabilized since September 2018 and are starting to recover from their recent lows.

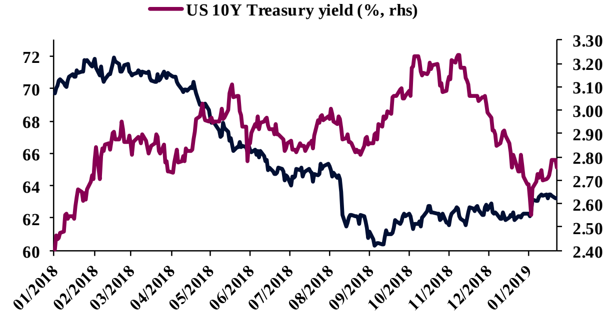
At this time last year, EM currencies reached 30-month highs as the global economy was still poised by a benign risk-on sentiment. Back then, the narrative about a synchronized cyclical recovery and overall optimism about growth over the long-term were prevailing. But things turned sour for EM as global financial conditions tightened amidst rising political risks and much weaker economic performance in the Euro area and Japan. Even China, a key part of the 2017 EM rebound, started to decelerate as domestic policies were less supportive and trade jitters with the US dented business and consumer confidence.

From February to September 2018, when non-resident portfolio outflows from EM excluding China amounted to USD 44 Bn, the currencies of several key EM plummeted. The J.P. Morgan Emerging Market Currency Index (EMCI), which tracks the movement of ten major EM currencies against the USD, was down more than 16%, hitting record lows since the creation of the index in 2010. Thereafter, however, the EMCI has stabilized markedly and even benefited from a partial bounce back of 4.8%. Four main reasons have supported EM currencies.

First, a sharp repricing of US interest rates after September-October, when 10-year US Treasury yields hovered comfortably above the 3.0% mark. 10-year yields are now 40-50 basis points (bps) below their recent peaks, despite the fact that the US Federal Reserve (Fed) pressed ahead with rate hikes in September and December. Weaker demand, corrections in equity markets and signals of an imminent pause in the US Fed normalization cycle are contributing to push yields down. As US yields go down and make US fixed income assets less attractive to investors, EM assets become more attractive, which favors capital inflows to or limits capital outflows from EM.

Second, positive developments in US-China trade negotiations, which reduces risk sentiment and favors open economies and key exporters to China. Trade tensions have eased significantly since early December, after the Trump-Xi meeting in the sidelines of the G-20 summit in Buenos Aires, when a 90-day truce was agreed on the application of further tariffs against USD 260 Bn of Chinese exports to the US. Rising trade tensions and worsening US-China relations were an important part of the recent risk-off bouts. Disruptions in global trade or in China's growth are particularly threatening to EM with high export shares.

EM currencies and US 10Y Treasury yield



Sources: Bloomberg, QNB Economics analysis

Third, the stabilization and improvement of commodity prices, which boosts external balances of commodity exporting EM. After plummeting by 10-20% since their recent peaks in April-May 2018, prices of metals have stabilized and prices of agricultural commodities have recovered by 6% from their September lows. On a similar note but with different timing, Brent crude oil prices have tumbled by more than 40% since early October, before rebounding by 22% since late December 2018. This is a major support for EM commodity currencies as demand for local currencies increases.

Fourth, a moderation of broad-based USD strength, which bodes well for EM. The USD has appreciated by 4.3% for the year in 2018 against the US Dollar Index (DXY) basket of currencies from advanced economies, but the big surge took place in April-

May 2018, before the DXY started to move around a narrower range. Since its peak in November, the USD is down 1.3% against the DXY basket. A stronger or strengthening USD tends to pull capital to US assets, while a weaker or weakening USD tends to push capital to non-US assets, including EM.

While recent trends have been mostly positive to EM and the balance of risks has been improving, existing risks cannot be ignored. Key uncertainties include the US monetary policy path, trade talks and the China slowdown. In different ways and through different channels, they can all create a new bout of sudden changes in capital flows and cause FX depreciations or even currency crisis, especially in EM with high and rising debt levels. In other words, the backdrop is better, but EM are not out of the woods yet.

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