EM Currency: Turning Point?

This year has been particularly good for emerging markets and there are several reasons underlying the so-called EM rally.

The main one is probably the yield hunt, in which yield-hungry investors move to riskier assets in order to have some decent return in the low interest rates environment, thus boosting risky assets and compressing risk premium. Moreover, emerging markets are characterized by higher interest rates that reflect both the higher political and credit risk and different inflation dynamics.

Another important reason has to do with oil and, in general, commodities. An oversupplied market has brought crude oil price from an average of 110$ a barrel in the years before 2014 to the average of 40-45$ a barrel in the last months. The lowest point was reached during the panic over global growth and a slowdown in China that hit financial markets in January and February of 2016 (crude oil was traded as low as 27$ a barrel). However, from that moment there was a strong recovery in the price of oil which has experienced an increase of more than 60% and currently trades in the range of 40-50$. This has also fostered a broader recovery in the commodities world.

With some exception, emerging market economies are net exporters of commodities and therefore EM stocks tend to increase with higher oil prices. Emerging economies are also experiencing improving macroeconomic fundamentals. An asset class that is doing particularly well is EM currency.

The top-three performing currencies are the Brazilian Real, the Russian Ruble and the South African Rand, with a year-to-date performance against the dollar of, respectively, 18.10%, 11.64% and 11.32%. Despite the broader rally this year, at the beginning of August, after renewed expectations on a FOMC rate hike at its September meeting, the pressure on EM currencies increased. In fact, the JPMorgan's Emerging Markets FX Volatility Index surged in that period. However, after a lower than expected US job creation in August, the volatility has decreased and there has been a wide recovery in the asset class. Furthermore, at its most recent September meeting, the FED did not hike rates leaving room for EM currencies rally to continue.

However, how long can this rally in Emerging markets last?

There are several signs that the Fed hike is eventually approaching. Three members of the FOMC (Esther George of the Kansas City Fed, Loretta Mester of the Cleveland Fed, and Eric Rosengren of the Boston Fed) have voted for a rate hike in September. Moreover, the probability implied from FED Funds Futures for a hike by the end of the year currently stands at 60%. We see a rate hike as a potential downside for the currencies in the emerging markets.

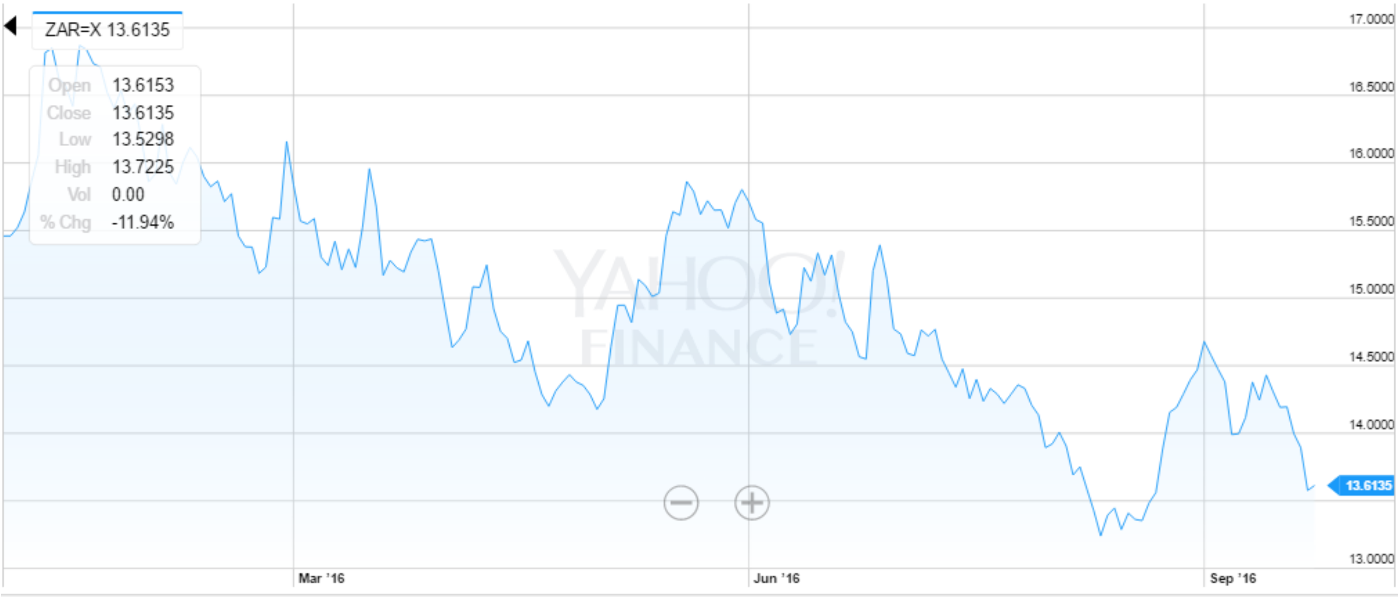
In the other part of the article, we will focus on South African Rand and Brazilian Real because they are among the best performers, but, also, because the two countries have experienced political turbulence recently.

South African Rand

The rand has started the year trading at around 15.51 per USD. After a depreciation at the beginning of the year, hitting a low of 16.87 per USD in January, it experienced an appreciation until reaching a peak at 14.29 per USD at the end of April. The slump was also exacerbated by a political scandal. A report in South Africa's Sunday Times newspaper asserted that Pravin Gordhan, the finance minister, faced "imminent arrest" with charges on espionage. The reason was an investigation on the South African Revenue Service (SARS) that, according to the report, illegally spied on senior officials. Mr Gordhan was involved because the unit was set up in 2007, at a time when he was in charge of the SARS.

After this political instability, the Rand rebounded in the run-up to the Brexit vote due to the renewed risk appetite. The climb has also been supported by the fact that, in August, the African National Congress suffered its worst electoral result since it came to power in 1994, with a share as low as 55%. This was taken as a sign of political liberalization by markets, especially because President Jacob Zuma's is seen as corrupt and has been involved in several scandals.

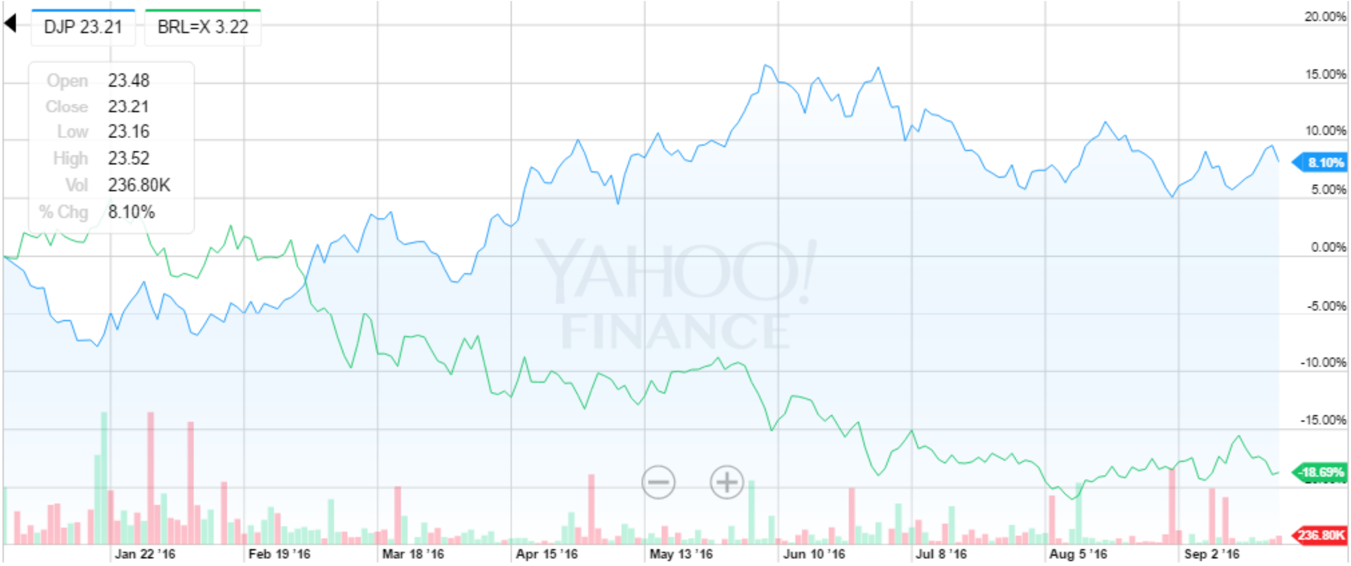
The reasons outlined above are still in place now. On the other hand, we think the FED is likely to hike rates in December. Therefore, our outlook for the Rand remains positive, at least in the next couple of months. December represents a serious downside threat for the currency. Here, we take the view of many analysts that, even though a FED rate hike would cause a significant downward adjustment, the rally is likely to continue even after the hike.



Brazilian Real

So far this year has been very good for the Brazilian Real; the USDBRL Spot Exchange Rate moved from 3.96 to 3.24 with an appreciation of roughly 18%. However, the previous year for Brazilian Economy was one of the worst in the century, characterized by a contraction of 3.8% of the GDP. Furthermore, low commodity prices and political scandals represent a serious threat for the economy.

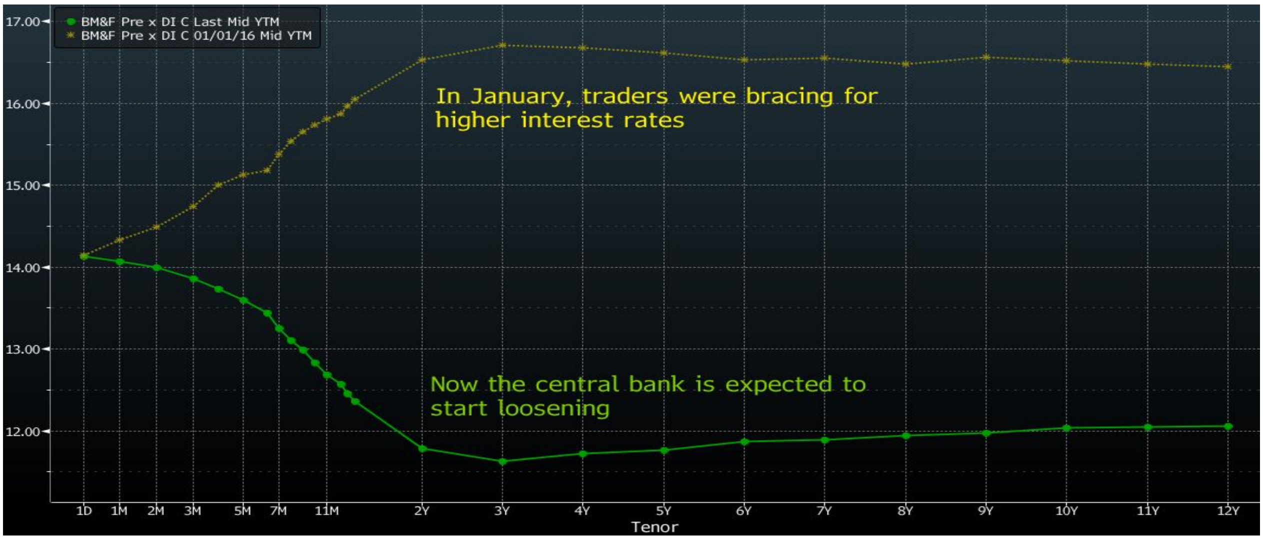
The country, even though being the 7th biggest economy in the world, is still heavily dependent on exports and prices of commodities (oil, corn, soybeans, iron ore). Consequently, the value of Brazilian Real is directly correlated with commodity prices. As evident from the chart representing the Bloomberg commodity index and USD/BRL there is a very strong inverse correlation between two variables.



USD-BRL - DJP iPath Bloomberg Commodity Index

On the political side, the interim president Michel Temer currently leads the government. The Operation Car Wash ("Operação Lava Jato") which started in March 2014 brought light to various cases of corruption involving important political personalities. In fact, on the 9th of August the Brazilian Senate voted for the impeachment of the previous president Dilma Rousseff. In addition, the former President Luiz Inacio Lula da Silva is facing criminal charges.

On Thursday, September 22, 2016 data showed a Mid-Month CPI (YoY) (Sep) of 8.78% after the previous result of 8.95%, it seems like that the policies to contain inflation are starting to work. The recently appointed president of Banco Central do Brasil, Ilan Goldfajn may take the chance before the end of the year to reduce the interest rate and help the economy to exit the recession, which is also supported by the Fed decision to leave interest rates unchanged. The chart below shows the reaction in the swap market: while in January with a falling currency the only option feasible seemed another rate hike, now with the signal of lower inflation the Central Bank is expected to react to stimulate credit.



Source: Bloomberg.com

Our view for Real for the next months is to short it; as a matter of fact, there is a visible risk of divergence in Central bank policies. On the one hand, Central Bank of Brazil has space for decreasing the interest rate, whereas on the other hand, it is becoming more probable that Fed will increase the interest rate in December, having as consequence flows of capital back in the United States. This scenario would have a strong impact on the value of the currency. Moreover, the real economy is still suffering a contraction of GDP and a reduction of industrial production of 6.6% (YoY), and we must discount the political situation with the problem of corruption far from being solved.