Emerging markets face currency conundrum

By David Wigan

As the pendulum of economic growth has swung in recent years towards fast growing economies, global capital has followed in its path. In the process, emerging market currencies have evolved into a distinct generator of investment returns, and a new source of potential risk.

One of the lessons of the global financial crisis is that investment diversification is increasingly challenging in a globalised market. Economies rise and fall together, and emerging markets are unable to escape the shifting fortunes of Europe and the US.

The rise in correlation was starkly illustrated late last summer, when concern over euro zone sovereign defaults prompted a rush for the exit from emerging market assets that had previously seemed insulated from remote concerns.

The Greek crisis, coupled with worries about a US double dip recession, led to a global stampede toward “risk-off” strategies, prompting steep declines in emerging market equities, and a subsequent drop in currency valuations. Over a few weeks in September the Brazilian real, South African rand and Polish zloty all fell by nearly 10 percent against the US dollar, wiping out gains made in the first eight months of the year.

In addition, the countries that had benefitted most from capital inflows were shown during the sell-off to be most vulnerable. Central and Eastern Europe saw sharp revaluations, with Poland and Turkey at the vanguard, while Korea and South Africa were also hit.

“Global investor confidence has become a potent influence on emerging market currencies, at times defying changes in fundamental variables,” said Ala Kassay, an economist with France-based country risk consultancy TAC Financial. ““Capital flows are closely aligned with confidence and investors need to be aware that sharp swings in confidence can have short and long run implications for returns.”

Since the beginning of 2012, sentiment toward risky assets has picked up, and emerging market currencies have seen the benefit, for the most part recovering a large part of the losses incurred late last year. HSBC’s emerging market currency model portfolio returned a nominal 13.1 percent in the first weeks of the year, despite continuing concerns over volatility,

“The majority of the recent flows have been concentrated towards hard currency funds, implying lingering nervousness among investors over taking local currency risk,” said Murat Toprak, an EMEA FX strategist at HSBC in London.

As confidence seeped back into the markets this year, emerging market policy makers were keen to ensure the uptick in sentiment did not lead to destabalising capital inflows.

That was manifested in the re-emergence of so-called currency wars, or central bank intervention to prevent currency strength that may derail local exports. Brazil and Colombia have both been active in the foreign exchange markets, buying US dollars to help depreciate the real and peso. Meanwhile, Poland's finance ministry indicated that it plans to sell less euros to avoid excessive strength in the zloty. In Asia, China appeared to pull in the reins on yuan appreciation, after allowing a modest gain against the dollar last year.

"The upshot is that the aggressive emerging FX rally seen in the first few weeks of the year has stalled," said HSBC's Toprak. " We remain broadly constructive on EM FX, but the next leg up may require a deeper paradigm shift emanating from more significant improvements in US economic data, European 'fixes', or both."

One area in which European and US policy makers have helped fuel demand for emerging markets currencies is interest rate policy, with both the European Central Bank and Federal Reserve keeping rates at historical lows, and showing scant sign of moving toward tightening.

Over a large part of the past decade the so-called carry trade has enabled investors to borrow money in low interest rate environments and reinvest in higher yielding emerging markets. In recent years, Japan's low rates have made it the nexus for carry trade borrowing, with Brazil the primary target market, as investors looked to take advantage of government bond yields in excess of 10 percent.

In recent months a new trend has emerged, with the euro beginning to establish itself as a carry currency, reflecting investor bets that slow economic growth is likely to keep interest rates low for the foreseeable future.

"There appears to be a lot of tail risk from the euro zone, and there is a bit of a theme emerging in which the euro is becoming a funding currency for investors to access emerging market exposures," said Bartosz Pawlowski, head CEEMEA strategy at BNP Paribas in London. "We are not at a stage yet where Europe is a big exporter of capital, but we can probably assume the ECB will not be able to hike rates anytime soon and may impose additional liquidity measures."

The European Central Bank has in recent months provided euro zone financial institutions with more than 1 trillion euros of cheap funding through so-called Long Term Refinancing Operations (LTRO) – liquidity which, alongside the fruits of quantitative easing in the UK and US, is finding its way into emerging markets.

So concerned has been Brazil over the potential impact of ECB and Fed actions that it took exceptional measures, imposing a 1 percent financial transaction tax on short dollar positions in the futures market and a new 6 percent withholding tax for foreign buyers of bonds. Still, that hasn't stopped foreign investors snapping up $15 billion of foreign currency bond issuance in the first six weeks of the year, to which the Brazilian central bank has responded with selling of the real in the futures markets.

Barclays in early February questioned whether the ECB's LTRO operations are likely to lead to a secular move back into risky assets, and in particular high yielding emerging market currencies. While the foundation for such a move was sound, said Barclays London-based analyst Raghav Subbarao, the move is unlikely to be of the same magnitude as was seen during the exceptional rally of 2009.

“We suggest caution in drawing too close a parallel with 2009,” Subbarao said, in a note. “Valuations are much less favourable for the carry currencies, (ECB and Fed) policy responses (in terms of rate cuts) have been much more muted, and investors will likely continue to be wary as long as the potential for a flare up in euro area risks remains high.”

Some countries that may have felt hostage to low interest rates in Europe and the US have opted for compensating monetary action, with Brazil and Turkey cutting to offset the impact of a strong currency on growth.

Brazil in early March cut its key rate by a larger-than-expected 75 basis points, as it stepped up moves to revive export industries hobbled by the rise in the value of the real. The central bank lowered its benchmark Selic lending rate to 9.75 percent from 10.50, taking borrowing costs to their lowest level in nearly two years. Unfortunately for policy makers, an unintended consequence of rate cuts may be a bond market rally, likely to attract inflows from fixed income investors.

A primary impact of monetary loosening and quantitative easing is on commodity prices, which have been shown to rise sharply following injections of liquidity. The impact of rising prices is a double edged sword, depending on whether emerging markets are net importers or exporters of commodities. For commodity importers, which is the majority of emerging markets, quantitative easing is likely to lead to faster inflation and a worsening trade deficit as import costs rise. In India, this effect has acted as a drag on the rupee, which fell 16 percent against the dollar last year.

A rising oil price resulting from faster global growth is likely to have less of an impact on emerging market currencies than a supply side shock, analysts say. Concern over the latter is largely focused on the political situation in Iran.

The International Monetary Fund recently warned of a 20-30 percent oil price spike if Iranian exports are disrupted, either through the knock-on effect of financial sanctions or the possibility that Iran imposes a blockade of exports through the Straits of Hormuz, through which around 40 percent of global oil exports are shipped.

Analysts at HSBC suggest that, in any event, a rising oil price is likely to lead to greater volatility in EM currencies, with trade balances at risk on the one hand, and capital inflows likely to be bumpy should inflationary pressures prove sticky.

Amid an uncertain future for commodity currencies, one issue that does not get as much attention as it perhaps deserves is the growth of Chinese influence in markets such as Brazil, South Africa, Korea and Malaysia. As China looks to reduce its dependence on the dollar and increase the influence of the renminbi, it has invested vast sums in infrastructure projects in key emerging market trading partners, leading to big increases in flows, and potential opportunities for currency investors.

“China is effectively sidestepping the dollar in these countries and trying to develop alternative markets that it can trade with,” said BNP’s Pawlowski. “It is worth recognising that those countries that cooperate with China are likely to be clear winners.”