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Macro Research
EM currency outlook

What's next for EM currencies?

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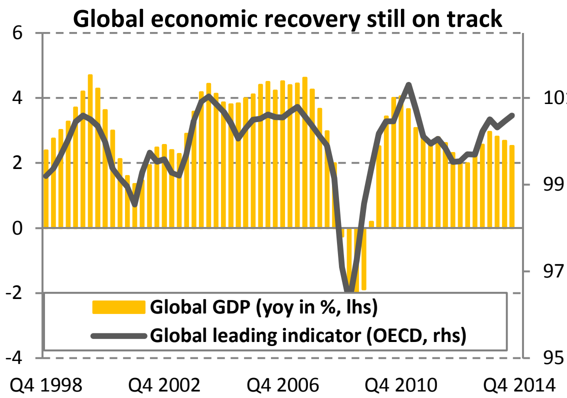
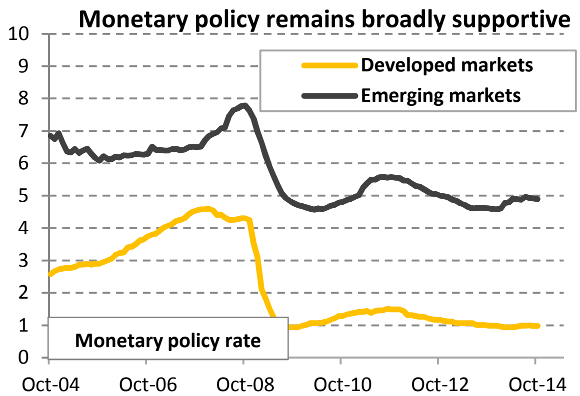
EM currencies in calmer waters following the 2013 turmoil

Following the Fed's famous taper speech in May last year, EM currencies depreciated significantly throughout 2013. Although the depreciation was seen across the board, there were big differences in the amount of currency depreciation, with the so-called fragile five currencies (IDR, ZAR, TRY, BRL, INR) falling the most. Since the beginning of this year, however, most EM currencies have entered calmer waters again. Among the best performing currencies so far this year are THB, INR, IDR, and KRW (all more than 6%) while the RUB (-14%), CLP (-4%), HUF (-3%) have extended their losses. More recently, EM currencies have come under renewed pressure. Over the last three months, EM currencies saw an average correction of 5% against the USD. But with the latter appreciating around 5% against the EUR over the same period, EM currencies are flat against the EUR. Looking ahead, with the Fed slowly but surely moving in the direction of a first rate hike in 2015, EM currencies are likely to continue to experience downward pressure against the USD. Overall, EM currencies should continue to hold up firmly against the EUR. That said, although the BoJ and the ECB are still in easing mode and therefore global liquidity is set to remain abundant, we think it's likely that the path to tighter US monetary policy comes with increased market volatility. Currencies of recipient countries (i.e. countries with large current account deficits) are likely to stay most vulnerable in this climate. However, given the sharp depreciations seen last year, higher real interest rates in general and the fact that the first rate hike in the US should now be widely anticipated (apart from the exact timing), we don't expect the see a repeat of the 2013 currency turmoil. In the following paragraphs, we will discuss the outlook for the major EM currencies. The graphs on page 7 may provide further useful information.

Global economic background





Despite current financial market turmoil, the global recovery remains on track. Improving confidence, reduced fiscal tightening, accelerating global trade and supportive monetary conditions suggest that this gradual recovery will continue in coming quarters. That said, economic progress is also uneven. While growth in the US and the UK has climbed back above pre-crisis levels, economic activity in Europe and Japan remains sluggish. Global inflation remains low and this isn't about to change any time soon. There is still slack in the world economy that's holding inflationary pressures in check. On top of that, commodity prices have been easing again as of late, with especially oil prices dropping substantially. The next big risk for the world economy and financial markets lies in monetary policy. While the ECB and the BoJ are still on the easing path, the Fed and the BoE are heading for rate hikes next year. There is a significant risk that this move is accompanied by increased market volatility. That said, for now the Fed and the BoE are moving extremely cautiously as

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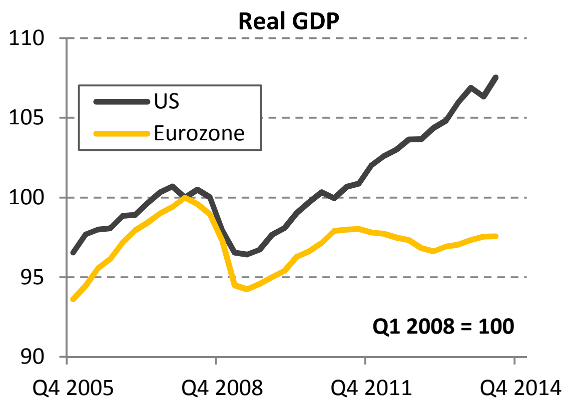
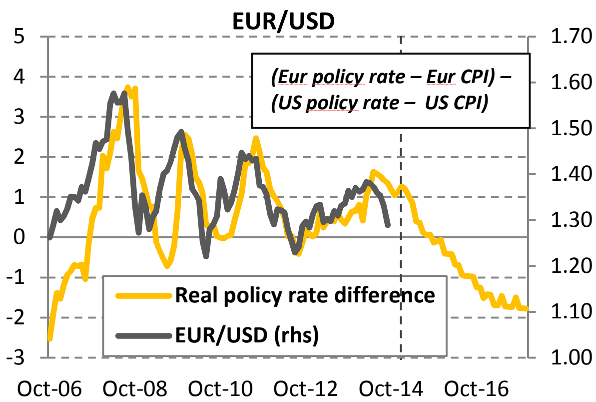
they are still far more concerned about economic growth than about inflation/bubbles. As long as that remains the case, global monetary policy will remain broadly supportive.

USD set to appreciate further against EUR

Although the USD has already strengthened significantly against the euro over the last couple of months (+5%), we think the USD appreciation has further to go. The reason lies in the expectation that US monetary policy will diverge from that in the eurozone. Indeed, the US economic recovery remains firmly on track while economic activity in the eurozone remains modest at best with inflation at ultra-low levels. This is likely to push the ECB in the direction of further monetary easing. The Fed, on the other hand, is slowly but surely moving in the direction of tighter monetary policy. This, in turn, should result in the outperformance of the USD.





EM Currencies General Summary

Positive (+)	Neutral (=)	Negative (-)
BRL, INR, RUB, PLN, MXN, HUF, IDR, CLP, PHP, CNY	KRW	TRY, ZAR, THB

1. BRL - Brazilian economy stuck between low growth and stubbornly high inflation

- The Brazilian economy keeps on struggling. Moreover, leading indicators show little sign of improvement and inflation remains stubbornly high. As inflation expectations remain high, the central bank (BCB) cannot afford to loosen monetary policy in order to support economic activity.
- Real interest rates are now hovering around 5%, the highest level in the EM universe. Although this is attractive for investors, this tight monetary policy stance is likely to stand in the way of any meaningful economic recovery. Brazil's problems are mostly supply-side related. That's why the pressure on Brazil's next president to conduct structural reforms is high. But whoever becomes the next president, expectations of a swift turnaround should be tempered. Structural reforms typically take time and the fact that there are more than 20 political parties in Brazil's congress is set to make consensus building very difficult. Therefore, near-term prospects for Brazil's economy are likely to remain downbeat.
- The latest BCB minutes suggest that the policy rate will remain at the current level (11%) in the next few months. However, as inflation expectations show no sign of easing, even with economic activity in the doldrums, tighter

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monetary policy may still be needed to bring down inflation. Although overall external vulnerability is lower than often estimated, the BRL may come under renewed pressure as the Fed is edging closer to tighter monetary policy. The BRL has been one of the most volatile currencies in recent months. Given the high interest returns and relative cheap valuation in a long-term theoretical perspective, however, the BRL could still be considered an interesting investment alternative. In a somewhat longer term perspective, we remain cautious on the BRL.

2. TRY - Turkey remains highly dependent on foreign capital inflows

- Leading indicators suggest the Turkish economy is grinding to a halt. Following increased political risks in the beginning of the year, the Turkish central bank (CBRT) was forced to sharply tighten monetary policy as Turkey is highly dependent on foreign capital. With the economy in poor shape, monetary authorities have started to loosen monetary policy a bit in order to support economic activity. Meanwhile inflation remains high. The CBRT clearly indicated that interest rates will not be cut until there is a clear improvement in the inflation outlook. Indeed current inflation hovers around 9%, almost double the inflation target (5%). As the effect of the currency depreciation on inflation eases further in coming months, the central bank could eventually decide to lower interest rates further.
- However, given Turkey's high dependence on foreign capital, it's not unthinkable that the TRY comes under renewed pressure against the back of expectations of less accomodative monetary measures in the US. All in all, although the TRY is far from expensive at current levels and yields are attractive, we would remain cautious on the TRY.

3. INR - Improving economic momentum and reduced external vulnerability

- Indian economic growth in Q2 picked up significantly. Whereas average growth figures over the last two years hovered around 5%, Q2 saw growth accelerating to close to 8% (QoQa). Recent leading indicators continue to point to relative upbeat growth prospects. Inflation, meanwhile, has fallen back below the government's 2014 target of 8% on the back of easing food and energy prices.
- The minutes of the latest central bank meeting suggest the RBI will keep interest rates at current levels (8%) in the next few quarters. There's no immediate need to tighten monetary policy now that inflation is sliding down. That said, monetary policy cannot be loosened significantly as the 2016 inflation target of 6% remains very challenging, certainly in a context of accelerating growth.
- As the US is slowly but surely moving in the direction of tighter monetary policy, financing conditions could become more volatile with capital flows to emerging markets coming under renewed pressure. However, with economic momentum improving and reduced external vulnerability, India should be able to weather this situation relatively well. All in all, given the high interest returns and decent economic outlook, The INR is likely to remain an interesting investment opportunity.

4. RUB - CBR moving to currency intervention

- The Russian economy is in recession. In the first two quarters of the year the economy contracted by 1% in annual terms. What's more, leading indicators show little sign of improvement. In its most recent policy meeting, the central bank (CBR) decided to keep the policy rate unchanged at 8% following the increase by 50bp in July. In addition, the CBR says that the current stance will be enough to achieve the medium-term inflation target of 4%. Today, inflation is almost double as high. Admittedly, the depreciation of the RUB (-14% against EUR, -19% against USD over the last 12m) plays an important role in this.
- Against the back of a difficult geopolitical situation, the question of course is whether downward pressure on the RUB is about to disappear. The RUB is now close to the levels where the CBR has indicated it would intervene in the currency market to support the value of the currency. While we're not sure whether this will be enough to stop the RUB from depreciating further, this clearly indicates that there are limits to where the CBR is prepared to let the currency fall. Therefore, we think another sharp drop in the RUB is not likely, at least not in the short-term.

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- Moreover, the RUB now trades at cheap levels versus its fundamental value. In combination with the high returns, we think the RUB is now starting to look attractive. That said, risks are high and in a medium to long-term perspective, we would still be extremely cautious.

5. ZAR - weak economic activity, external vulnerability remains high

- Economic activity in South Africa was flat in the first half of the year with leading indicators showing no sign of improvement. Meanwhile, inflation (6.4% in August) remains above the central bank's (SARB) upper-target (6%). The combination of stubbornly high inflation and sluggish growth continues to pose a difficult dilemma for monetary policy. With inflation expectations still high, the SARB sees the risks for inflation still on the upside. That's the reason why policy loosening in the near future is unlikely.
- The ZAR could experience renewed downward pressure on the back of increased market volatility as the Fed edges closer to its first rate hike. Indeed, at around 5% of GDP, South Africa's current account deficit, and thus external vulnerability, remains high. Moreover, FX reserves are at low levels compared to the country's short-term external refinancing requirements. All in all, despite the currency's theoretical undervaluation, we would still remain cautious on ZAR

6. PLN - Modest growth and below target inflation, NBP set to do more

- Economic growth in H1 has slowed down again. Leading indicators, although they may reveal an overly optimistic view of the economy, are still consistent with decent economic growth. Inflation, meanwhile, remains uncomfortably close to 0% and far below the central bank's target of between 1.5% and 3.5%. This has been putting pressure on the central bank (NBP) to do more.
- After leaving the policy rate at 2.5% for more than a year, the NBP cut interest rates by 50bp to 2% this month. It is likely that more action will follow soon. Against this backdrop, the PLN could see some downward pressure. But given that the currency has been remarkably stable so far this yea and the ECB is also likely to do more, this is far from certain. All in all, on current interest returns and low volatitility, we still see opportunities in PLN.

7. MXN - Economic activity set to accelerate from low levels

- After several years of disappointing growth, economic activity is starting to accelerate. Improving economic conditions in the US should further support Mexico's economy. Mexico's central bank (Banxico) estimates that the economy will grow between 3.2% and 4.2% in 2015 and thinks that risks are balanced to the upside.
- Inflation, meanwhile, is hovering around the central bank's upper target of 4%. Temporary factors that kept inflation high are fading but the accelerating economy suggests inflation is set to remain at elevated levels. Banxico is likely to keep interest rates at current levels for now and monitor closely where inflation is heading in the meantime. The MXN is more or less correctly priced from a long-term theoretical perspective. All in all, we still see opportunities in the MXN.

8. KRW - Gradual recovery in sight for Korean economy

- The Korean economy is still in recovery mode but there are some recent signs of flattening out. As the global economy continues its moderate recovery, economic activity in Korea is also expected to strengthen further. Inflation at just over 1% remains clearly below the central bank's (BOK) target range (2.5%-3.5%). That is why, after keeping its policy rate unchanged for more than a year, the BOK loosened monetary policy in august.
- The BOK is now likely to await the impact of the latest rate cut and gradually strengthening economy on inflation. In the next couple of months, the current monetary policy stance is unlikely to change. Following this year's appreciation (+6% against the EUR), the KRW has entered expensive territory. Even though the BOK is expected to

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hike interest rates sooner than the ECB, we see little opportunities in the KRW. Moreover, KRW volatility has been relatively high in recent weeks.

9. HUF - Hungarian economy showing clear signs of recovery

- Leading indicators suggest economic activity in Hungary is improving rapidly. Although headline inflation is hovering around zero and core inflation stays low, inflation expectations remain close to the central bank's (MNB) target of 3%. Over the last 12 months monetary policy was loosened significantly. The main policy rate was cut to 2.1% from almost double that level one year ago. As a result the HUF experienced downward pressure.
- Inflation is likely to remain subdued but should pick up from current low levels as the effects of the regulated energy price reductions last autumn wane. The economy should continue to recover although the pace of the recent acceleration is unlikely to hold now that economic sentiment in the rest of Europe has come under pressure again. All in all, the MNB is likely to remain on hold for now. The HUF is now trading at fairly cheap levels and with the end of the monetary easing cycle in sight, it's feasible that the HUF could recover some of the lost ground. Moreover, external vulnerability has decreased significantly since the 2008-2009 recession and volatility remains low. That said, in a longer term perspective we remain negative on the HUF.

10. IDR - Indonesian economy continues to hold up firmly

- Although economic growth has come down from previous high levels, leading indicators suggest that economic activity should continue to hold up firmly. That said, the latest PMI figure surprised on the downside and Indonesia's central bank (BI) also expects the economy to gradually cool further. At 4%, inflation is not a major issue anymore now that it moved back into the central bank's target range (3.5%-5.5%). Inflation is expected to stay there in the foreseeable future although it can not be excluded that a change in administered prices pushes inflation temporarily higher again.
- BI has kept its policy rate at 7.5% for almost a year now and as things stand this situation is likely to remain unchanged in the next couple of months. With the current account deficit higher than 3% of GDP, external vulnerability remains an issue. If the Fed's turn to tighter monetary policy is accompanied with increased volatility in financial markets, the IDR is likely to come under renewed pressure. All in all, however, on current valuation and given current interest returns, we still see opportunities in IDR.

11. THB - Thai economy set for stronger growth

- Economic activity has been disappointingly weak in H1. However, following the coup d'etat last May, a great deal of political instability has disappeared. Both business and consumer confidence have strengthened as a result. At around 2%, inflation remains comfortably within the central bank's (BOT) target range (0.5%-3%). Moreover, the BOT is confident that inflation will remain subdued and within the proposed target range even after taking into account the planned energy price restructering by the government.
- Minutes of the latest BOT policy meeting suggest that the current monetary stance will stay stay put in the quarters ahead and then rise gradually in line with the expected recovery. The THB is no longer cheap and the robust current account surplus has al but disappeared over the last five years. Moreover, the interest return on THB investments is rather modest. All in all, we would remain cautious on the THB.

12. CLP - Chilean economy in trouble

- Economic growth in Chile continues to decelerate with leading indicators painting a gloomy picture. Inflation on the other hand exceeds the high end of the target (2%-4%). That said, the depreciation of the CLP (-16% and -11% against the USD and EUR respectively) has been an important contributing factor. Medium-term inflation

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expectations continue to hover around the central bank's (CBC) mid-target (3%). The latter suggests that the CBC should not be too worried about inflation and focus mostly on weak economic growth.

- The CBC has cut interest rates eight times since October last year (from 5% to 3 %). We think the easing cycle is not yet completed and further stimulus measures are still likely. The latter could put additional downward pressure on the currency. All in all, given the still decent yield and large theoretical undervaluation, we see opportunities in CLP.

13. PHP – Economic activity remains strong

- Economic activity in the Philippines continues to hold up firmly. Strong growth in combination with rising headline inflation (to 5%, the higher end of the target range of 4±1%) has led the central bank (BSP) to hike interest rates to 4% for the second time since the start of the summer. The BSP highlights that inflation expectations remain high and inflation risks for 2015, when the BSP will lower its inflation target to 3±1%, are still on the upside. That said, with core inflation hovering around 3% for some time now, there is no immediate need for further significant tightening of monetary policy. In any case, the BSP is expected to increase interest rates sooner than the ECB. The PHP is no longer cheap but with external vulnerability rather low and relatively decent interest returns, we still see opportunities in the PHP.

14. CNY - Managed slowdown continues

- Most recent leading indicators reveal that economic sentiment is waning again. While exports and export orders are picking up, domestic forces are driving the latest decrease in sentiment. This is in line with the present correction in China's property market. The upshot is that economic growth is set resume the downward trend observed after the Chinese economy sharply recovered from the 2008-2009 crisis. Indeed, there's little to no doubt that growth will continue to slow down from the current 7.5%. This may even happen faster than financial markets currently anticipate. The economy's dependence on credit and investment is still uncomfortably high. It is absolutely clear that more structural measures will be needed in order to get economic growth on a more sustainable footing. However, dire warnings of an imminent sharp slowdown are likely to prove premature once again.
- The CNY remains pegged to the USD. Given that we are positive on the latter, we think the CNY will appreciate against the EUR.

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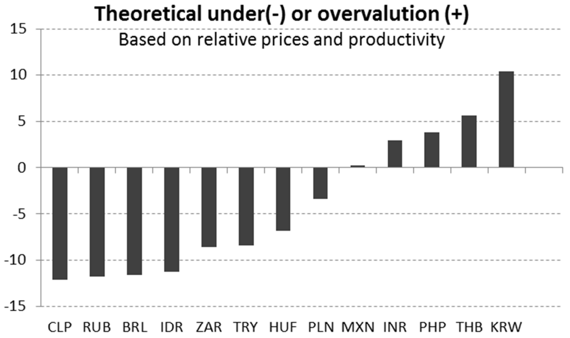
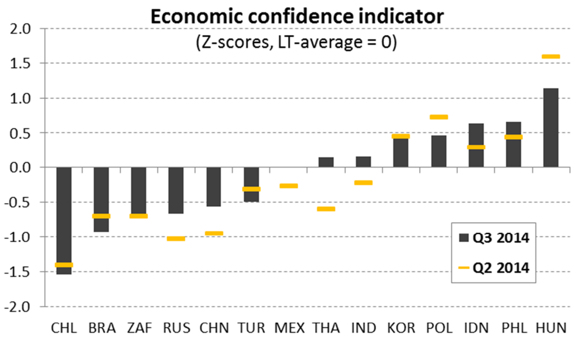
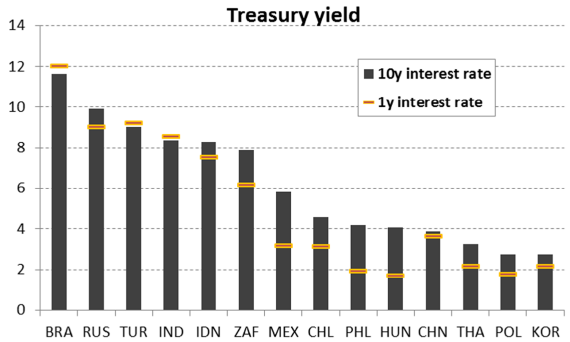
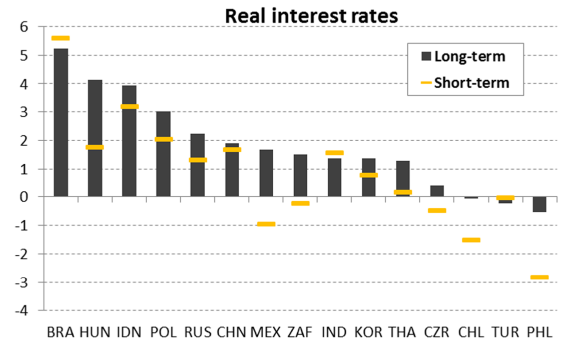
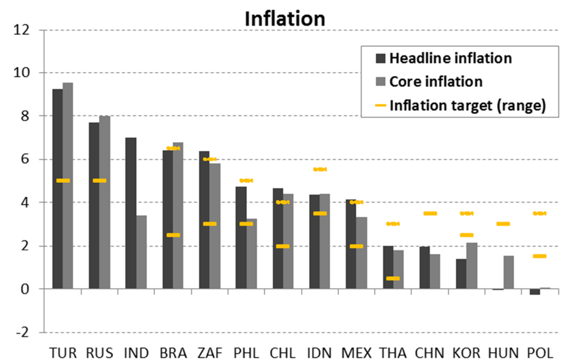
Annex

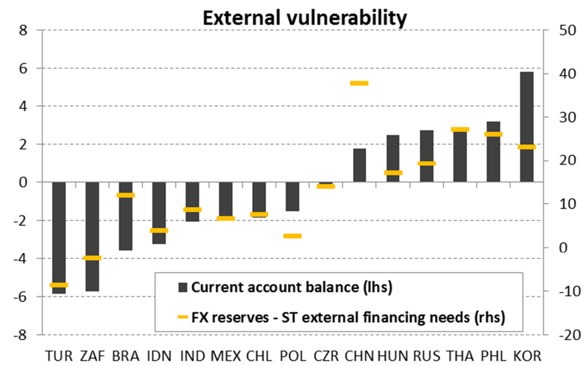


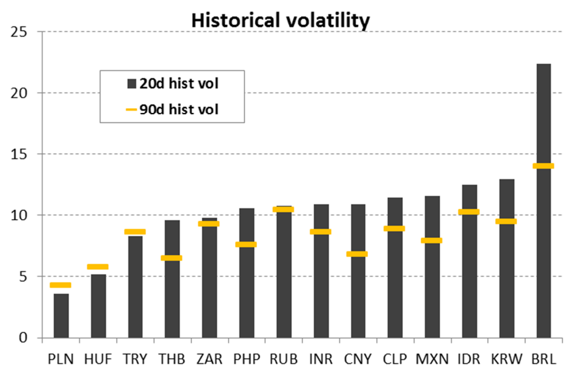


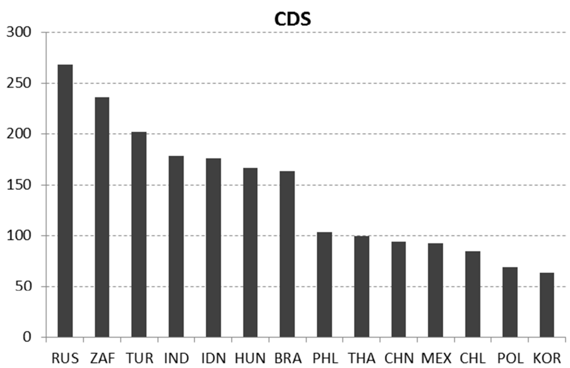












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