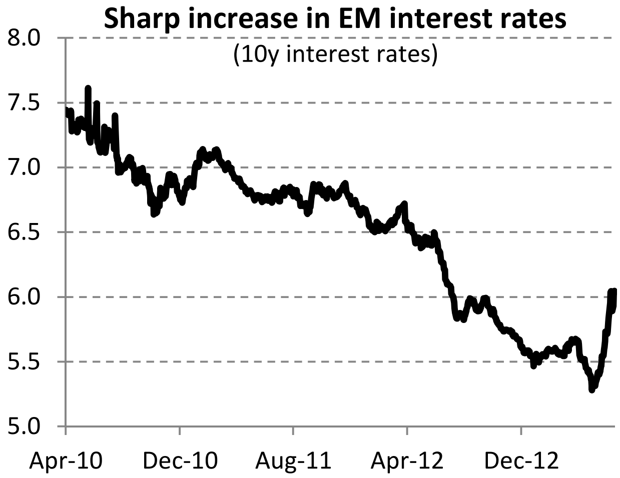
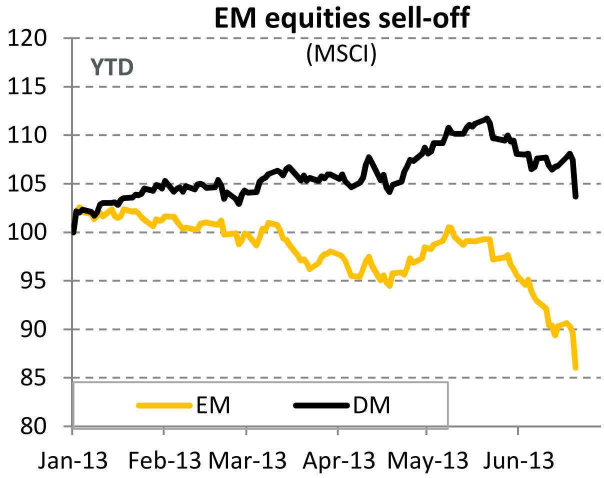
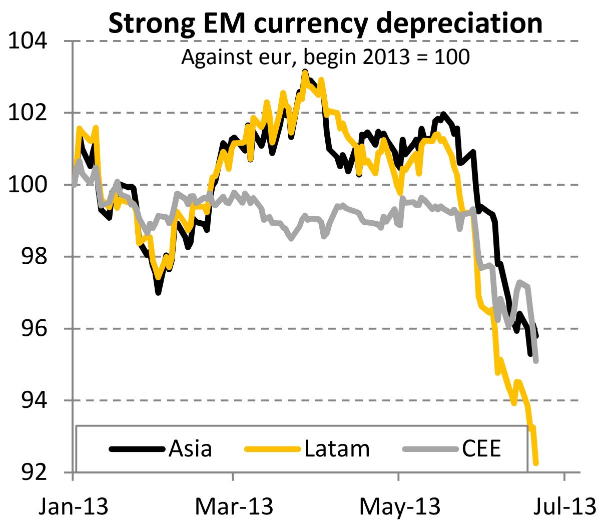
EM currencies remain vulnerable

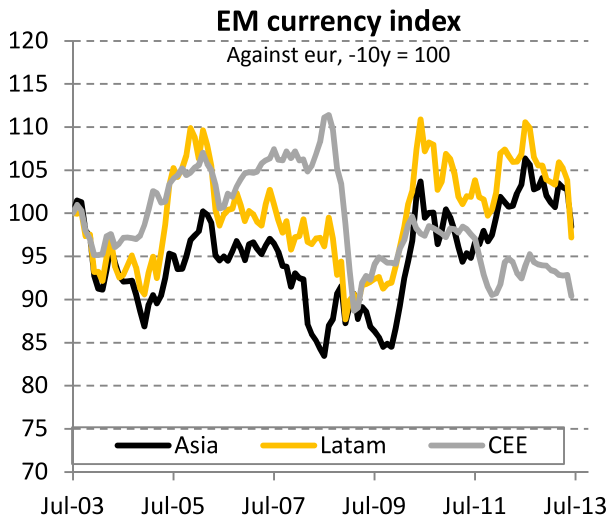
- In recent weeks EM equities and bonds have suffered a strong sell-off, mainly on the back of reduced monetary stimulus prospects out of the US. Meanwhile, economic data in EM have been falling short of expectations. In line with the sell-off in equity and bond markets, EM currencies took a (severe) hit. For those who believed EM currencies were a one-way bet (upward), the latest developments should be a wake-up call and a reminder that EM financial assets remain particularly vulnerable in times of increased market stress.





- Broadly speaking, since the sell-off started one month ago, currencies in Latin America have depreciated the most while CEE currencies have been somewhat more resilient. That said, CEE currencies have never experienced the significant appreciation as many Asian and Latin American currencies did in the aftermath of the 'Great Recession'. Also worth noting is that, broadly measured, EM currencies are now back below the levels of 10 years ago, the time when EM growth really took off.

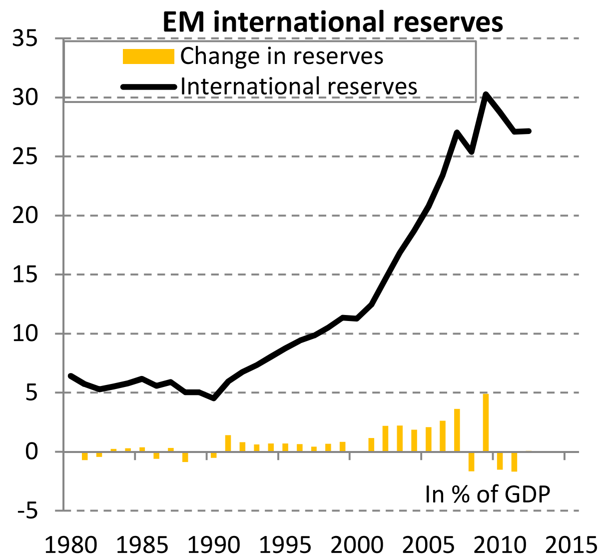


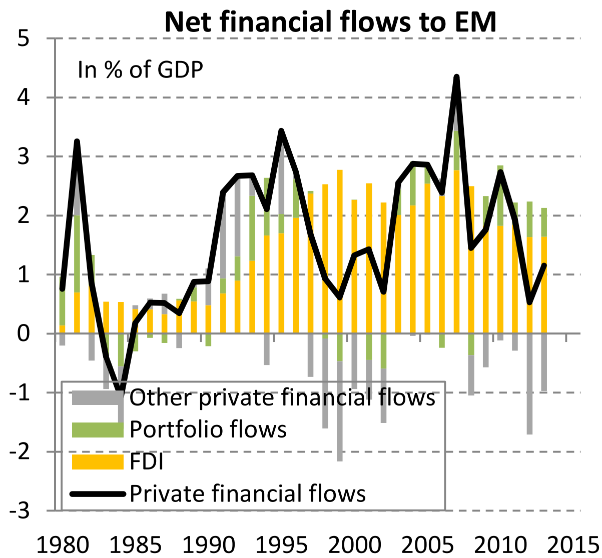


- EM currencies are likely to remain under pressure in the face of a possible change in direction of monetary policy (even if monetary tightening is not on the agenda for long). Another reason why EM currencies are likely to stay vulnerable is that EM are not up for a strong recovery. The notion that economic weakness in the BRIC's is largely the result of structural problems has important implications for the broader EM growth picture given that they make up roughly half of EM economic activity.

The good news is that political authorities in these 4 countries seem aware of the necessity of deep and widespread reforms. Against the background of vested interests, corruption, upcoming 2014 elections (India and Brazil) and weak global growth, however, it remains unlikely that sufficient progress will be made in terms of structural reforms.

- But, while it is difficult to assess the remaining downside potential, the strong sell-off that we have seen recently should soon end. First, central banks all over the world are still adding monetary stimulus and a return towards monetary tightening is not on the cards before the beginning of 2015. Second, the prospects of a more sustainable recovery in the US in the second half of the year should provide support for EM growth. Moreover, central banks have now begun to use the substantial FX reserves (which they have built over the last decade) to slow currency depreciation. More central bank action can be expected if the recent trend would continue. Finally in a somewhat longer-term perspective, capital flows to EM are unlikely to reverse. EM's higher growth potential on the back of bright demographic prospects (in general, with China and Russia as notable exceptions) and higher productivity growth will continue to attract capital inflows.





- In general, those countries with the largest current account deficits and the weakest domestic fundamentals are likely to remain most vulnerable. In an overall regional perspective, Asian currencies should prove more resilient than their CEE and Latin American counterparts. In Latin America, trade deficits are now wider than the levels seen prior to the 'Great Recession'.