Assessing the Likelihood of Another EM Currency Crisis

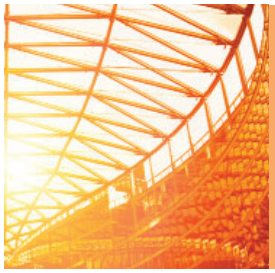
We do not anticipate a systemic emerging markets currency crisis like that of the late 1990s, though EM currency weakness and volatility are likely to persist for the next few years

- August was an unsettling month for EM currencies, but the reality is that these currencies have been falling steadily for several years, and weakness in the Chinese renminbi was overdue.
- While currency fundamentals are stronger today than during the EM crises of the 1990s, and most EM economies have not come under severe stress from declining currencies, three interrelated risks bear monitoring: commodity prices, Chinese growth, and tightening by the US Federal Reserve.
- Overall, we still see more downside for EM currencies in the intermediate term, which will continue to weigh on EM asset classes.

Given the recent volatility in emerging markets asset classes following the surprise devaluation in the Chinese renminbi (RMB) in August, the question of whether markets are heading for an EM currency crisis like that of 1997–98 is again on investor's minds. While market and economic conditions are in flux, for now our view remains that a systemic EM currency crisis will be avoided thanks to the flexibility provided by floating exchange rates, local currency debt markets, and foreign currency reserves. However, EM currency weakness and volatility are likely to persist for the next few years given cyclical headwinds and needed economic adjustments. This will continue to weigh on EM asset classes in the near term. This research note shares our current thoughts on the outlook for EM currencies and is an update of analysis first shared in September 2013.[1]

C|A research publications aim to present you with insights from a variety of different viewpoints. The views of our Chief Investment Strategist can be found each quarter in VantagePoint.

[1] See Aaron Costello and Jason Widjaja, "Are We Heading for an EM Currency Crisis?," Cambridge Associates Market Commentary, September 2013.



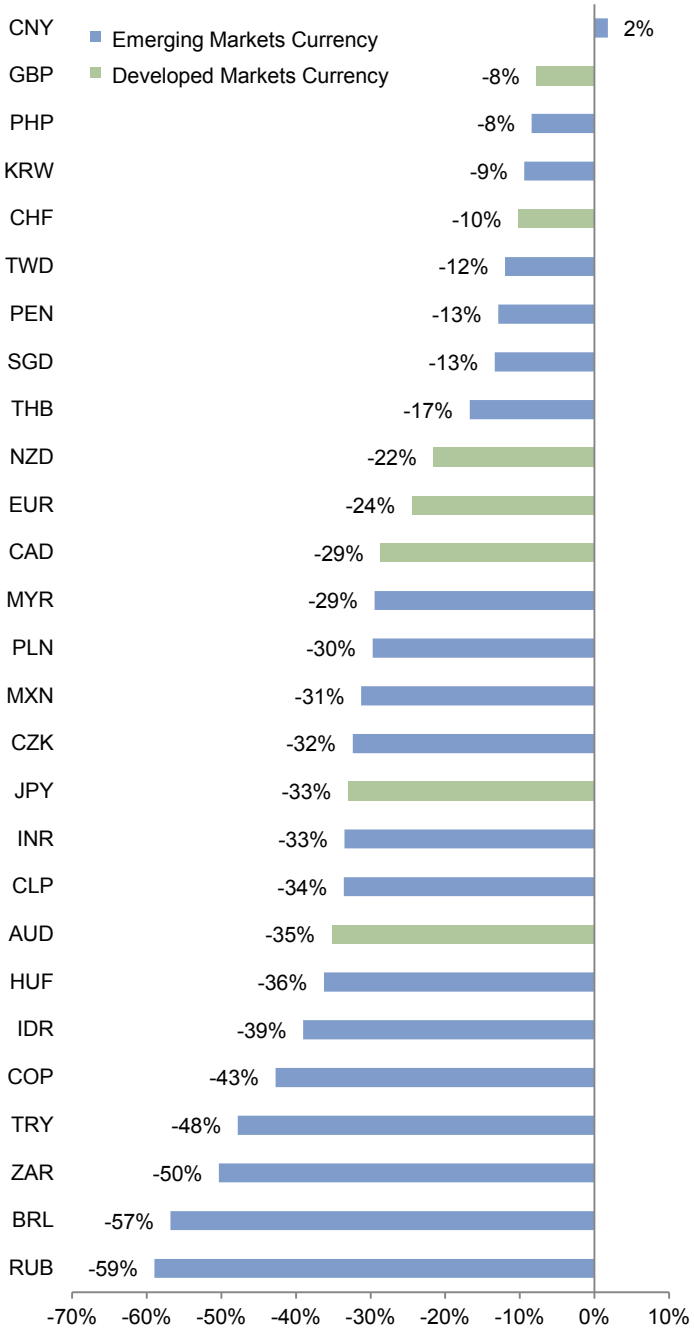
Surveying the Damage

While August saw broad-based selling in EM currencies in the aftermath of China's decision to allow the RMB to fall 3% in one day, the reality is that EM currencies have been falling steadily for more than four years. Figure 1 shows the performance of global currencies since April 2011, roughly the beginning of the upturn in the US dollar. Looking at this chart, a few points emerge.

First, the Chinese RMB (or CNY) is the only currency that has gained versus the US dollar over the past four years, and these data include the decline in August. This shows just how much pain China has shouldered by propping up the RMB, and why weakness in the RMB is overdue. Second, aside from the eye-catching 50%–60% declines in the Russian ruble (RUB), Brazilian *real* (BRL), South African rand (ZAR), and Turkish lira (TRY), most EM currencies have performed in line with, if not better than, the 33% decline in the Japanese yen and 24% decline in the euro. Thus, EM currency weakness is partly due to the broader theme of USD strength.

Third, markets have clearly been distinguishing between currencies based on fundamentals, with the currencies suffering the largest declines being commodity exporters (RUB), those with large current account deficits (TRY), or both (ZAR and BRL).

Figure 1. Global Currency Performance vs USD
April 30, 2011 – August 31, 2015



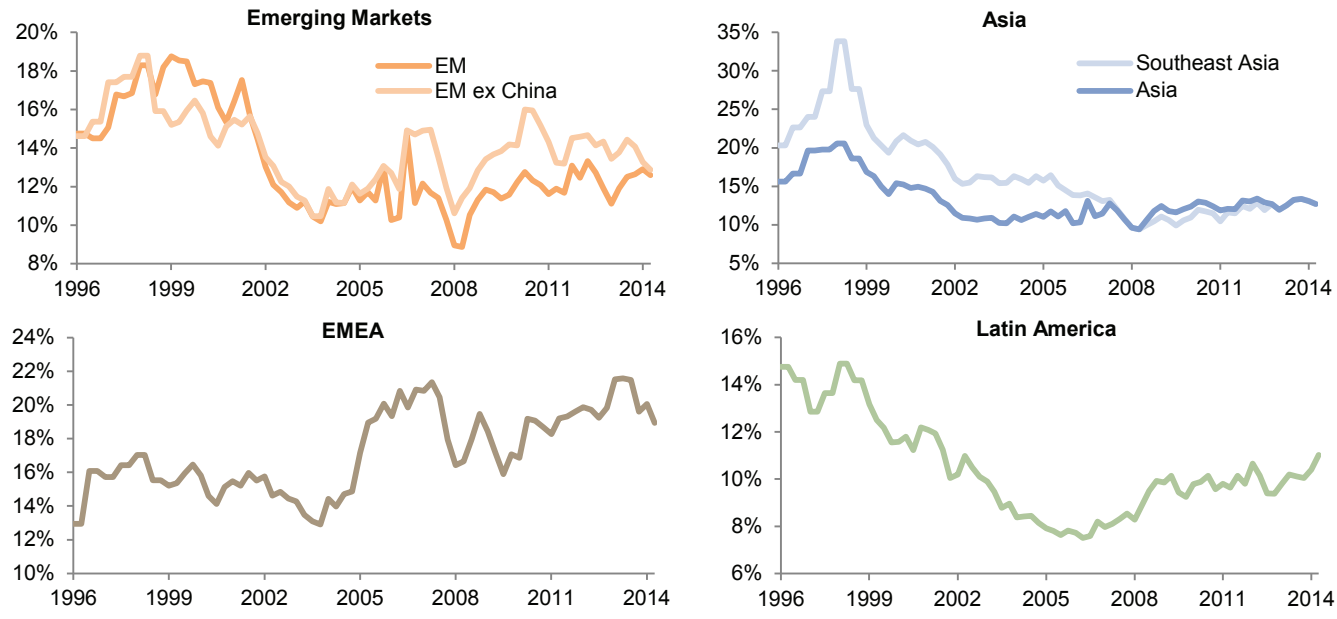
Anatomy of a Crisis

Some of the declines in EM currencies over the past four years are comparable to, if not greater than, those seen during 1997–98. While the impact of falling currencies has certainly not been painless for EM economies, financial contagion has not yet emerged. This is because the nature of today's currency and debt markets is fundamentally different than in the 1990s.

As a recap, the EM crises of the 1990s stemmed from a reliance on short-term USD inflows/debt facilitated by currency pegs to the US dollar (either explicit or implicit). This was especially the case in Southeast Asia, which in 1996 had foreign bank claims equivalent to 25% of GDP (Figure 2). Foreign borrowing was used to finance long-term local projects, creating both a currency and maturity mismatch between assets and liabilities. Most EM economies were running current account deficits and had low FX reserves—a situation viewed as stable so long as the currency pegs held. However, once the currency pegs were broken and currencies rapidly fell, banking systems froze as capital fled and local interest rates surged to try to stem the outflow. This worsened the economic contraction and defaults.

Today's situation is different in many respects. First, no major EM country has a pegged

Figure 2. International Bank Claims as a Percent of GDP
Fourth Quarter 1996 – First Quarter 2015



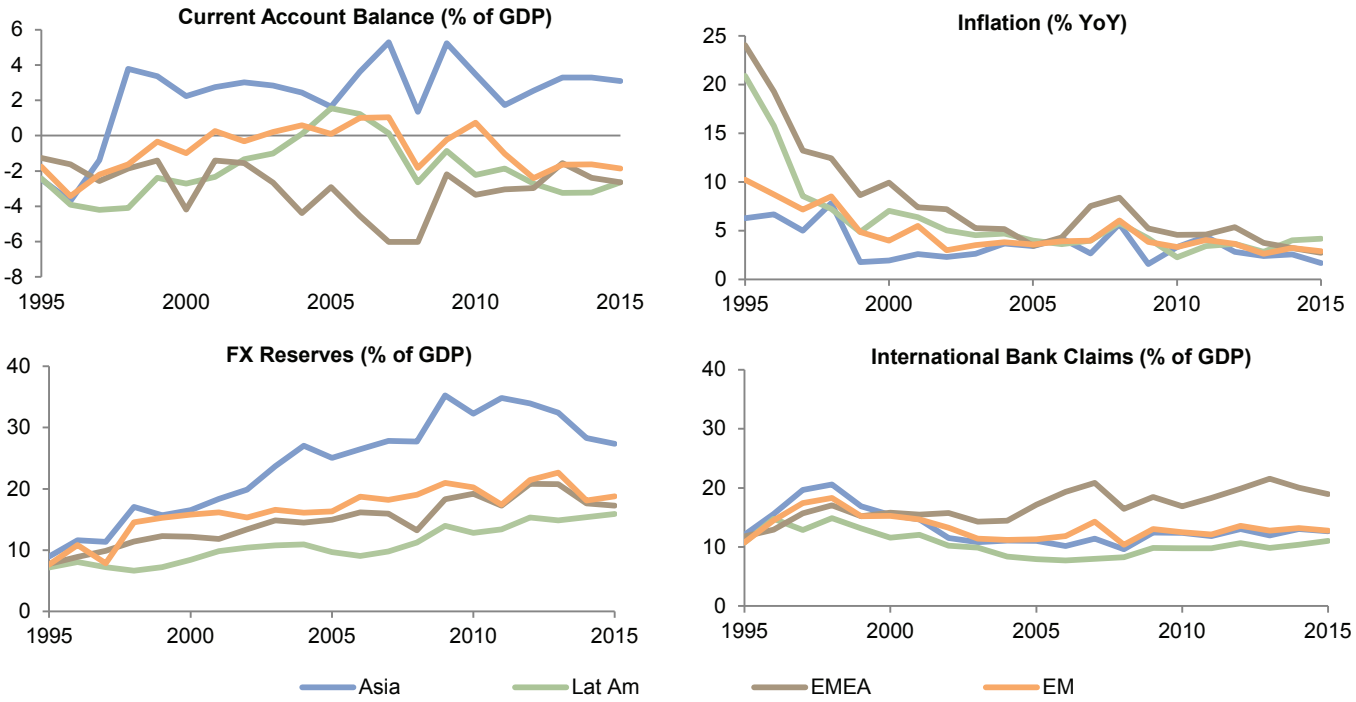
exchange rate.[2] Second, current account deficits are generally smaller, while currency reserves are much larger and inflation lower.

Though this is broadly true, there are regional differences (Figure 3). Asia appears the most robust due to current account surpluses and higher reserves, while Latin America and EMEA countries tend to have current account deficits and lower reserves. Still, foreign claims appear manageable, with many countries maintaining FX reserves equal to or greater than short-term external debt and foreign bank claims.

This is why large declines in many currencies have not triggered undue stress in local banking systems. Floating exchange rates have allowed a more gradual adjustment, unlike the 1990s, which saw the abrupt breaking of pegs. Further, the development of local currency bond markets has reduced currency mismatches at the sovereign and corporate level, and reserves have allowed for more controlled currency depreciations amid capital outflows.

[2] Hong Kong, which is considered a developed equity market, maintains a hard peg to the US dollar, as do Saudi Arabia and other Gulf states. The RMB is not pegged to the US dollar, although it is managed by the People's Bank of China. Some smaller frontier economies have pegged rates.

Figure 3. Emerging Markets Macro Indicators
1995–2015



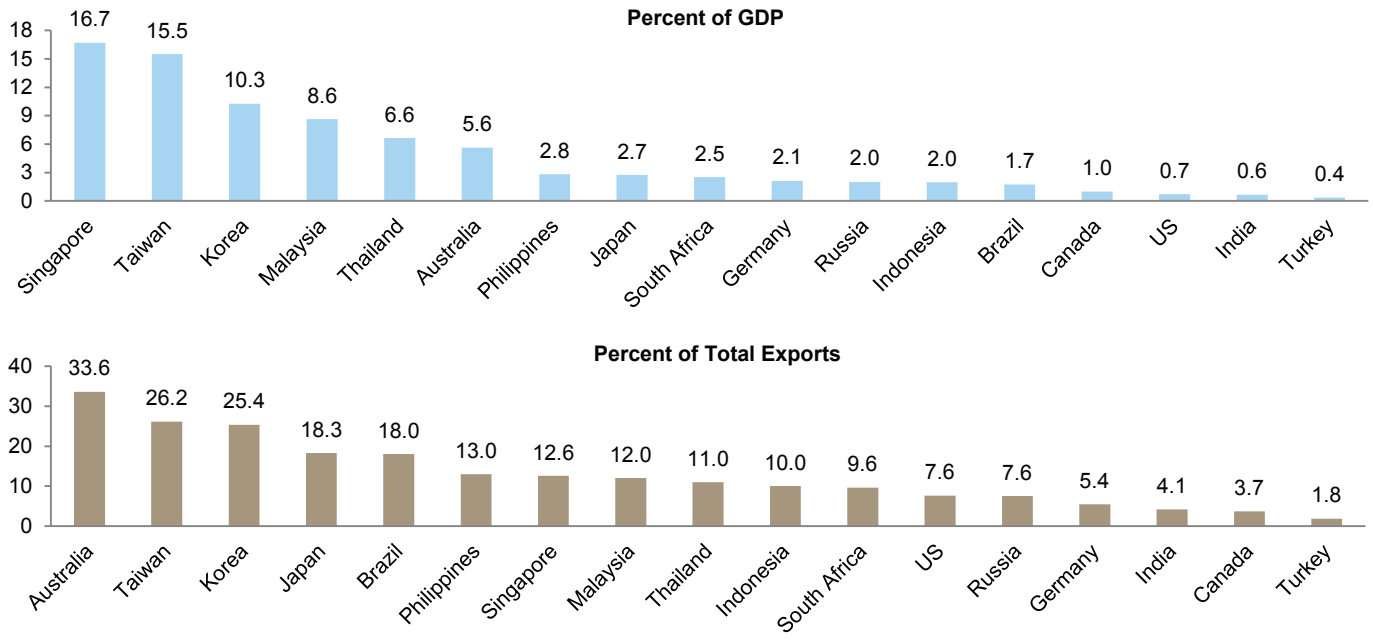
Risks Remain

While currency fundamentals are stronger today and no major emerging market has yet come under severe stress from falling currencies, three interrelated risks bear monitoring: commodity prices, Chinese growth, and tightening by the US Federal Reserve.

Commodity Crunch. The hardest hit currencies have generally been those of commodity exporters. Continued weakness in commodity prices could increase systemic risk in these countries if companies default on domestic and foreign debt tied to commodity investments, and current account and government deficits widen. These risks seem largely priced in to these currencies and related financial assets (stocks and bonds), but it is hard to imagine a cyclical recovery in these currencies absent a recovery in commodity prices.

The China Factor. As market action in August exposed, China is a key factor driving EM currencies. Weak growth in China feeds through to commodity prices, while a weaker RMB places pressure on economies that export to and compete with China. Figure 4 provides some insight into those emerging and developed economies most vulnerable via trade exposure to China—predominately commodity exporters and export-oriented economies in Asia. Importantly, a "hard landing" in China would hit EM growth further and intensify capital outflows from

Figure 4. Exports to China
As of December 31, 2014



emerging markets. Our view is that while the RMB needs to depreciate further given stress in the Chinese economy, a major devaluation is unlikely and would do China more harm than good. While we believe China has the monetary and fiscal firepower to avert a domestic financial crisis and support the currency (provided the capital account remains partly closed), we do not expect a strong recovery in economic growth.

Fed Tightening. Rising US interest rates will place additional pressure on countries with current account deficits to attract capital by either increasing domestic rates and/or weakening currencies. A stronger US dollar in response to Fed tightening would also continue to weigh on commodity prices and broader EM currencies.

To help identify which currencies are most vulnerable, we have grouped countries into four buckets based on their underlying fundamentals (current account + net reserves) and valuations (real effective exchange rate). Encouragingly, most currencies today have what we deem as positive fundamentals, although some of these currencies are still relatively expensive, while those with negative fundamentals have already undergone sizable currency depreciations, leaving them relatively cheap and potentially less vulnerable (Figures 5 and 6).

The key variable will be the pace at which the Fed ultimately hikes rates, and whether it is in response to robust US growth or rising inflation pressures. A gradual set of rate hikes amid improving US growth would give deficit countries additional time to adjust before pressures become too acute, while countries with current account surpluses might actually welcome the currency weakness as it could help exports, especially if US and even European demand begins to recover. This is essentially what occurred over 2004–06, when EM currencies rallied amid Fed hikes, although at that time the US dollar was weakening, a key difference from today.

Figure 5. Emerging Markets Currency Fundamentals and Valuations
2015

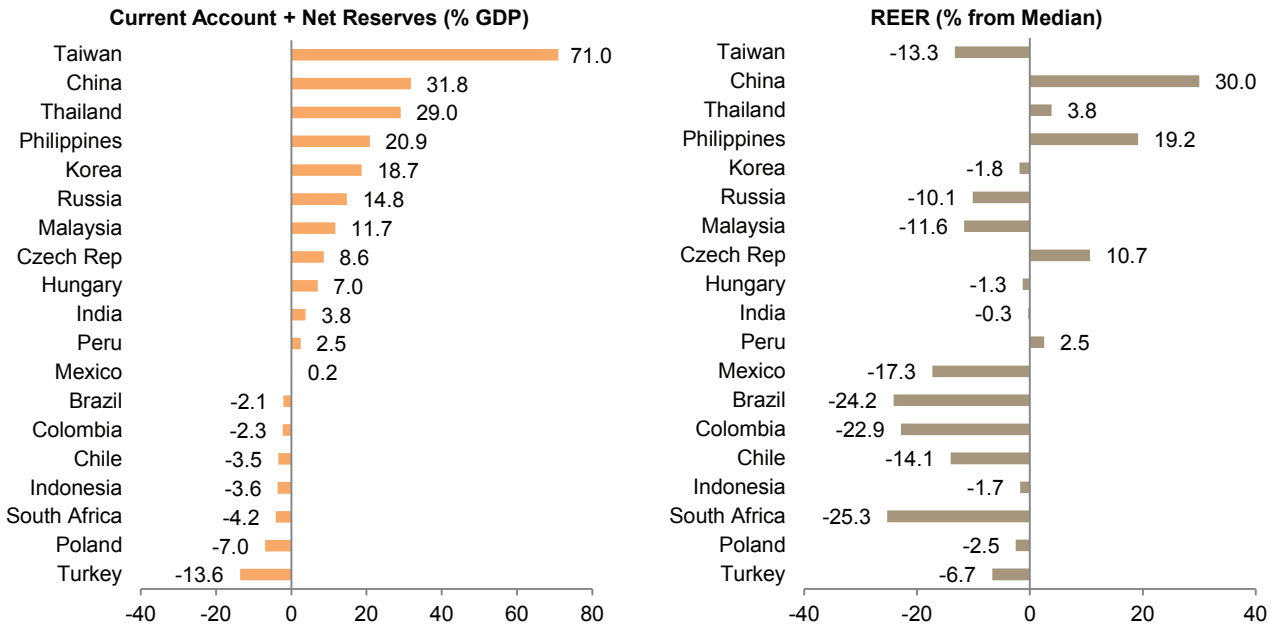
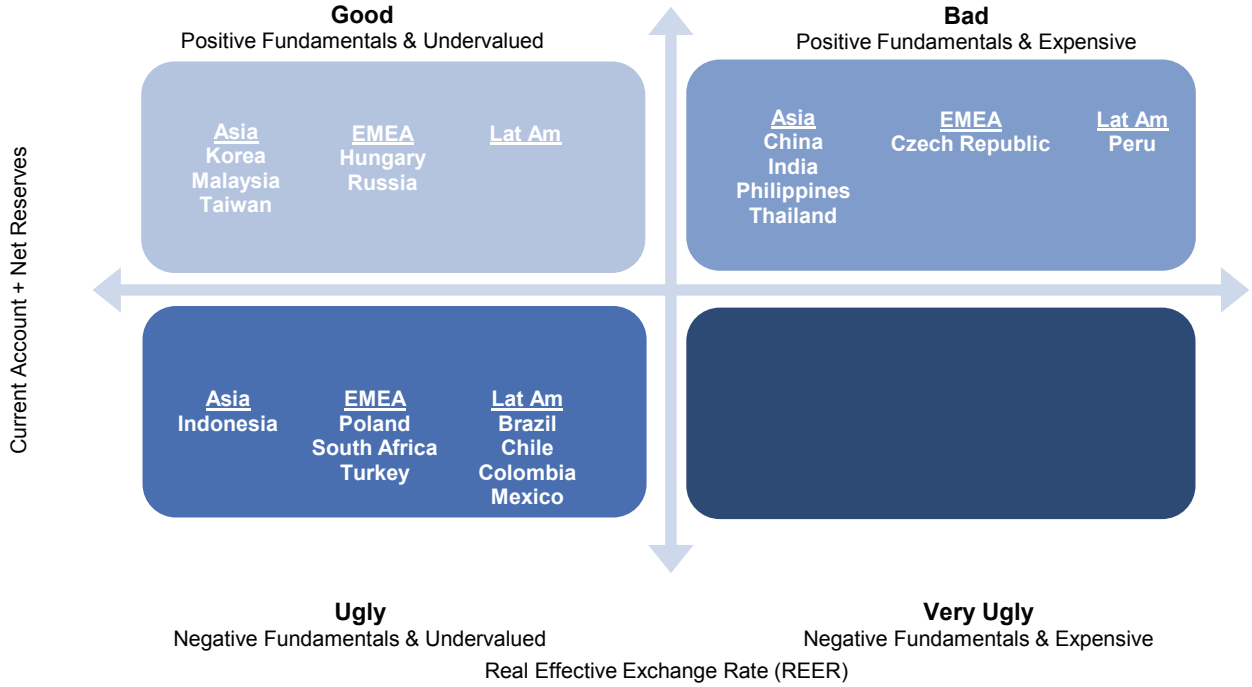


Figure 6. Emerging Markets Currency Vulnerability Matrix

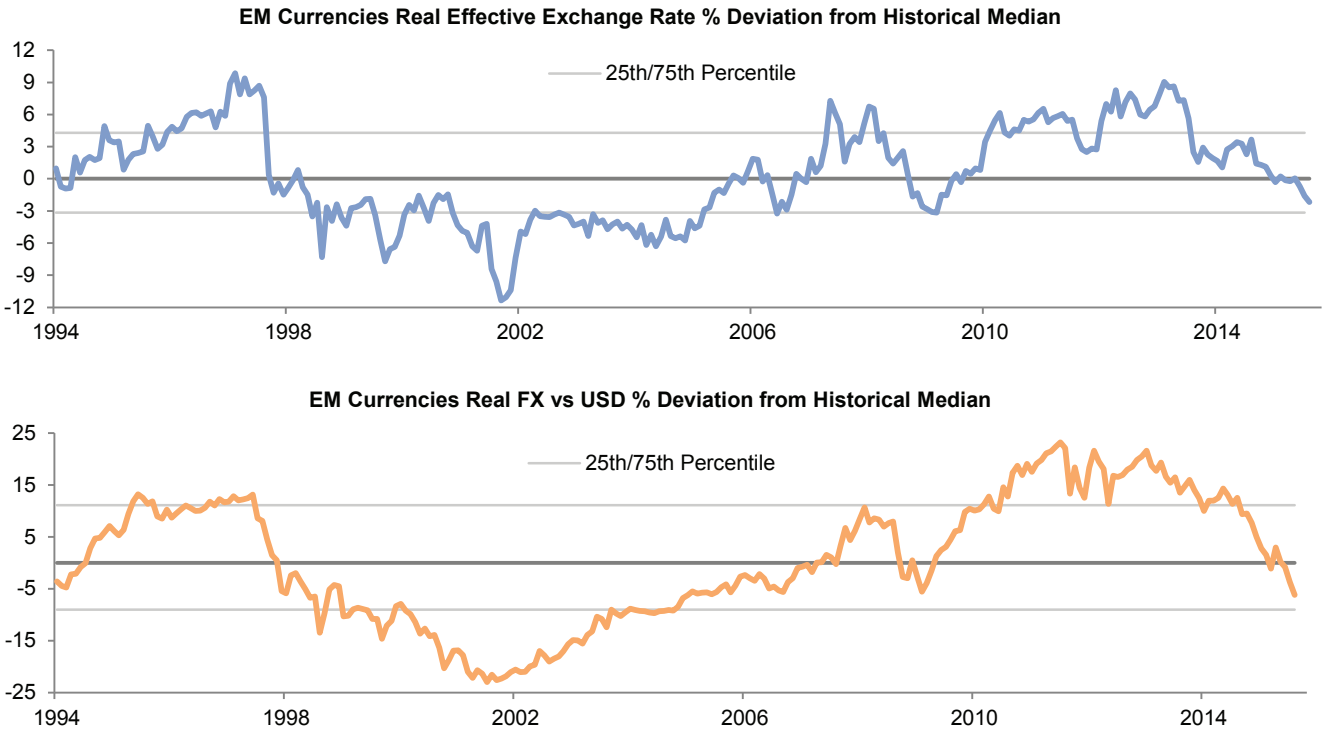


EM Currencies Are Not Yet Cheap

Overall, we think more downside for EM currencies is likely in the intermediate term, especially since currencies are not yet uniformly cheap. Of the 20 EM currencies we track, the "median" EM REER is only 2% below its long-term level at the end of August (Figure 7). This is just above the 25th percentile of the distribution, which implies EM currencies are still in the fair value range. The same holds even if we just look at EM currencies versus the US dollar instead of in trade-weighted terms.

At face value, the median EM currency has scope to fall another 10% in trade-weighted terms or 18% in US$ terms before reaching 2001 lows. While there appear to be pockets of under-valuation in select currencies, these are mainly commodity-linked currencies with current account deficits—i.e., those currencies more at risk in the current environment.

Figure 7. Emerging Markets Currency Valuations
January 31, 1994 – August 31, 2015



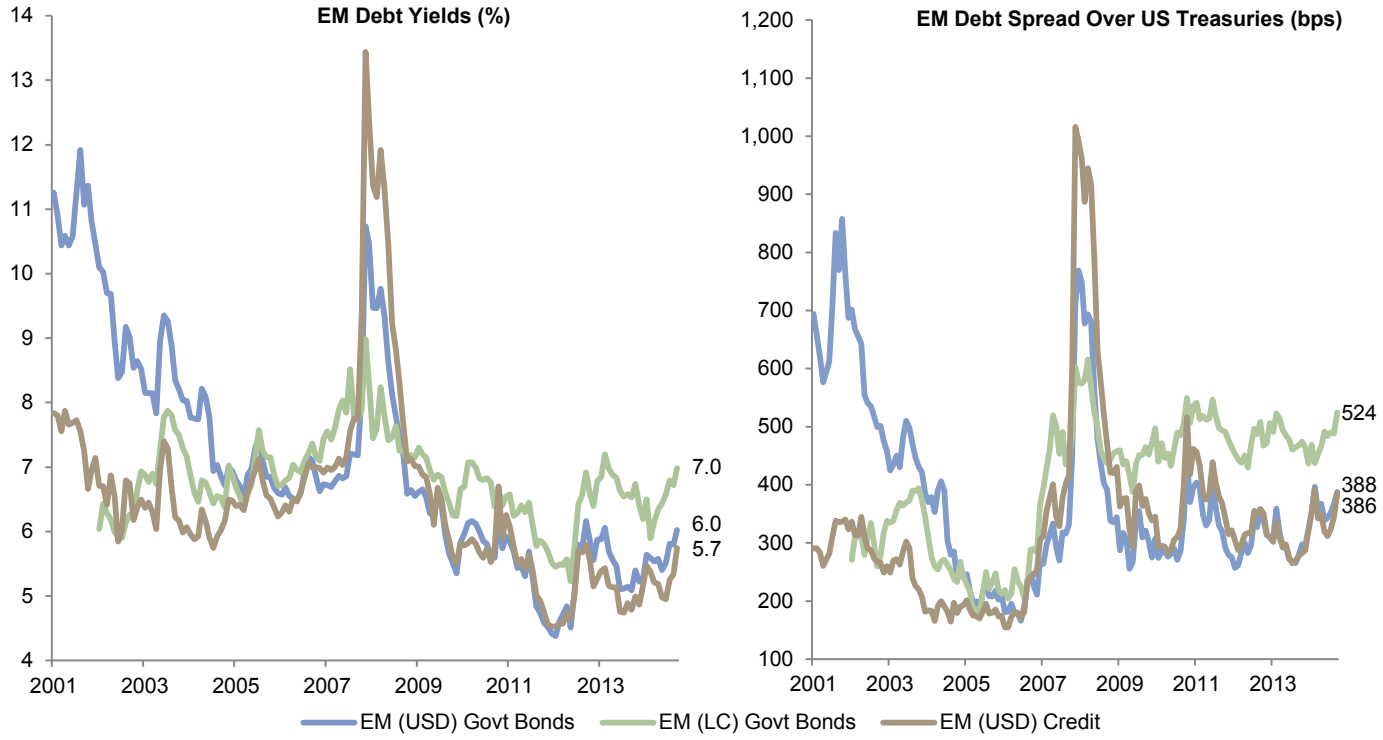
Implications: Too Soon to Expect a Sustained Recovery

In sum, while recent current weakness is unsettling, we do not yet view it as triggering, or even symptomatic of, a broader EM currency crisis. Rather, flexible exchange rates are serving as a shock absorber for EM economies. While meaningful adjustments have been made, more weakness is in store for EM currencies given headwinds from potential Fed tightening, weak commodity prices, and uncertainty over China and the RMB.

Although a delay in Fed tightening and subsequent weakening of the US dollar may trigger a near-term rebound in EM-related assets, any such rally will be short lived absent a sustained rebound in global growth that helps drive commodity prices higher. Given current supply/demand imbalances, this seems unlikely in the intermediate term.

As such, we do not yet see a compelling buying opportunity in EM debt as a beta play. While local currency bond yields have risen to a level we consider attractive (Figure 8), currency weakness will continue to weigh on

Figure 8. Emerging Markets Debt Yields and Spreads
December 31, 2001 – August 31, 2015



returns, especially since the EM local currency benchmark is tilted toward commodity-linked currencies. Meanwhile, yields on hard currency sovereign and corporate bonds have returned to fair value but remain vulnerable to a rise in US interest rates and are not yet showing the signs of stress that imply a buying opportunity.

Given the divergence in EM fundamentals and performance recently, active management in EM debt remains quite compelling today, and we still favor the broad, open-mandate managers that can assess relative value across EM fixed income segments and currencies. But this is more of a long-term alpha play than a source of attractive beta.

Regarding EM equities, currency exposure relative to debt markets is tilted more toward Asia (approximately 66% of the index), which in our analysis tends to offer better fundamentals. Thus, while currency weakness will also be a drag on returns, we have more confidence that these currencies can better weather any upcoming storm. ■

Aaron Costello, Managing Director
Jason Widjaja, Associate Investment Director

Exhibit Notes

Global Currency Performance vs USD
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Singapore's equity market is considered developed, but its currency is considered emerging.

International Bank Claims as a Percent of GDP
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.
Notes: All data are calculated as the median value for countries in the respective regions. Asia includes China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, and Thailand. EMEA includes Czech Republic, Hungary, Poland, Russia, South Africa, and Turkey. Latin America includes Brazil, Chile, Colombia, Mexico, and Peru. Emerging markets includes all of these countries. Southeast Asia includes Indonesia, Malaysia, Philippines, and Thailand.

Emerging Markets Macro Indicators
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.
Notes: All data are calculated as the median value for countries in the respective regions. Data for 2015 are based on Oxford Economics forecasts except for international bank claims, which reflects data for first quarter 2015. Asia includes China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, and Thailand. EMEA includes Czech Republic, Hungary, Poland, Russia, South Africa, and Turkey. Latin America includes Brazil, Chile, Colombia, Mexico, and Peru. Emerging markets includes all of these countries.

Exports to China
Sources: International Monetary Fund and Thomson Reuters Datastream.

Emerging Markets Currency Fundamentals and Valuations
Sources: Bank for International Settlements, J.P. Morgan Securities, Inc., Oxford Economics, and Thomson Reuters Datastream.
Notes: Net reserves are calculated as FX reserves minus international bank claims. Current account + net reserves chart based on Oxford Economics 2015 forecasts except for international bank claims, which are based on first quarter 2015 data.

Emerging Markets Currency Vulnerability Matrix
Source: Cambridge Associates LLC.

Emerging Markets Currency Valuations
Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Emerging Markets Debt Yields and Spreads
Sources: Barclays, Federal Reserve, and J.P. Morgan Securities, Inc.
Notes: Spreads are yields over the US Treasury curve. Yields are represented by: JP Morgan EMBI Global Diversified Index ("EM (USD) Govt Bonds"), JP Morgan GBI-EM Global Diversified Index ("EM (LC) Govt Bonds"), and JP Morgan CEMBI Diversified Index ("EM (USD) Credit").