

Emerging Market Currencies: Still a good investment

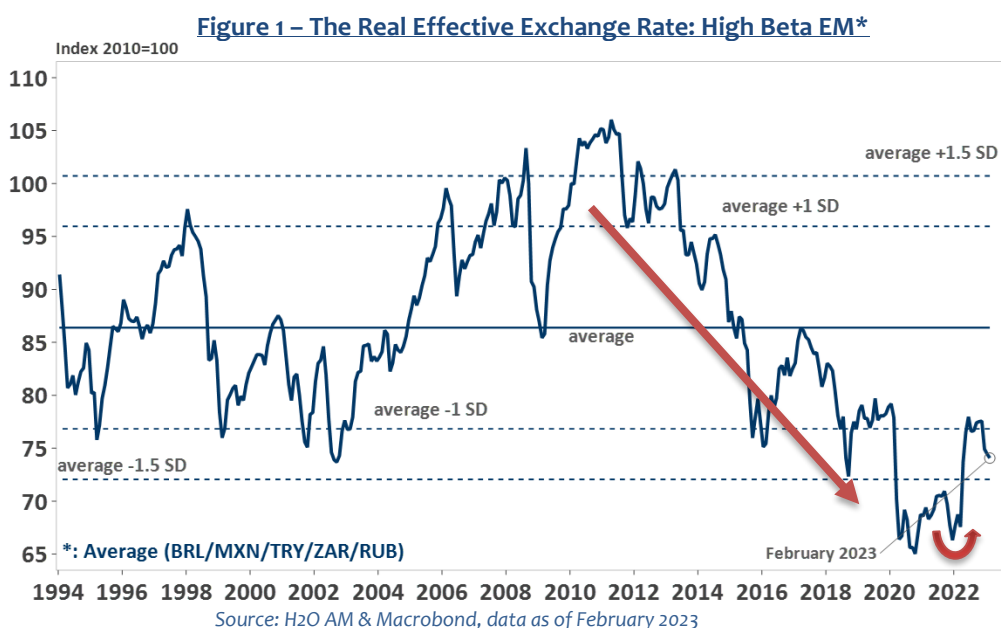
London – April 6, 2023

In 2022, the growth of emerging economies has shown resilience despite strong headwinds: i) The Russia-Ukraine war; ii) the Chinese slowdown due to Covid restrictions; iii) Core rates tightening to combat inflationary pressure. Yet, emerging market indices suffered heavy corrections on the back of USD strength supported by rising US yields combined with the striking outperformance of the US economy.

The US monetary tightening cycle will likely soon reach its peak which should further weigh on the USD to the benefit of alternative investments. This would effectively mark the end of 10 years of US dollar strength that started in 2013 with the Fed’s taper tantrum and the outperformance of the US economy over EM as commodities entered a long-term bear market. Today’s background is supportive of EM assets so long as the global hard landing scenario, which is ruled out from H2O AM’s base case ([Link to Scenario Video*](#)), remains distant.

Various EM countries are set to benefit from the “nearshoring trend” provoked by the US and Europe’s impulse to repatriate production domestically or within ally territories as recent global chains disruptions and rising geopolitical tensions revealed major risks to economic sovereignty and growth. Further support to EM growth should emanate from an upcoming positive cycle for commodities derived from the Chinese recovery and infrastructure investments in the green transition across countries.

This environment militates in favour of a higher premium for EM economies while valuation of their currencies remains very attractive in real terms, as attested by their combined Real Effective Exchange Rate (Figure 1). In fact, **commodity exporters with high carry and value still represent a good combination and are set to provide positive returns in 2023**, after ten years of underperformance. Among those, Brazil, Mexico, Chile, and South Africa emerged as clear beneficiaries of this trend over the past few months.



*Password: H2OAMvideo

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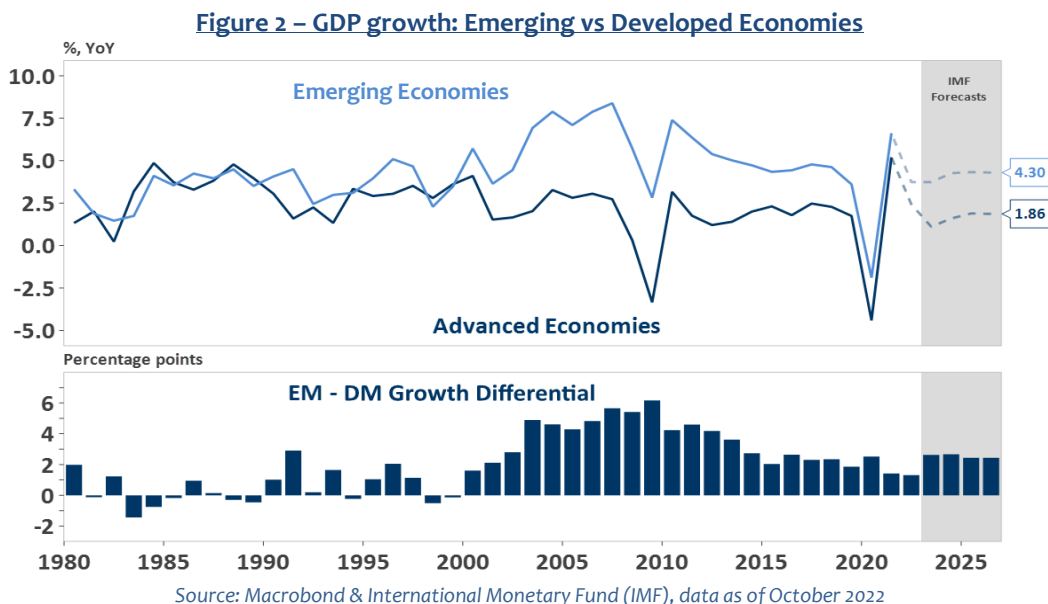
Growth Outlook for 2023: US slowdown, Europe middle-through and China reopening

The US economy is slowing but remains afloat. Although the impact of tighter lending standards imposes a drag on growth, overall aggregates still suggest a positive outcome for 2023 and early 2024. The current financial stress induced by US regional banks will be contained as the Fed and FDIC are equipped to prevent contagion risks.

On the other hand, Europe’s growth outlook depicts a more resilient pattern with a buoyant Services sector, lower energy prices which improve purchasing power, and a banking system that is less prone to failures. Pressure over global manufacturing is set to fade with the easing of supply-chain bottlenecks and the Chinese rebound.

Though long-awaited, the Chinese reopening came earlier and faster than anticipated, thus removing a two-year roadblock for EM economies and global supply chains. This is an important cycle stimulus for the world economy and should predominantly favour emerging markets in 2023. Chinese imports, which represent a major component of the global manufacturing sector, decreased significantly in 2022 owing to successive lockdowns. But following the ease of restrictions, goods imports ought to strongly recover as private consumption and exports rebound simultaneously. The share of imported products within Chinese exports remains significant. Besides, Asian countries with a large tourism sector stand to benefit the most from the return of Chinese tourists which have just started to travel again following the removal of restrictions.

As a result, **EM growth outperformance over DM is expected to widen in the coming years** (Figure 2). Together with peaking US rates and growing concerns over the attractiveness of US assets, investors are likely to view EM as an interesting investment alternative.



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Brazilian Real



BRL is one of the best candidates to benefit from China's reopening thanks to the high proportion of commodity exports and manufacturing in its economy. External accounts will stay sound in 2023 on the back of high terms of trade and elevated FDIs. Debt sustainability risk remains distant as strong nominal growth will contain higher debt levels.

The FX carry vs USD is expected to remain high as the Banco Central do Brasil (BCB) should stay put for a while. Although on the path of deceleration, the current economic cycle still generates above-target inflationary pressure according to the bank which currently projects inflation to reach 5.7% in 2023. Another reason behind the central bank's reluctance to cut rates early is found in the recent degradation of inflation expectations for fears that the nation's economic policy authority, the National Monetary Council (CMN), will revise the official inflation target upward. The executive branch of the government wishes to bring down yields from levels it deems detrimental to the economy and questions the central bank's stance to keep the inflation target at levels perceived as too low for "Brazilian standards" according to President Lula da Silva. The target currently stands at 3.5% for 2023.

Mexican Peso



Being the asset of choice for many EM currency investors, MXN has recently suffered from the "winner's curse" as positioning on the Mexican currency built-up swiftly since the start of the year. Nonetheless, MXN remains attractive in terms of FX carry and valuation. Following another rate hike in March bringing policy rates to 11.25%, the Bank of Mexico signalled its intent to keep its options open on whether to end the tightening cycle now or continue hiking in May. The bank could be inclined to preserve its restrictive monetary policy for longer than expected by investors.

Mexico stands to significantly benefit from the nearshoring narrative, suggesting that it will remain a key FDI destination (especially in manufacturing). On the political front, President Andrés Manuel López Obrador commands strong approval from the population.

Chilean Peso



Chile's Central Bank kept rates on hold since October 2022 at 11.25% after delivering an impressive tightening cycle (+1075 bps) to bring policy rates to their highest level since the late 90s. Going forward, we can expect the bank to stay on the cautious side despite inflation expectations having already converged to the 3% target and consensus pricing imminent cuts.

Chile experienced a large positive swing in external accounts since December 2022. Imports contracted due to the monetary tightening and the fading impact of pension fund withdrawals that had boosted consumption. At the same time, exports strengthened as global growth was sustained while oil prices declined (Chile is the world largest exporter of copper but is also a net oil importer). The impact of China's reopening on metal prices should continue to improve the country's terms of trade and provide support to the economy's commodity-driven export sector.

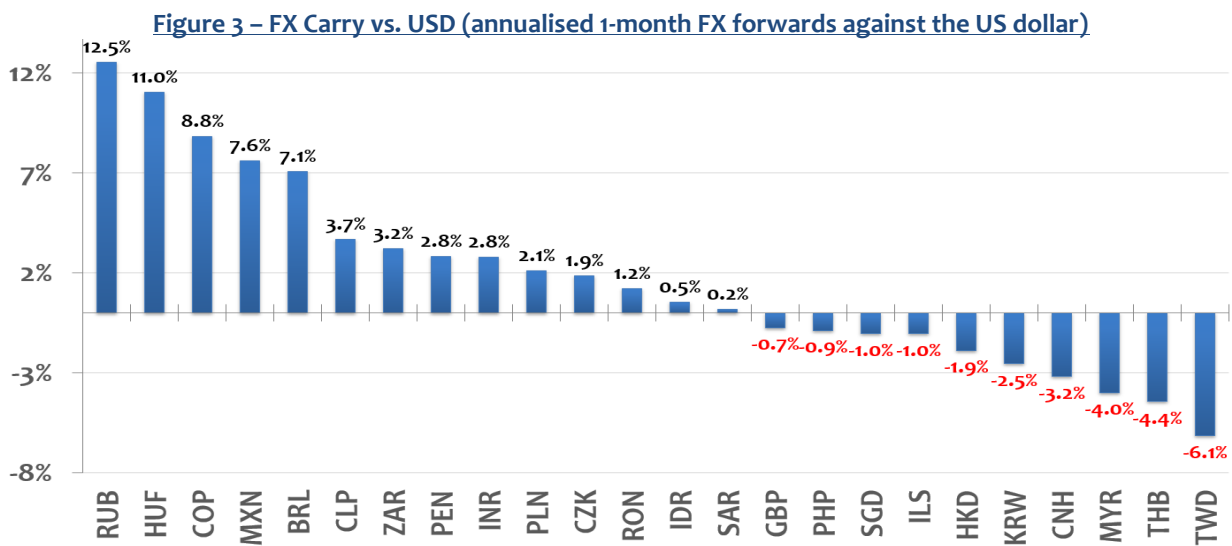
Colombian Peso



Fitch and S&P downgraded the country's credit outlook into speculative grade mid-2021, expressing concerns over the public debt's trajectory following the pandemic shock and a lack of confidence in the state's fiscal tightening agenda. COP has underperformed the EM complex since the second half of 2022 due to weak external accounts: Colombia reported its largest imbalance in current account deficit since 2015. On the monetary front, the Central Bank is expected to continue hiking following high core CPI prints; we anticipate declining inflationary pressure in the months ahead. But besides the currency's extreme under-valuation in REER terms and high nominal / real yields, compelling arguments for holding COP are found in the country's potential current account improvement derived from an aggressive tightening cycle and better oil revenues.

High Risk Premium

To combat high inflation and contain currency depreciation, most EM Central Banks (excluding China, Turkey, and Russia) were not only the earliest, but also the most aggressive in tightening financial conditions. And while their policy rates are likely to peak soon in the wake of ongoing disinflation, Central Bank officials have preserved a cautious (hawkish) tone, suggesting a **prolonged horizon before interest rates are loosened**. With historically high levels of real policy rates, these economies now benefit from a high carry against the US dollar (Figure 3).



Source: Bloomberg, data as of March 2023

With persisting zero-to-negative real rates among G4 sovereign bonds due to sustained inflation, the FX class, and more specifically the EM FX, represents a favourable alternative when seeking positive real returns. Admittedly, the trajectory and the depth of such markets can make the day-to-day position more volatile. However, in the long run, the high carry combined with the fact that market positioning has recently been washed away following the March banking stress outweighs the drawbacks.

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