Global Macro Strategy

Can narrowing trade imbalances boost EM FX?

Strategy

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Improving trade balances in EM: icing on the cake for FX markets?

Trade balances in EM have shown clear sequential improvement in recent months, including in the beleaguered markets of Brazil, Indonesia, South Africa, and Turkey. Along with a muddled Fed and renewed credit vigour in China, are the ingredients now in place for an extended period of stabilisation in EM currencies?

Better lucky than smart? The drivers of improving trade balances matter

Import compression, mostly through lower oil prices, has fuelled the adjustment in EM trade balances over the past twelve months. Real export growth has ground to a halt, and export competitiveness has shown few signs of improvement. This matters because exports have historically been a powerful driver of EM currencies, while changes in in the trade or current account balance are statistically insignificant. Weak exports can also exert further pressure on EM growth and balance sheets, both of which are closely correlated with capital account flows into EM. All considered, capital account pressures could provide a powerful offset to current account healing in the months ahead.

Isn't the market already too bearish?

In hindsight the late summer months saw too rapid a build-up in FX hedging demand, jolted by uncertainties about China's FX and equity market management and a sharp drop in commodities and US HY markets soon after. However, we find the pace of depreciation in EM currencies this year to be broadly consistent with historical analysis on the relationship between FX and export volumes. EM sovereign credit spreads have recently retraced but look increasingly vulnerable in the context of our balance sheet risk framework. Recall that the onset of weakness in EM currencies earlier this year played out almost entirely due to the burden of EM's own pressures, and despite falling US rates. Little has changed fundamentally.

Favour local debt over FX. China, India, Israel and Mexico stand out

In our view the trading theme that presents greatest value in EM FX/fixed income is to be selectively long in EM local markets against a cautious stance on currencies. Duration in selective EM markets can benefit from developed world policy staying looser for longer, and the persistent weakness in EM growth dynamics. We think monetary conditions in India, China and Singapore in particular remain very tight, and weaker currencies and/or lower rates will likely be pursued there. Mexican and especially Israeli swap curves remain steep and in our view offer more attractive opportunities than the local currencies. Meanwhile if credit concerns in EM do re-ignite, as we expect over the medium term, underweight positions in EM currencies are likely to provide some effective protection.

Near-term signposts for the stabilisation to continue

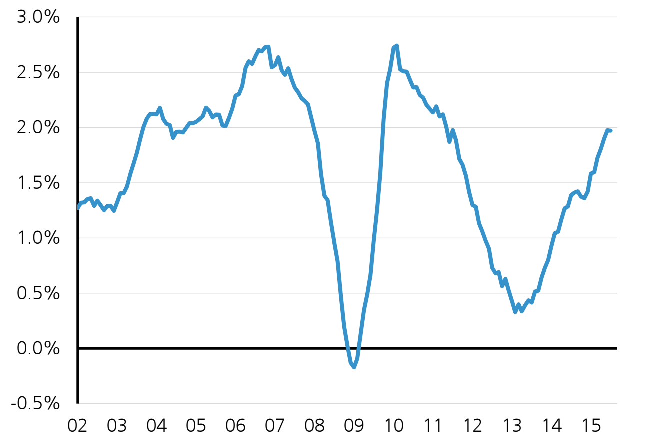
Despite clear medium-term headwinds for EM FX, some near-term signposts that may extend the recent rally are: the ECB decision later this week, the US ECI report and Bank of Japan decision on October 30th, Turkish parliamentary elections on November 1st, Bihar election results in India on November 8th, and potential inclusion for China in the IMF SDR basket later this year.

Not for the first time, currencies have been the weakest link in the EM asset spectrum this year. In local currency debt, the EM benchmark has posted a respectable 3.6% total return, but this figure drops sharply to -9.7% when calculated in dollars. MSCI EM returns are negative 0.6% ytd in local currency terms, but 7% weaker in dollars. The fate of EM currencies thus has key implications for all investors across all EM asset classes.

In this context, many investors are asking whether the recent powerful improvements in trade balances in EM (Figure 1) may be sufficient to fuel EM currency strength, or at least stabilisation, over the coming months and quarters. While most investors see the recovery in EM assets over the past fortnight as a short-covering rally, with little validation from base metal prices, most are carefully scrutinising whether pessimism on EM currencies may remain excessive and whether an improving external dynamic may be getting overlooked.

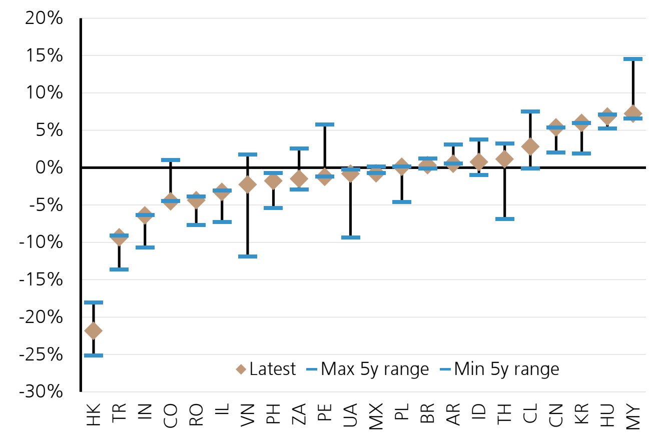
In this note we identify four reasons why EM's current account healing, in its current form, is unlikely to drive a sustained rally in currencies. We also outline what other factors we are watching in the near term that may inform a more tactical positive stance on this asset class.

Figure 1: EM trade balance/GDP, 12m rolling



Source: Haver, UBS. EM is measured here as a simple average of 23 economies.

Figure 2: Trade balance/GDP across EMs – ranges over 5y



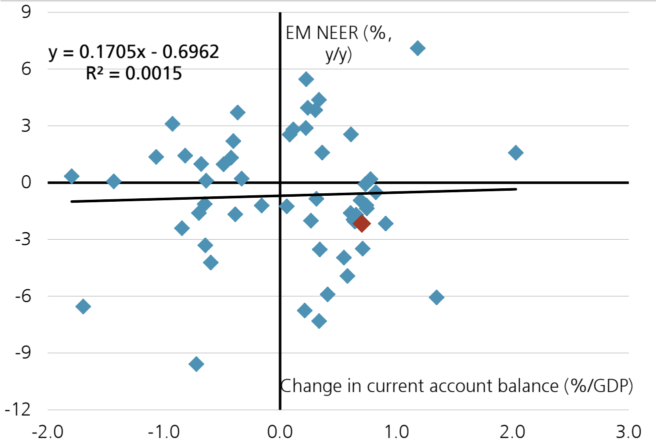
Source: Haver, UBS. Chart shows data in 12m rolling terms.

1) Export growth matters more for EM currencies than delta on the trade/current account

The simple truth remains that current account/trade balance dynamics have tended to be very poor predictors of currency movements over the last 20 years. Indeed they have tended to be statistically insignificant (Figure 3). Two simple examples are shown below: current account healing in Mexico during 2002-2004 clearly didn't benefit the peso, while major current account deterioration in South Africa didn't impede the rand from 2005-2007.

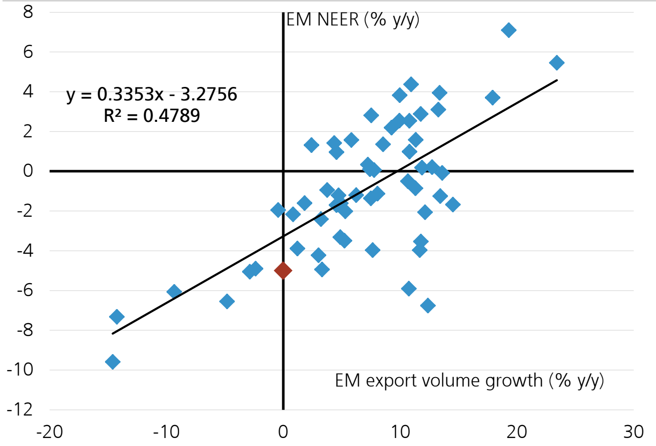
By contrast, real export growth has tended to be much more closely related to FX performance than the evolution of the external balance (Figure 4). Seen through this lens, the weakness in EM FX this year does not appear to be a strong overshoot in the context of today's anaemic export reality.

Figure 3: EM NEERs vs. change in current accounts



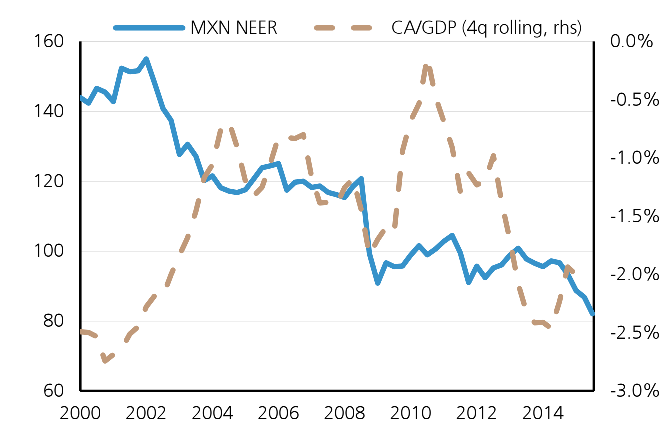
Source: Haver, UBS. Chart is based on quarterly data since 2000. EM NEERs here use a simple average of 23 economies.

Figure 4: EM NEER vs. export volume growth



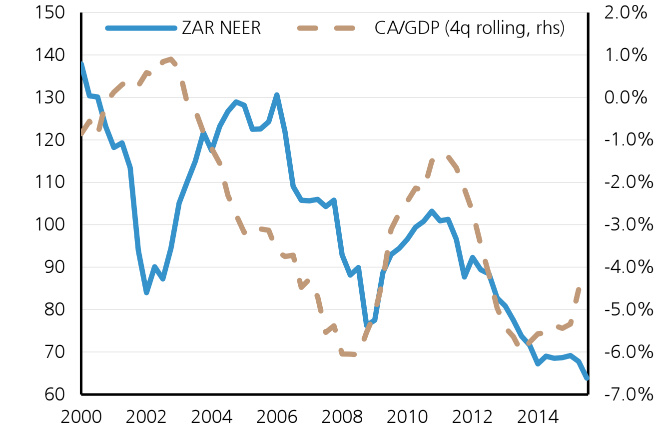
Source: Haver, CPB World Trade Monitor, UBS. Chart is based on quarterly data since 2000. EM NEERs here use a simple average of 23 economies, volume growth from CPB. Red dot denotes latest observation (Q2-2015).

Figure 5: Mexico: NEER vs. current account/GDP



Source: Haver, UBS

Figure 6: S. Africa: NEER vs. current account/GDP

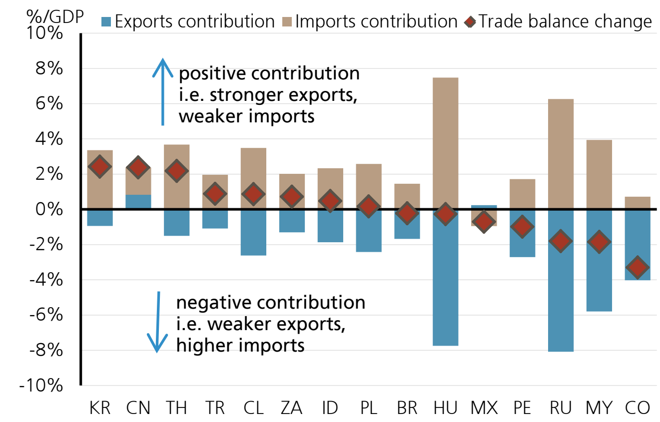


Source: Haver, UBS

2) External adjustment continues to be driven by import compression, posing risks to EM balance sheets

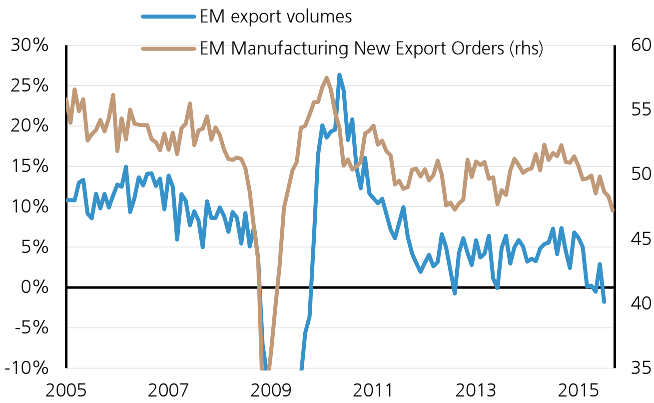
Figure 7 below shows that export growth has contributed negatively to trade balance changes over the past year in the vast majority of EM countries. Y/Y export volume growth has decelerated towards zero in recent months, outside of a small number of economies such as Mexico and the CEE3. Sequential export volume growth has recently been stagnant/modestly negative for EM as a whole, while forward-looking indicators such as new export orders for key manufacturing economies such as China, Korea, and Taiwan are continuing to deteriorate below 50 (Figure 8). While import compression is understandable in the early stages of external adjustment, the persistent inability of EM to move beyond this to 'stage 2' – an export recovery – can exert further negative pressure on EM growth and balance sheets. Both of these are already at their weakest positions in a decade.

Figure 7: 12m change in trade balance/GDP by component: no positive contributions from export growth



Source: Haver, UBS

Figure 8: EM export volume growth and manufacturing new export orders: weakness is continuing sequentially



Source: Haver, UBS

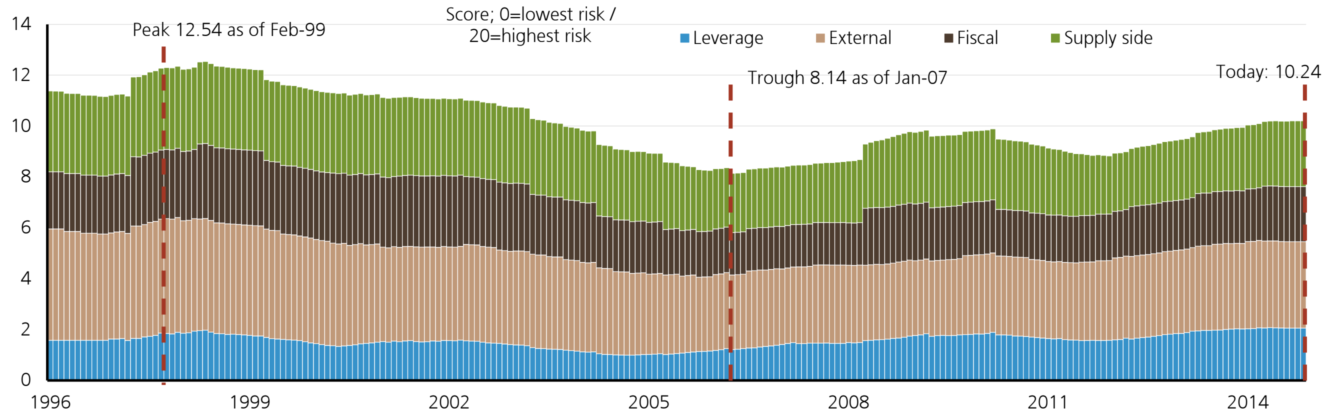
Which dimensions of EM balance sheets are most exposed to export weakness?

First, we anticipate that EM's fiscal risk scores will be vulnerable to both active and passive deterioration in the coming months and quarters. Our external and fiscal risk scores tend to be closely correlated over time, indicating the pro-cyclical and interdependent nature of these two key balance sheet components. The starting points here are not strong, with MSCI EM countries for instance currently recording their worst fiscal score in two decades on our metrics – even excluding the growth of contingent fiscal liabilities, a very generous assumption. Active fiscal loosening to compensate for weak exports is thus unlikely to go unnoticed, and can drive further widening in credit spreads / increased term premia in EM local bond markets, with knock-on impacts to FX. Even on a passive basis, we estimate that if EM GDP growth persists at Q2-2015 levels (0.8% or 3.6% real growth on an MSCI- and EMBI weighted basis, respectively), fiscal scores can deteriorate by around 0.9 points per year, consistent with MSCI EM's overall risk score reaching levels typically consistent with crises in less than two years.

Meanwhile, EM credit/GDP (leverage) has continued to build in recent quarters, despite weaker domestic demand growth. While this can help to cushion the downturn in growth, markets will still take note of the strained starting points. We find that EM credit/GDP is generally already higher than would be predicted by its level of development. For example we find that MSCI EM domestic credit/GDP is more than 60pp above its predicted value[1], and this degree of over-leverage is at its highest in the past 20 years. Leverage in EMBI-EM economies is lower, but is also at its highest point in the last 20 years and now in line with its predicted values, having been 'under-levered' previously. Again in this context, we think trade adjustments without the support of exports can be increasingly perceived as negative for EM balance sheets and currencies. Relative to our 2-year target for EMBI spreads of around 520bps, the recent retracement in spreads below 400bps leaves little room for complacency.

[1] We obtain a predicted value for EM domestic credit/GDP by taking panel data across EM, the US, UK, Germany and Japan over the last 20 years and comparing this with GDP per capita. As expected, the line of best fit is positively sloped, showing that economies with higher levels of GDP per capita can have higher leverage.

Figure 9: EM macro balance sheet risk score broken down by components



Source: Haver, UBS. The EM aggregate presented here is EMBI+ weighted. MSCI EM and GBI EM weighed balance sheet scores are available too.

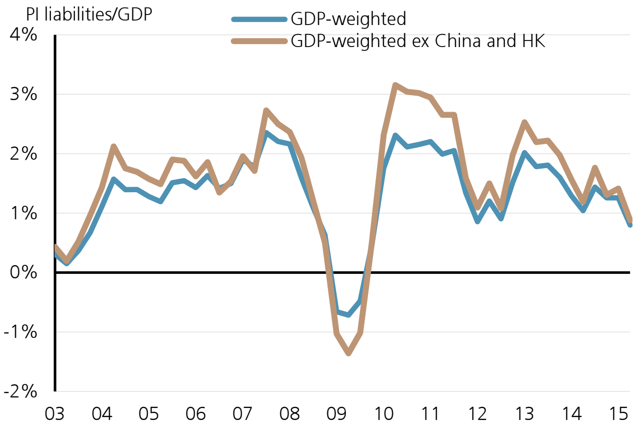
3) Capital account vulnerabilities may overwhelm current account improvements

While trade and current accounts in EM may extend improvements in 2016, the capital account threatens to provide a powerful offset.

First, there has been no foreign positioning capitulation in EM assets – fixed income in particular – that points to major distress today. A few economies such as Hungary, Russia, Malaysia and Thailand have suffered portfolio investment outflows, but for EM as a whole these inflows have merely decelerated (Figure 10).

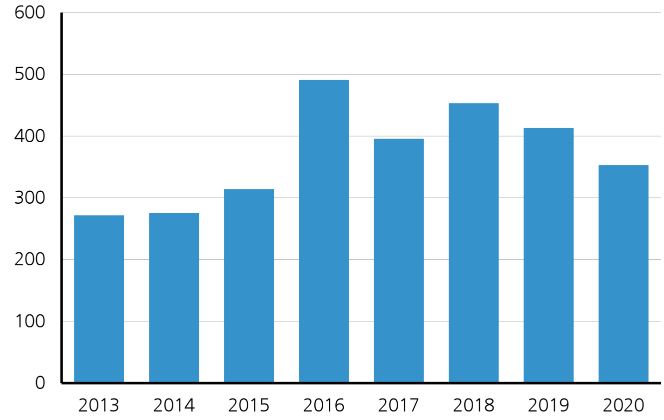
There are clear risks here. Net FDI and portfolio investment flows over the past 15 years have tended to be well correlated to GDP growth and our macro balance sheet risk index, both of which remain under clear downward pressure today (Figure 12 and Figure 13).

Figure 10: Portfolio investment liabilities/GDP (12m rolling): no major exodus from EM thus far



Source: Bloomberg, UBS estimates

Figure 11: Estimated hard currency debt maturity profile for EM sovereigns and corporates (USD billion)



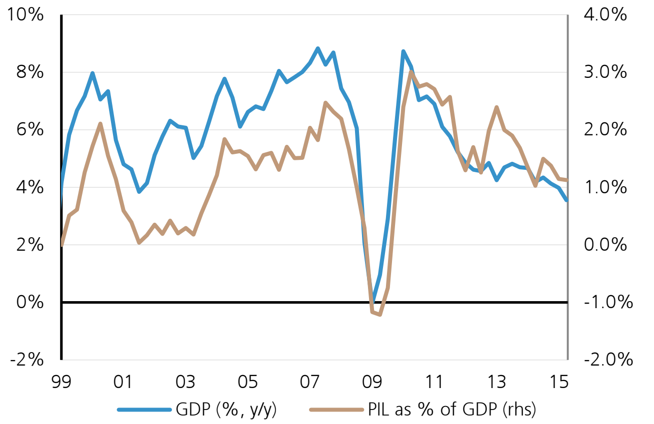
Source: Bloomberg, UBS estimates

Meanwhile EM hard currency debt issuance has undoubtedly slowed in 2015, but the maturity profile intensifies in 2016 (Figure 11). To the extent that EM corporates are now more levered than DM corporates, leverage has grown rapidly in cyclical sectors such as construction, and oil and gas, and several may have

engaged in speculative carry trades[2], there is a clear possibility that EM corporates could reduce net issuance further in the coming year. Mindful of these looming refinancing pressures, and with inflation generally not a major binding constraint in the current environment, EM central banks will likely look to replenish FX reserves stockpiles again to support balance sheets, presenting another hurdle for the currency markets.

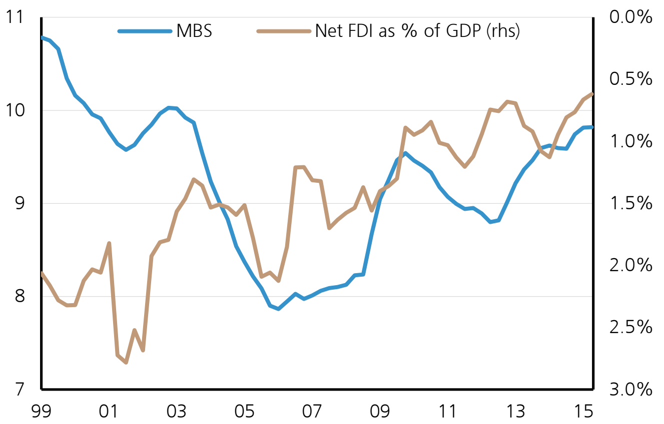
Reduced inflow on the capital account could thus overwhelm future improvements in the current account, in our view.

Figure 12: EM GDP growth vs. portfolio investment liabilities into EM



Source: Haver, UBS. Countries here are aggregated with MSCI EM weights.

Figure 13: UBS EM macro balance sheet risk score vs. net FDI (inverted)



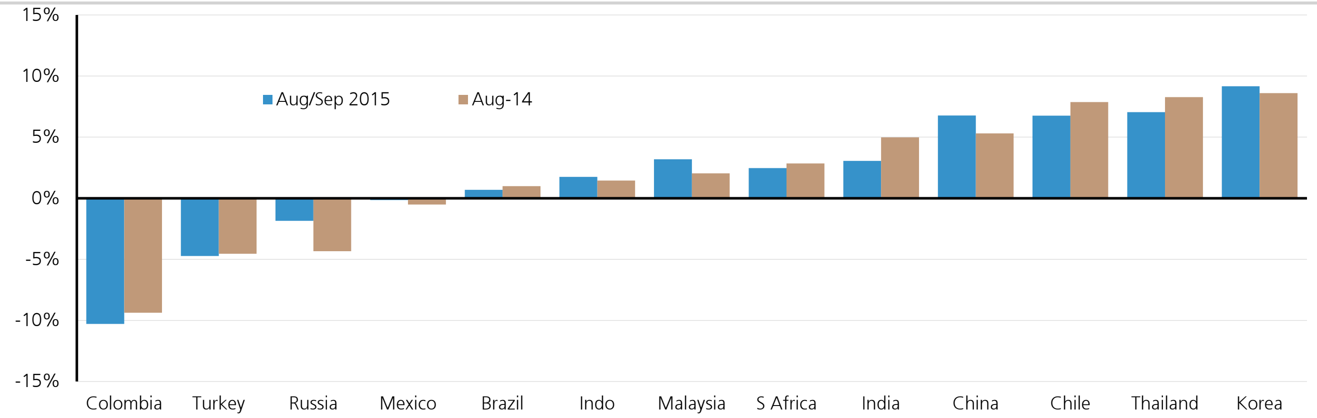
Source: Haver, UBS. Countries here are aggregated with MSCI EM weights.

4) Export competitiveness still does not appear to be sharpening

One unsurprising but often under-appreciated dynamic in EM in recent quarters has been the outsized contribution of oil prices in driving trade balance adjustments. Indeed we find that non-oil trade balances have seen little or no adjustment over the past year in markets such as India, Brazil, South Africa, Thailand, Turkey, Chile, Colombia, and Israel (Figure 14). Many of these markets are precisely those where investors are most concerned about weak external competiveness. In these markets, it appears the improving delta on current account balances in several major EMs may be close to peaking.

[2] See "Global dollar credit and carry trades: a firm-level analysis", Bruno and Shin, Bank of International Settlements, Aug 2015.

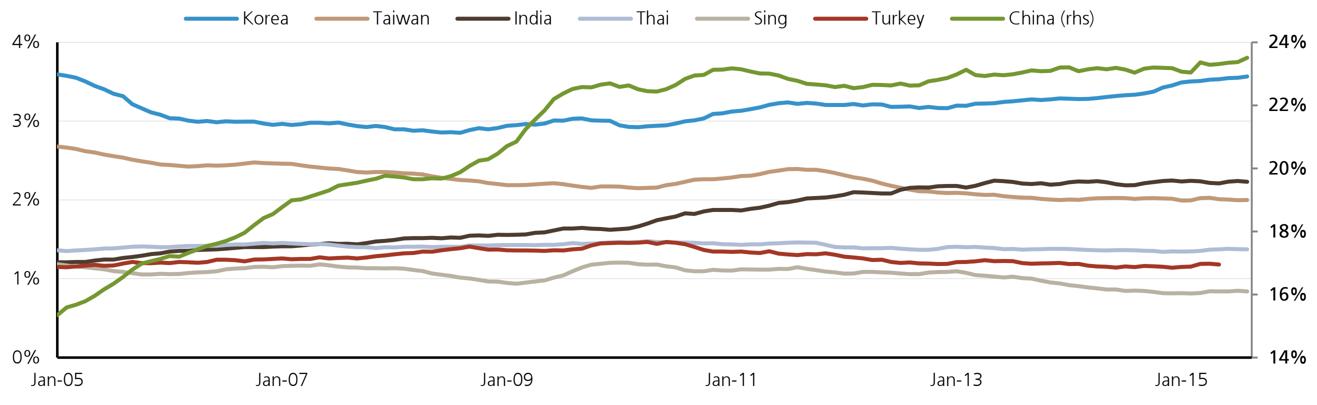
Figure 14: Non-fuel trade balance, % GDP, 12m rolling: latest vs. 12m ago



Source: Haver, UBS estimates

A similar message on limited competitiveness improvement can be seen through analysis of EM's share of into US (non-petroleum) imports. Most major non-commodity exporters in EM such as China, India, Thailand, Turkey, Taiwan and the Philippines are struggling to gain incremental share in US non-energy imports. Korea appears to be a welcome exception.

Figure 15: EM non-commodity exporters' shares in US non-petroleum imports (12m moving average)



Source: Haver, UBS

What other factors could extend the stabilisation in EM currencies?

As explained above, we are sceptical that improvements in the current account will be sufficient to power a sustained EM FX rally in the context of continued export paralysis and rising capital account vulnerabilities. We do not believe EM currencies are today pricing in these headwinds adequately. Nonetheless, on a more tactical view, there could be other factors that push back the realisation of the currency weakness that we expect. Below, we outline some of the key near term factors we are watching in this regard.

- More developed world stimulus. Our Japan economists see a strong possibility (50%) of the BoJ easing policy further on October 30th, through an

acceleration of the monetary base by a further 5-10 trillion yen per year. On the same day, another weak quarterly Employment Cost Index report in the US could further push back Fed tightening expectations for 2016, though these have already eased significantly, implying pressure on other DM central banks to drive EM gains. The ECB also meets later this week, though our European economists see a very low probability of further easing until spring next year at the earliest.

- Political developments, such as the Bihar state elections in India currently underway, a more reformist administration in Turkey following the November 1st election, or a more disciplined fiscal stance in Brazil following recent credit downgrades would be clear positives for EM. While impacts would be felt greatest locally, we believe these could serve to catalyse broader inflows into EM indices.

- As UBS' China property analysts have pointed out, there has been clearer evidence of Chinese housing inventories/sales ratios easing in recent months. Though many investors are understandably, in our view, sceptical as to how sustainable the improvement in sales momentum will be, an acceleration of this trend and continued growth in the credit impulse would likely provide greater confidence in a rebound in Chinese property construction next year. Thus far this momentum has not been sufficient to prevent our economics team from downgrading their 2016 GDP growth forecasts this week to 6.2%.

- Real non-petroleum imports in the US have averaged a healthy 6% y/y pace year to date. While recent tightening in financial conditions casts some doubts on the sustainability of such strength, it is plausible that the delayed impact of lower oil and energy prices could further reinvigorate US import demand in the months ahead. Korean export shares in the US have grown impressively over the past year, implying some hopes for broader rebound in other manufacturing and technology exports in EM.

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Source: UBS. Rating allocations are as of 30 September 2015.
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Hungary	-	-
India (Republic Of)	-	-
Indonesia (Republic of)	-	-
Israel (State of)	-	-
Japan	-	-
Korea (Republic of)[22]	-	-
Malaysia	-	-
Mexico	-	-
Russia	-	-
South Africa (Republic of)	-	-
Taiwan	-	-
Thailand (Kingdom of)	-	-
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