



EMFX Outlook 2018: Growth-led Revaluation

- The EM FX rally versus the dollar in 2017 has been largely driven by weakening of the broad USD itself rather than “intrinsic” EM revaluation. Also, it overshadows a rather lacklustre performance of the ‘carry trade’ per se.
- We believe EM FX can perform well for the remainder of 2017 and in 2018 on the following factors: 1) EM FX valuations are still attractive; 2) There is room for further EM inflows (particularly into equities); 3) Higher, more synchronized growth and narrowing gaps are supportive for EM currencies; 4) EM’s external vulnerabilities have reduced, and are far lower than in 2013.
- Which specific EM currencies stand out as attractive? We divide our prospective longs into three categories: 1) ‘Defensive’ longs – currencies that have stronger buffers/fundamentals and hence should be able to perform in a broad range of external environments (even more difficult ones); these include RUB, BRL, THB and KRW. 2) ‘Idiosyncratic revaluation trades’ – currencies which may not have as strong buffers but are cheap and have significant scope for appreciation in positive external environments; these include MYR, PLN, HUF, CLP, and PEN. 3) ‘Wild cards’ – currencies dependent on specific sources of risk. In this camp we have long ZAR (and – initially – short MXN).
- Which specific EM currencies stand out as vulnerable? We are bearish on COP, INR and ILS due to either domestic concerns, valuations or external vulnerabilities.
- What are the outstanding RV trades? We like the ‘good vs. bad EM’ commodity RV trade of long RUB and BRL vs. short COP.
- While we are broadly constructive on EM FX for 2018, there are risks, primarily stemming from an acceleration in US inflation (and hence a more hawkish Fed), global QE reduction and a slowdown in Chinese growth.
- However, a number of these external risks could manifest around Q2 (e.g. US inflation rising and Chinese growth slowing), thus marking Q2 as an important checkpoint for re-evaluating our constructive view on EM FX. But for this reason we also expect Q1 to be particularly constructive for EM FX (a window of opportunity), as the supportive factors remain in place while the potential risks are skewed towards the following quarter.