Equity allocations near historical lows still

Emerging Markets: Fund Portfolio Weights, by Asset Class
% of global equity allocation

Sources: EPFR, IIF estimates; includes mutual funds and ETFs

Source: Deutsche Bank, IIF, EPFR, estimates; includes mutual funds and ETFs .

2. EM FX valuations are still attractive

According to our preferred DBeer model (which models FX as a function of inflation, terms of trade and productivity) EM FX is still nearly 5% undervalued in aggregate (chart). The overall undervaluation of EM currencies despite their appreciation relative to the USD reflects EM FX's loss of ground relative to the EUR (and other G10 currencies). Accordingly, on a trade-weighted basis (which underpins valuation estimations) the rally has been limited this year. More importantly, periods of significant undervaluation tend to be corrected amidst higher EM growth and more restrictive monetary conditions – both of which we expect will be in place next year as real rates also seem to have bottomed in EM.
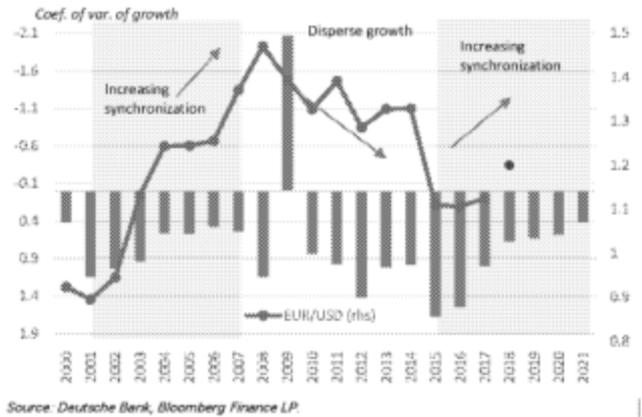
EM FX is still significantly undervalued

DBeer misalignment (TWI basis, %) — EMEA — Asia — LatAm

EM FX undervalued

Source: Deutsche Bank; Note: EM FX appreciation cycles in green and depreciation cycles in red.
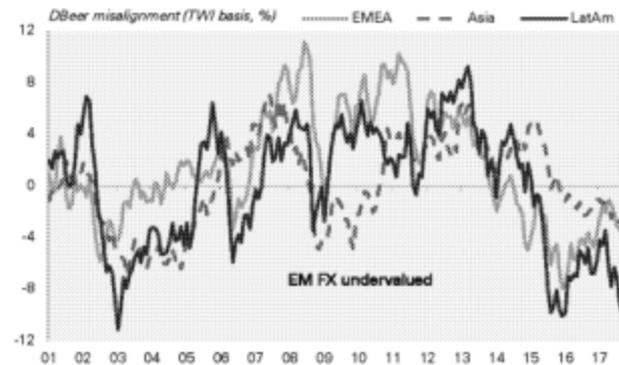
In addition, USD strength and hedging demand seem unlikely to disrupt EM FX revaluation. DB foresees EUR/USD at 1.20 in 2018 and higher in 2019. If anything, more synchronized and faster growth reduces policy imbalances (supporting ECB catch-up), which has been associated with EUR strength (chart). Absent USD strength, FX-hedging demand should remain subdued as long as US inflation is contained – a risk likely to increase later in the year, however.

The USD could still be supportive in 2018

Coef. of var. of growth

Disperse growth

Increasing synchronization

Increasing synchronization

Increasing synchronization

—■— EUR/USD (rhs)

Source: Deutsche Bank, Bloomberg Finance LP.

Which specific EM currencies stand out?

With valuation and growth/flows as the main tailwinds but facing rising core yields, we favour currencies where these tailwinds are stronger and those that score higher on defensive metrics (i.e. are better able to withstand rising core yields).

1) 'Defensive' longs

The main macro headwind we foresee is tightening liquidity conditions on ECB tapering and Fed's divestment (amid increased supply on fiscal easing). Also, with less room to maneuver the risk of policy mistakes is higher and volatility tends to increase as liquidity tightens. In our view, as long as inflation pressures are limited, sudden-stops are unlikely and these risks will be contained and skewed toward H2. Still we prefer EM currencies that are better able to withstand shocks and perform even in more difficult external environments.

Our 'defensive' ranking is based on three 'defensive' dimensions – real rates, FX reserves and current account/basic balance flows. As the chart below shows, THB, RUB and BRL have among the best scores in our 'defensive' ranking. These are among our preferred EM longs for 2018. We are also bullish on KRW – while it is in the middle of the pack on our 'defensive' rankings, its robust external balances provide strong buffers, in our view.