



Theme #9: Mexican Siesta

- With the reduction of global tail risks, EMFX is still attractive as a carry proposition due to elevated interest rate differentials and reduced volatility.
- However, differentiation could play a more prominent role as fundamental deterioration gradually spreads from the core to the periphery.
- In some cases, government intervention will continue to have an important influence on short-term FX movements.
- We still recommend short EUR/BRL and short EUR/CLP as carry trades. While we remain constructive on MXN in the medium term we recommend tactically taking profits.

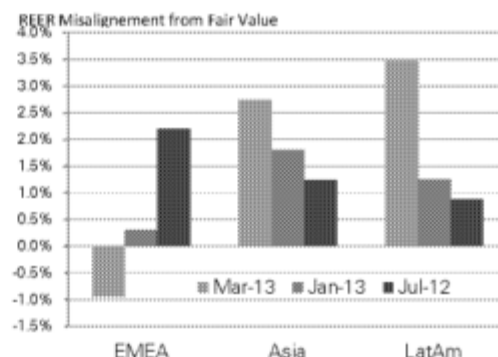
The noticeable reduction of Eurozone tail risks has helped EM currencies to become less sensitive to EUR/USD movements. With still relatively better growth perspectives, and in many cases, elevated interest rate differentials, EM currencies maintain some residual allure in this environment of reduced volatility. Nevertheless, as the deterioration of fundamentals slowly spreads from the core to the periphery, differentiation begins to play a more prominent role. Despite some overvaluation and, in some cases, deterioration in external accounts, capital inflows on the back of persistent monetary accommodation at the core should help to avoid any important correction, at least in the near term. Aggressive FX intervention could be problematic when central banks are more worried about losing competitiveness amid sputtering economic growth than the potential inflationary effects of weaker currencies.

The BRL is a clear example of a central bank stepping in front of weakening fundamentals. In our view, the BRL will remain range bound due to official intervention, offering an attractive carry/volatility combination. The lukewarm interest rate hiking cycle, when inflation dynamics are all but comfortable, indirectly imposes greater constraints on acceptable FX depreciation. Even though the FX pass-through is relatively low in Brazil, and fundamental drivers are pointing toward further depreciation, the central bank has already signaled that it does not want to face any risks on the inflation front by promptly intervening when it considers necessary. We thus continue recommending short EUR/BRL to maintain a long BRL exposure as a carry trade (current: 2.60, entry: 2.56, target: 2.45, stop: 2.64).

In contrast, MXN is an example of positive differentiation. Mexican assets continued to benefit

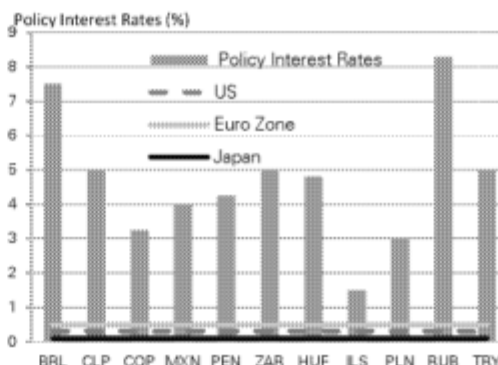
from the combination of excess global liquidity amid a weakening global environment, in which it is becoming increasingly difficult to find a good story on fundamentals like Mexico's engaging in long-due structural reforms. An anticipated credit upgrade (by Fitch) and political signals for the continuation of the reform agenda pushed the MXN to break the critical 12 level in the last few days. Even though the structural backdrop is sound, we believe that the short-term upside potential of the MXN is now limited. The gradual materialization of the reform agenda and the inevitable recovery in the US will certainly provide some medium-term support for the currency. In the short run, however, heavy positioning and potential transitory increase in risk aversion could induce a temporary break in the appreciation trend.

Figure 1: LatAm and Asia FX on overvaluation territory



Source: Deutsche Bank

Figure 2: Still elevated interest rate differentials



Source: Deutsche Bank