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FOREX TRENDS: Smaller and "Exotics"

Summary

In this, the third issue of Econotes on forex trends, we cover some of the smaller currencies which, sometimes, are called "exotics" as if they come from distant islands such as Russia, Brazil or Turkey! Be that as it may, as with all the other currencies we have surveyed, these units, too, have their individual characteristics and trends reflecting domestic and external factors. They vary from the high volatility and poor outlook of the Argentinean peso to the better performing Mexican peso, to the weakening Brazilian real, and to the weaker ruble thanks to the Ukrainian crisis. The Turkish lira and the S.African rand have their own issues and challenges.

Investment Conclusions

On the basis of consensus forecasts to 3Q.15 the weakest currency with an expected 20.0% depreciation is the Argentinean peso, for all the well-known reasons. The Brazilian real follows with an expected 10% drop within 12 months, whereas the outlook for the Mexican peso has improved to a 3.0% rise. The Lira, Rand, and Ruble are all expected to weaken versus the USD to yearend but not more than about 1.0%.As none of the equities of these six economies figure prominently in EMK portfolios, the obvious investment recommendation is mostly, short position crosses.

Ruble, Rand and the Lira

Justifiably, the **ruble** has weakened significantly following the Ukrainian crisis which seems to move on a continuous evolving basis as opposed to leading to a cathartic climax. With the on-going threat of imposing progressively more severe sanctions on Russia, and with Russia's only effective countermeasure being that of banning its exports of natural gas to the EU, the situation has reached an symmetrical hiatus. The EU, on average, relies for about 45% of its energy needs on Russian imports and, hence, an imports ban would have severe consequences. But equally, Russia would commit BoP suicide with an exports ban to the EU. Hence the MAD situation (Mutually Assured Destruction) leads to an uneasy equilibrium which is unlikely to lead to an even steeper drop in the ruble. (Chart 1, red).**The Turkish lira** has performed reasonably now that the political uncertainty has subsided after the presidential elections. The current account deficit as percent of GDP has improved significantly falling from 6.8% in 1Q.13 to 4.6% in 1Q.14 while the forex reserves increased modestly. A weaker lira supports exports and especially tourism, an important sector in Turkey.Hence the mild expected depreciation of the lira of about 1.0% over the next 12 months does not appear unreasonable in this context.

The S.African rand (green line in Chart 1) seems to have stabilised.The economy,however,is still decelerating from the impact of the prolonged strikes which affected the mining sector.However,the current acount deficit shrank during 1Q.13 to 1Q.14, from 6.2% to 5.0% of GDP while the forex reserves remained stable.The consensus expectations seem reasonable with a fall of 1.0% in the rate forex a year from now.

Chart 1: Forex to the USD,RUB (red),TRY (yellow),ZAR (green) 2013-2014

Source: Bloomberg

Not all Latams are the same !

. **The Mexican peso** followed the fairly common trajectory of several other currencies in 2013, weakening against the USD but then, during 2014, it strengthened only to weaken again. The performance of the Mexican economy, especially since the NAFTA agreement with the US and Canada, had for long been considered as a proxy for the dynamics of its big neighbor, the US. It was not for nothing that president Porfirio Diaz (1830-1915) had famously said "Poor Mexico, so far from God, so near the US "However, the economy is set to diversify from just being an exporting basis to the US.The start has been made with the state removing its monopoly from oil production and allowing extensive private sector participation, coupled with large infrastructure investments. GDP growth after hitting a low of -8.0% in

FACTBOX : Defaulting hurts the poor not vultures

The continuing fight between Argentina and the "vulture funds" has raised a lot of moral and strategic issues, including now a shift of sentiment against these funds. This would be a pity as most the press discussions of the merits or otherwise of the vulture funds tactics miss out that the default by Argentina hurt foremost "the poor" whose interests no one defends. The 2001 external default included domestic defaults with the main holders of bonds being Argentineans. Countries need to face their obligations and if this is to be done by US funds, so be it. Incidentally, the main losers in Greece's default were mostly Greek institutions and pension funds...

in 2009, has now bottomed and is reaccelerating, while the current account deficit also bottomed and is, at best, stabilizing. The outcome of all these developments is the likely strengthening of the peso, which could outperform all other Latam currencies (Chart 2, yellow).Unfortunately the same cannot be said about the **Argentinean peso** which markets expect to devalue by 20.0%. within 12 months. (Chart 2, green).The authorities have already imposed capital controls as reflected in the unofficial forex rate which is much higher than that of the official rate. It is the fear of further capital controls which makes Argentinean assets, however cheap, risky to hold. **Brazil's** impending presidential election on 5/10, has create expectations of a more

Chart 2: Forex to the USD, BRL (red),MXN (yellow),ARS (green)

Source: Bloomberg

A brief focus on Brazil and a summary

business friendly opposition party winning.The last two years have been difficult for Brazil with the economy decelerating. In three out of the last four quarters to 2Q.14, the economy shrank on QoQ basis. Despite support from commodity prices, the economy started to reflect the absence of investment, while sentiment soured after repeated scandals. Petrobras, the giant state oil firm, and its pricing policies have come under a lot of criticism. But the current account deficit has not yet deteriorated while forex reserves have grown. It may then appear that the the consensus forecasts could be rather harsh, a 10% drop in the USD/BRL. But if policy-making and the economy do not change paths quickly, this view may be justified and be reflected on Brazilian assets in general.Three of the currencies surveyed here, the ruble, the rand and the real are closely connected to commodity prices given the exports structure of their respective economies.The consensus forecasts for all of them are flat to negative thus reflecting the overall poor outlook for commodities, especially iron ore and oil. The case of the Argentinean peso is very different as it is under the pressures of the default. Mexico's improving economic outlook clealry shows in the consensus views on the peso.

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