

EM FX Plunges as Commodity Prices & Risk Mood Collapse

The coronavirus pandemic has taken a heavy toll on practically all major currencies with widespread losses against the greenback only sparing the Japanese yen. Nowhere is this more evident than in emerging market currencies, which, on a trade-weighted basis, have lost around 7% of their value against the greenback since the start of the month. The unforgiving slide in equity and commodity markets and extreme uncertainty around the future of global economic growth points to sustained weakness within the EM FX space, with the outlook worsening with each passing day.

The dearth of risk appetite amid the collapse in equity markets and a morose economic outlook has led to massive outflows of funds from emerging markets. Daily tracking data from the Institute of International Finance (IIF) shows that international investors have shed massive amounts of EM equities and debt (chart 1). This, alongside and combined with USD funding pressures and a sharp drop in commodity prices, has led to a double-digit depreciation in a number of EM currencies, with the Russian ruble (RUB) losing nearly a quarter of its value in the year to date; the Mexican peso and Brazilian real follow closely behind with year-to-date losses above 20% (chart 2).

Our risk appetite index—which combines a handful of market risk proxies—has fallen to its lowest point since the great financial crisis, with our EM trade-weighted FX index following closely along (chart 3). While MXN carry trades had increasingly become a solid bet over the last couple of years—particularly against the EUR due to very attractive financing costs—the high degree of peso volatility has all but erased any advantage of this trading strategy (chart 4) which has likely led to a sharp retracement of MXN positions. Tomorrow’s CFTC open interest figures for the week ending on March 17 are likely to reflect a massive unwind of MXN long positions amid a near-10% decline in its value during this period.

So far in 2020, WTI crude oil prices have declined by around two-thirds owing to an expected fall in demand due to slowing growth globally but also, more recently, in light of the price war initiated by Saudi Arabia two weeks back following the breakdown of OPEC+ talks, with Russia resisting calls to curtail output. The one-two punch of crude prices hitting their lowest mark since 2002 and the precarious risk-environment have hit commodity currencies the hardest. All six of the weakest performing EM currencies so far this year have on average a ~95% correlation to both crude oil prices and market volatility (VIX) in the year-to-date. One case that stands out is the performance of the Peruvian sol, as the central bank intervenes in currency markets to prevent a sharp depreciation in the sol, whose correlation to crude prices and volatility stands at roughly 95%.

We believe that risk appetite is set to remain weak and thus check any advance in EM currencies through at least the middle of the year when the peak in COVID-19 contagions outside of China may be reached. The mood is unlikely to shift, and may likely worsen, as case counts around the world (namely the US) continue to rise and economic data for the first and second quarter begin to trickle-in showing the devastating blow to growth from extensive social distancing efforts; the contraction in GDP growth for the second quarter in the US and the Eurozone is likely to reach double digits in annualized terms.

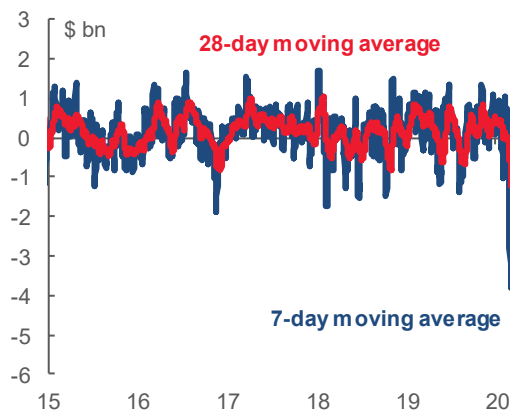
The damage from the coronavirus will unfortunately linger past the peak in case counts as the idling of various sectors of the economy leads to extended job losses globally, with a concomitant impact in trade in commodities and other merchandises—further impacting export-oriented economies. With global demand set to remain depressed through most of 2020 and no end in sight to Saudi Arabia’s ramp-up in production, EM FX will get little assistance from crude oil prices, which

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Shaun Osborne
Chief FX Strategist
461.945.4538
shaun.osborne@scotiabank.com

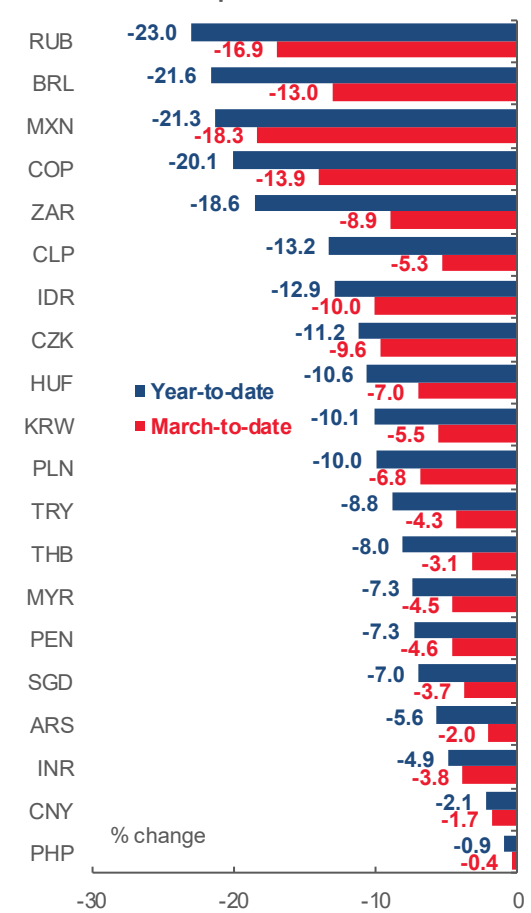
Juan Manuel Herrera
FX Strategist
416.866.6781
juanmanuel.herrera@scotiabank.com

Chart 1
Total EM Portfolio Flows Daily Tracker



Source: IIF, Scotiabank FICC Strategy.

Chart 2
EM FX Post Steep Declines to Start the Year



Source: Bloomberg, Scotiabank FICC Strategy.

are unlikely to post an important recovery in the near-term. The decline in commodity prices also places sovereign credit ratings at risk of important downgrades for certain nations whose public coffers heavily depend on the price of oil or other commodities and may not be able to hedge future revenues at favourable terms (e.g. Mexico).

On the flip side, EM FX may benefit slightly from a concerted effort by central banks globally to ease USD funding pressures (chart 5) through newly-established swap lines in tandem with the Federal Reserve. Until market uncertainty eases dramatically, however, these operations are unlikely to deliver long-lasting benefits and may only prevent a continued run-off in the USD.

For the moment, we maintain a bearish outlook on emerging market currencies, with the tide unlikely to turn decisively in their favour until the final months of the year or until the spread of COVID-19 materially decelerates. There exists the risk, however, that we see a resurgence in contagion counts after (if) social distancing measures are relaxed in the fall—coinciding with the start of the flu season in North America and Europe.

Chart 3

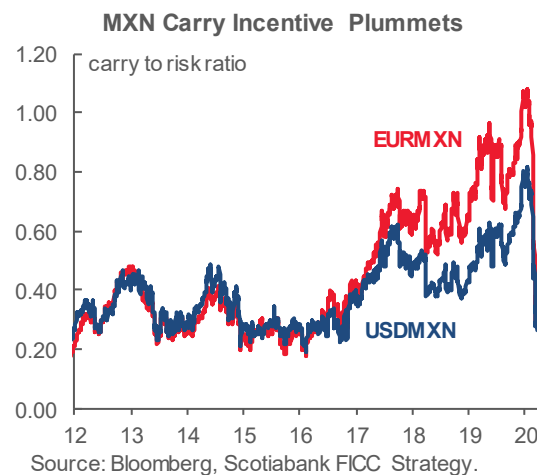


Chart 4

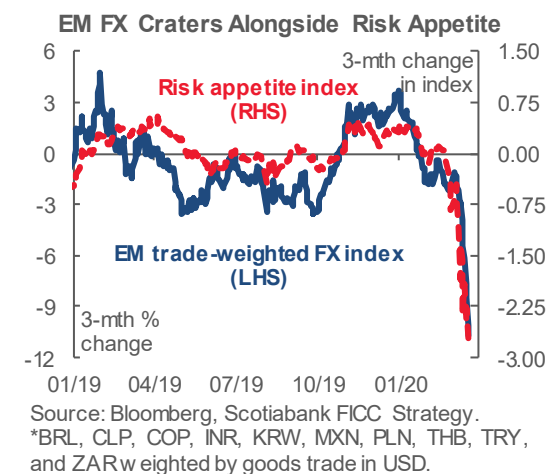
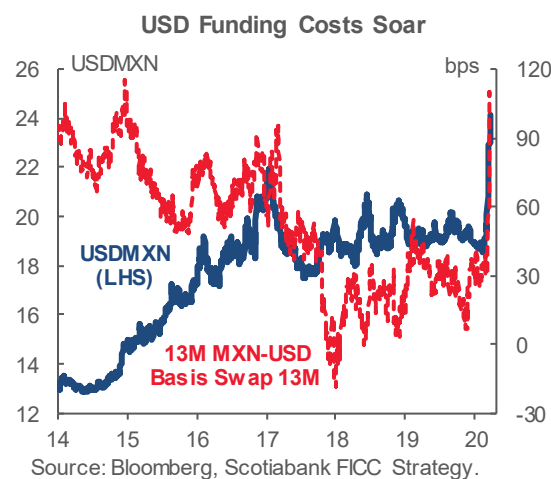


Chart 5



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