International Commentary — May 11, 2021

Q2 Emerging Market FX Vulnerability

Summary

We remain constructive overall on the outlook for emerging market currencies, especially as the U.S. dollar has moved lower as Treasury yields have slipped from recent highs. However, emerging market currencies do remain vulnerable to many different scenarios, particularly as some G10 central banks turn less accommodative and as the economic outlook for certain developing economies deteriorates amid a renewed surge in COVID cases. In this report, we update our emerging market FX vulnerability framework and highlight currencies where overall levels of vulnerability have changed.

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Q2 Emerging FX Vulnerability Update

Over the past few years, we have provided periodic updates of our emerging FX vulnerability framework. The framework is designed to highlight emerging market currencies that could be susceptible in a global risk-off scenario. Over time, the potential "risk-off scenario" has certainly changed. Through 2018 and 2019, a full-scale U.S.-China trade war was the most likely event that could have led to a large sell-off in global financial markets. At times, we got glimpses of the kind of volatility that could come from escalating tensions between the two largest countries in the world, but never saw a widespread sharp sell-off as a result of U.S.-China trade tensions. In 2020, the COVID crisis struck and we experienced what a global sell-off looks like as risk assets across developed and emerging markets came under significant pressure. Our FX vulnerability framework was effective at identifying currencies that were likely to weaken the most and which currencies were protected from a large depreciation.

With the depths of the COVID crisis likely behind us and trade tensions between the U.S. and China stable for now, the source of a global risk-off scenario will likely come from elsewhere. In our view, pre-emptive or earlier than expected Fed monetary tightening would most likely result in the next global sell-off of financial markets. With that said, the low probability of the Fed scaling back accommodative monetary policy without giving proper notice to financial markets is rather low. For example, our U.S. economists expect a tapering of asset purchases starting in 2022, which gives the Fed an ample amount of time to start signaling a scaled back quantitative easing program. However, the risk of a miscommunication of some kind and early Fed action is not zero. In the event this risk does materialize, we would expect risk assets across the board, and in particular emerging market currencies, to come under the most pressure.

In this report, we have updated our analysis for Q2 around this risk of premature Fed monetary tightening. The methodology behind our framework is somewhat complex, though current account balances, real interest rate dynamics, import cover ratios and political risk are contributing factors to our assessment (see following table). As mentioned, our analysis gives a good idea of which currencies could be most at risk and which currencies could see a more benign selloff.

Country	Q1'2021 FX Vulnerability[1 2]	Q2'2021 FX Vulnerability[1 2]	Current Account Balance (% of GDP)	Real Int. Rate Diff. With U.S. (%)	Import Cover (Months)	Political Risk Indicator
Turkey	Orange	Red	Red	Green	Red	Red
South Africa	Red	Red	Orange	Orange	Red	Red
Colombia	Orange	Red	Red	Orange	Orange	Red
Chile	Red	Red	Green	Red	Red	Red
Argentina	Orange	Red	Green	Red	Red	Red
Hungary	Red	Red	Orange	Red	Red	Orange
Mexico	Red	Orange	Green	Orange	Red	Red
Indonesia	Orange	Orange	Orange	Orange	Red	Orange
Poland	Orange	Orange	Green	Red	Red	Orange
Brazil	Orange	Orange	Orange	Orange	Green	Red
Peru	Orange	Orange	Orange	Orange	Green	Red
India	Orange	Orange	Orange	Orange	Orange	Orange
Philippines	Orange	Orange	Orange	Orange	Orange	Orange
Russia	Orange	Orange	Green	Orange	Green	Red
Thailand	Green	Orange	Green	Orange	Orange	Orange
China	Green	Green	Green	Orange	Green	Green

[1] Red indicates "Highly vulnerable", Orange indicates "Moderately vulnerable", Green indicates "No vulnerability"

[2] Highly vulnerable represents >20% depreciation, Moderately vulnerable represents 10-20% depreciation, No vulnerability represents 0-10% depreciation

Source: IMF, Marsh, Bloomberg LP and Wells Fargo Securities

The above table shows the most recent FX vulnerability analysis for Q2 as well as how overall vulnerability compares relative to the update from Q1. Most changes in overall vulnerability have been downgrades (*i.e.* currencies becoming more vulnerable), which makes intuitive sense as most emerging market economies have struggled to recover from the effects of COVID, while some countries are experiencing new waves of populist candidates flood local politics. As far as currencies that have become more vulnerable, the Turkish lira, Colombian peso and Argentine peso have fallen into the Highly Vulnerable category, while the Thai baht has moved into the Moderately Vulnerable category. In contrast, the Mexican peso surprisingly moved from being a Highly Vulnerable currency to Moderately Vulnerable.

In our view, the currencies that have become Highly Vulnerable make intuitive sense. The Turkish lira, with a track record of being one of the more volatile currencies in the world, shifted as the IMF expects a wider current account deficit than previous estimates as oil and other commodity prices have jumped. Turkey is a large commodity importer and higher prices should weaken current account fundamentals over time. In addition, the policymaking framework and strength of Turkey's institutions has deteriorated after President Erdogan replaced multiple central bank officials in an effort to implement his unorthodox views on monetary policy. For the last few years, Turkey has been a Highly Vulnerable currency, only shifting to Moderately Vulnerable following significant interest rate hikes in late 2020 and early this year. Despite rate hikes not being unwound just yet, the deterioration in other metrics places the Turkish lira atop our list of most vulnerable currencies.

In Colombia, the central bank has used FX intervention tools as a way of attempting to stabilize the peso. Despite higher oil prices, the Colombian peso has struggled to regain momentum as the economy struggles with COVID and the Central Bank of Colombia has not turned as hawkish as some other peer emerging market central banks. As a result, the Colombian peso has come under pressure and FX reserves of the central bank have dropped through the early parts of this year. In addition to a less robust stockpile of FX reserves, political dynamics in Colombia have worsened. Recently, cabinet members of President Duque proposed tax hikes on Colombia's middle class, which has sparked violent protests and demonstrations nationwide. The tax proposal also resulted in Colombia's finance minister resigning and calls for additional political reform across the country. In our view, political risk in Colombia has risen and is another contributing factor to the peso's underperformance this year. Going forward, we expect political dynamics to remain contentious and a source of vulnerability, pushing the peso into the Highly Vulnerable segment.

The Argentine peso is another currency that historically has been one of the more volatile currencies in the world. In 2018, the peso collapsed amid deteriorating economic fundamentals and questionable policy decisions, while in August 2019 the peso experienced another sharp devaluation on a surprise election outcome. A significantly weaker currency helped create a current account surplus, while external support helped bolster FX reserves in the short-term. Our framework highlighted the peso as Moderately Vulnerable in Q1; however, FX reserves are beginning to dwindle at a more rapid pace. Defending the value of the peso by selling FX reserves has become costly and is eroding the central bank's buffers. In addition, inflation has trended higher once again with the national CPI over 42% year-over-year and expected to rise even further over the second half of this year. Higher inflation has pushed real interest rate differentials with the United States back into negative territory and is another source contributing to the peso moving back to a Highly Vulnerable currency.

As far as the Thai baht, the baht is typically one of the least volatile currencies in Asia as well as within the emerging markets. As we highlighted in a recent report, Thailand is struggling with a new wave of COVID cases that is weighing on local financial markets as well as disrupting the economic recovery. Thai authorities have recently put stricter lockdowns in place, which should contribute to less travel and tourism related receipts for the government as well as cut off a key source of foreign exchange reserves. With foreign exchange reserves likely to dwindle over the coming months, Thailand's import cover metric has deteriorated and pushed the Thai baht into the Moderately Vulnerable category. Despite becoming a more vulnerable currency, we are confident the baht will return to a Low Vulnerability currency in the near future. We expect restrictions to be effective and for tourism revenues to recover by the end of the year. As Thailand's FX reserves tick higher, the country should not only move back into the Low Vulnerability category, but recover most of the losses experienced over the last month or so.

Finally, as mentioned, the Mexican peso comes as a suprise, shifting to a Moderately Vulnerable currency from the Highly Vulnerable segment. The IMF now forecasts Mexico's current account to be in surplus in 2021 as well as in 2022 as oil prices rise and sustain current levels, which is driving the peso to be a less vulnerable currency. It is also our view that the Central Bank of Mexico will raise interest rates later this year, which in the future, could improve Mexico's real interest rate dynamics relative to the United States. Even if real interest rates do improve, Mexico still scores poorly as it relates to FX reserve adequacy and political risk. Weak scores on import cover and political risk are unlikely to change in the near future, which likely means the peso has more of a risk to drop back into the Highly Vulnerable sector than move into the Low Vulnerability bucket. Regardless, we are currently optimistic on the peso's long-term appreciation prospects and the move to Moderate Vulnerability is consistent with our USD/MXN forecasts through the end of this year and into 2022.

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