Insights

Signs of stabilisation in EM local markets

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Liquidity appears to be returning to some areas of local markets, supported by strengthening demand from domestic buyers

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Emerging market (EM) local currency debt has had a difficult time over the last few years, with negative headwinds as a result of weakening commodity prices, the impact of rising rates in the US and the resultant effect on the growth prospects of EM countries, as well as a number of idiosyncratic events within EM.

Whilst the macro backdrop continues to be relatively challenging for all risk assets, we are beginning to see signs suggesting that, after more than four years of turmoil in local currency markets, a certain amount of stability appears to be returning to some currencies that have been particularly hard hit.

For many EM currencies, 2015 was a particularly tough year, where political events played a major destabilising role. These included the impeachment process of Brazilian president Dilma Rousseff, national and presidential elections in Turkey, national elections in South Africa, geopolitical concerns in Russia and the Polish national election, which led to a ratings downgrade by Standard & Poor's. This year the political calendar is less active, although the Rousseff impeachment process in Brazil still has to play out. For this reason, the domestic backdrop appears much calmer and that ultimately supports the local currencies.

The Turkish lira has responded positively to a calmer political backdrop

Looking at some specific-country examples, we know that in Turkey President Erdogan is likely to remain unorthodox in his views and will continue to dominate the political landscape, but in the absence of elections there is at least a period of relative calm. In terms of price action, it is fair to say that the weakness of the Turkish lira was dominated by politics (at a time when lower oil prices should have been a real positive for Turkey), and a lot of negativity is already in the price. With politics off the table, and local corporates having already proactively hedged their US dollar funding requirements, the lira has stabilised.

With lira borrowing costs very tight and the technical position of the market already oversold, we anticipate the potential for further stability and relative outperformance over the near term. Furthermore, the domestic pension fund industry is likely to become more active in local bonds, which by process is bringing a greater degree of liquidity back to the market. The Turkish government bond market is now one of the more liquid local bond markets, something we have not seen since the pre-taper period in 2013. We believe this too provides greater stability to Turkish markets.

RBC Global
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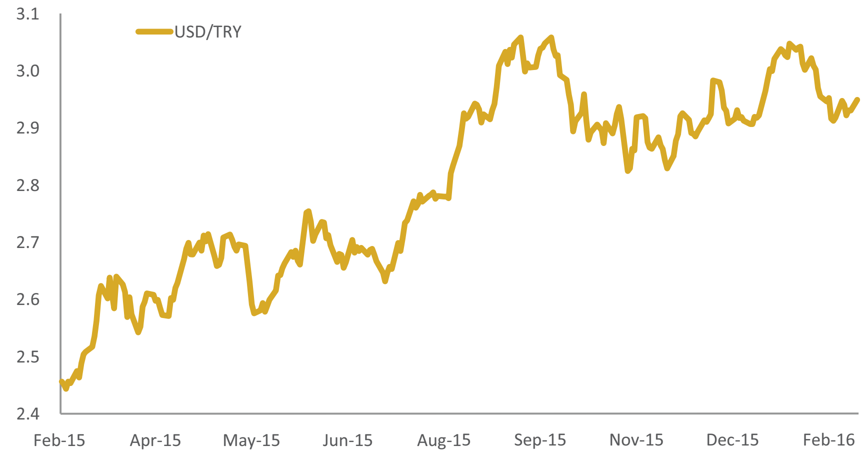
Fig. 1 Turkish lira versus US dollar

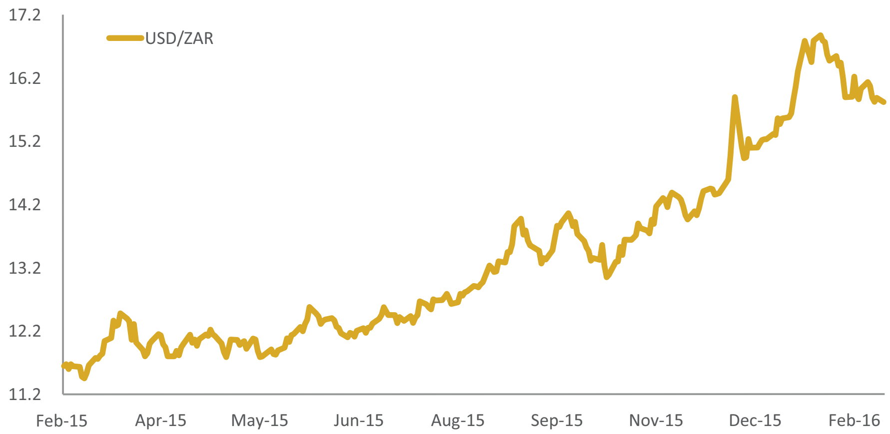


Source: Bloomberg, as at 15 February 2016

The South African rand could benefit from changes in fiscal policy

A similar argument applies to South Africa. Last year we saw the rand weaken 10% in one day after President Zuma removed the well-respected finance minister without consulting his cabinet, causing a dramatic fall in investor confidence and a real threat to the country's sovereign investment grade rating. Bond markets also collapsed before sense prevailed and the equally well-respected former finance minister was reinstated. The fallout from this episode, however, has potentially created the opportunity for the country to turn things around and restore international investor sentiment.

Fig. 2 South African rand versus US dollar



Source: Bloomberg, as at 15 February 2016

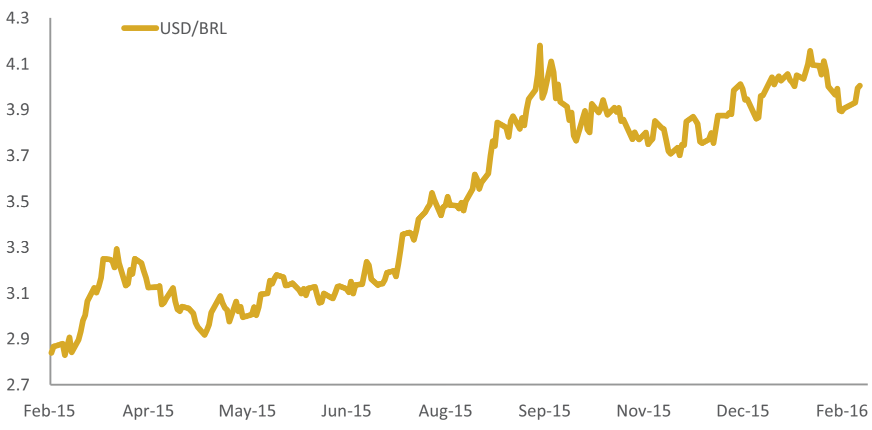
The technical picture of the rand still looks tight

The fiscal budget is due later this month. In our view there is growing optimism that the finance minister has been given the clearance to engage in true, orthodox fiscal management, which will deliver significant spending cuts alongside increased spending on health insurance and social services. However, the real game changing event will be the announcement of an increase in VAT to offset the increase in health spending, which is one of the key requirements of the ratings agencies. If the finance minister can achieve this, then there is hope and expectation that the rand can outperform over the coming weeks and months. The currency has been particularly hard hit in recent years and, of course, South Africa remains a structurally challenged economy. But the technical position of the currency still looks tight. Also, considering that the South African Reserve Bank has raised interest rates to meet the inflationary challenge, and the repatriation of excess holdings in the international portfolios of local pension funds, we envisage the rand performing relatively well over the near term.

The Brazilian real presents a potential opportunity

In Brazil, we have already seen the currency outperforming market expectations over the last two to three months. Of course, the political backdrop remains problematic and the economy shows no sign of turning around any time soon. But the intense level of investor negativity that had built up over the last two years has already had a meaningful impact on the value of the real (BRL), which has depreciated from BRL 2.00 in 2013, to BRL 4.00 today. As a result of this move there are signs that we have reached a level that has become interesting to the foreign investor. Notably, the release of the December FDI data showed that inflows for the month were the highest since 2010, whilst the current account deficit has also been declining in recent months. This coupled with funding costs in excess of 10% has helped to stabilise the real in a period of relative political calm. The impeachment process, however, has not fully played out yet and the outlook still remains poor. Nevertheless, at least the technical position of the market has been challenged enough by the current valuation of the currency to help stabilise the market.

Fig. 3 Brazilian real versus US dollar



Source: Bloomberg, as at 15 February 2016

We are seeing some encouraging signs of stability in three of the most volatile EM currencies

Some currencies appear to be stabilising although significant risks remain

As we have demonstrated, in Turkey, South Africa and Brazil we are seeing some encouraging signs of stability in three of the most volatile currencies in the EM local currency basket, and we believe this is being well received by the market.

However, other currencies continue to be under significant duress. The Colombian peso is being hit by the continued weakness in oil prices while the Russian rouble remains pressured because of geopolitical as well as oil price concerns, and even the normally stable Polish zloty has suffered following the outcome of the recent general election.

Ultimately, I believe EM local currencies are still likely to be hostage to global market risk appetite, which of course remains very challenging over the near term. Indeed there is a long list of concerns which includes fears for the direction of growth in China and renminbi depreciation, oil prices, global growth, deflation, Brexit, US Federal Reserve policy, European banking sector stability and geopolitics.

However, at least we are now seeing signs of stabilisation in some of the more volatile currencies which, if coupled with a positive risk-on backdrop over the near term, we believe can help to generate a real chance of local currency outperformance.

In other words, we may be nearing a sustained reversal in the performance of some local currency assets, and therefore current entry points could prove to be very attractive indeed.