4 Emerging currencies: will 2016 look like 2015?

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Many of the factors that challenged EM currencies in 2015 are likely to continue in the year ahead. Emerging Markets are caught between tightening policy rates in the US, a free-fall in commodity prices, which is partially driven by a China slowdown, and heightened idiosyncratic risks. Nevertheless, much of this has already been priced in EM and although our overall view remains cautious on the asset class, relative value positioning will arguably be more appropriate. On this front, weakness in the Chinese renminbi will be a key determinant of relative performance in our view.

Deflationary pressures will weigh on Asian currencies

While there has been a substantial correction of Latam and commodity currencies in 2015, Asian currencies remained rather strong, with the exception of the Malaysian ringgit, which fell heavily. This induced a relative loss of competitiveness on international markets. This is all the more true for low-yielding currencies like the Korean won (KRW), the Singapore dollar (SGD) and the Thailand baht (THB) and also for the Philippines peso (PHP). The sharp depreciation of the yen since the Abe government came to power in 2012 has been one of the factors behind that. These currencies (KRW, SGD, THB, PHP) will also remain under pressure vs the dollar as we expect some further depreciation of the renminbi vs the USD in 2016 (we have a target of 7 for the end of the year for the USDCNY). China's Asian peers will seek further currency depreciation in our view in order to maintain competitiveness and to battle deflationary forces. From a macro standpoint, the increased currency flexibility can be a positive for China in the medium-term. The country has been battling the impossible trinity of fixed exchange rates, open capital account and an independent monetary policy. Allowing for greater currency flexibility can add to the efficacy of monetary policy and enhance the tools at the PBOC's disposal for ensuring a soft landing.

Elsewhere in Asia, India remains the market's darling. India has recently been under the spotlight as it is one of the main beneficiaries of the sharp decline of oil prices and is the only Asian country where the growth outlook has not deteriorated and remains robust. There is a lot of speculation about the possibility that India might become the "next China": for instance, Stanley Fischer, the vice chairman of the Fed's Board of Governors, recently raised the question "Can India recharge growth in Emerging Asia?" ("Emerging Asia in transition", 19 November 2015). But even if India has obviously a huge potential (GDP per capita remains far below the average of Asia), significant roadblocks (like infrastructure bottlenecks) need to be overcome. The expected stability of oil prices at low levels is a factor of stability for the Indian rupee (the real effective exchange rate rose in line with the progression of the terms of trade). Whilst we agree with the improved fundamental picture, we do have concerns that the market is over-positioned on the currency side, and hence prefer a more neutral take on the Indian rupee. Globally, we expect the INR to evolve in line with the USD.

Perhaps for the first time in over the years, we prefer the Indonesian rupiah to the Indian rupee. Market positioning is much cleaner on the former, and we think the market is under-pricing the significant improvement in the external and fiscal balances, as well as the improved political stability under President Jokowi. The country is also less exposed to China than other countries in the region, although it may suffer under renewed pressure on commodity prices. An overweight position on Indonesia also provides positive carry for a portfolio that is underweight on the lowyielding/lowflationary currencies of Asia.

The situation of the Malaysian ringgit is very specific among Asian currencies. After a decade of quasi-stability of the Malaysian real effective exchange rate, it fell heavily in 2014/2015 (-12% just in 2015) and became significantly

The essential

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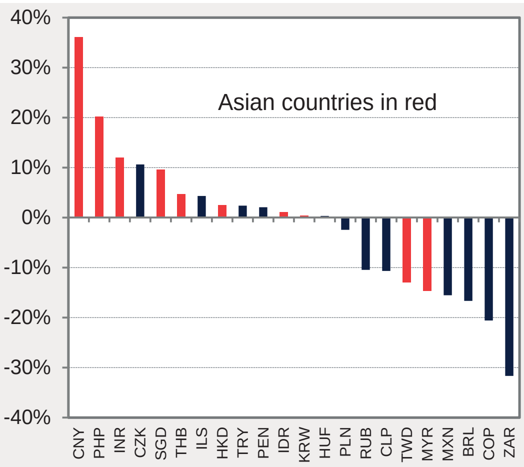
Our overall view remains cautious on EM FX and we think that relative value positioning will arguably be more appropriate. The weakness in the Chinese renminbi will be a key determinant of relative performance in our view.

> "Many of the factors that challenged EM currencies in 2015 are likely to continue in the year ahead"

1 Deviation of the real effective exchange rate from its long-term average (since 1994)



Source: Datastream, Amundi Research

undervalued. The ringgit suffered partly from the fall of oil prices but also from political uncertainty. The ringgit offers definitely some value (the growth outlook is one of the most robust of the region) but catalysts of positive performances are lacking. While the current account balance as well as the basic balance are clearly in positive territory, net portfolio outflows have been significant over the last months and this might last some time.

Latam currencies still suffering because of commodity prices

Latin American countries face the biggest challenges in EM given the concentration of exposure to commodities. Naturally, this is also the region where the greatest amount of value has opened up. But even here, we think a relative value approach makes most sense. Whilst we think the BRL has over-adjusted to its negative terms of trade shock, we think this is for good reason given the deterioration in the country's political landscape, worsening fiscal performance and an ongoing corruption scandal. The main supporting factor for the currency will be a sharp improvement in Brazil's external balances and a positive basic balance. Nevertheless another year of sharp contraction combined with a restricted central bank implies that further currency weakness is more likely than not. Mexico remains a fundamentally sound story, but oil exposure remains a headwind. In a positive EM environment, the Mexican peso will be well-positioned for a rally. Elsewhere, Chile is the most exposed country in the region to weakness in China via its copper industry, leaving us with a bearish bias on the currency. Whilst the COP has the highest correlation with oil prices, an increasingly vigilant central bank may provide some anchor for the currency.

CEEMEA: we prefer the ruble over the rand

Globally, Eastern European countries (Poland, Hungary, Czech Republic) are benefiting from the fall of oil prices but that did not trigger any appreciation of their currencies in real terms as they remained broadly anchored to the euro, which depreciated strongly versus the non-European majors (USD, CNY, JPY) in 2014/2015. Contrary to what some prophesized, the ECB's QE and negative rates did not induce massive inflows in these countries.

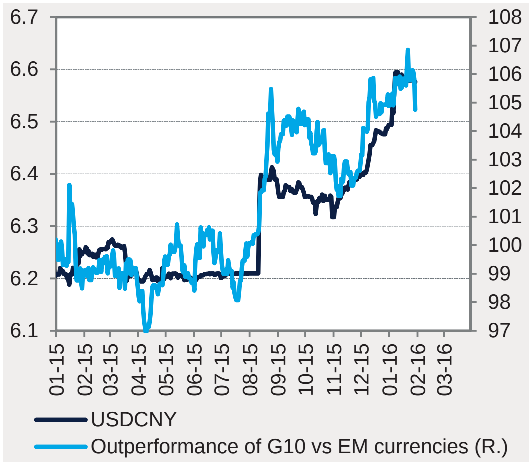
We remain bearish on the South African rand (ZAR) as South Africa continues to run significant external deficits (the basic balance is one of the most negative in the world) despite the large currency depreciation in 2015 (-14% in real effective terms). Growth prospects remain very weak: the IMF just downgraded dramatically GDP growth forecasts to just 0.7% in 2016 and 1.8% in 2017. South Africa suffers from declining commodity prices but also from huge supply constraints. The ZAR hit fresh all-time low versus the USD, as well as the Russian Ruble (RUB) but we definitely prefer the RUB over the ZAR. Compared to South Africa, Russia enjoys a more comfortable external environment and we view fundamentals to be more supportive of Russian assets. We prefer the ruble to the rand.

Turkey is by far one of the biggest beneficiaries of lower oil prices. But we think a lot of this is already in the price given the relative outperformance of the lira against other EM currencies. Turkey will face important geopolitical risks in 2016 with regards to the Kurds, as well as ISIS. The prospect of a referendum on executive presidency may also introduce some volatility on the currency. The most important short-term identifiable risk will be the change of central bank Governor in April.

Emerging economies will continue to face important challenges in 2016

Overall, we think emerging economies will continue to face important challenges in 2016, not least from China. Currencies will continue to be the main adjustment valve and this will be an important source of support for EM fundamentals. The sharp currency weakness of the past three years has ensured that EM current account balances have actually been improving on average, and fiscal balances in commodity exporting countries have not deteriorated as sharply as would have otherwise been the case.

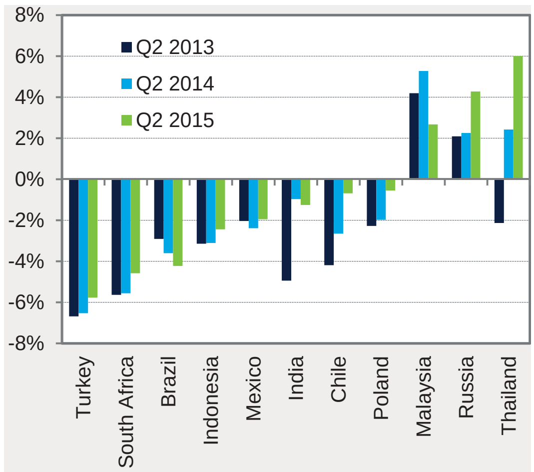
2 USDCNY parity and relative performance of G10 currencies vs EM currencies (100 jan. 2015)



Source: Bloomberg, Amundi Research

> Currencies will continue to be the main adjustment valve for emerging economies

3 Current account balance as % of GDP



Source: Datastream, Amundi Research

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