

Emerging market currencies

A cautiously optimistic outlook

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FLASH NOTE

SUMMARY

- The external backdrop, such as trends in the US dollar, commodity prices and the global economic outlook, could support EM currencies in the second part of 2024. But the risk of a US recession may weigh on EM currencies in the first half.
- Among high-yielding currencies, we would favour the Brazilian real because of its relatively cheap valuation and improving balance of payments flows. The Polish zloty may further benefit from positive dynamics in the balance of payments as well as a potential decline in the US dollar as the year wears on. A potential improvement in the economic outlook in the second part of 2024 would likely bode well for the highly cyclical Korean won.
- A strong US dollar in the first part of 2024 may lead to some temporary outperformance of the Indian rupee as the Reserve Bank of India keeps a tight leash on the currency but also because the Indian economy is relatively immune to the global business cycle.

EXTERNAL BACKDROP FOR EM FX COULD PROGRESSIVELY IMPROVE IN 2024

Emerging Market (EM) currencies as a whole tend to be highly exposed to the external backdrop. In particular, trends in the US dollar and commodity prices, the growth differential between EM economies and the US, China's economic outlook and the strength of global trade tend to be key factors for the performance of EM currencies.

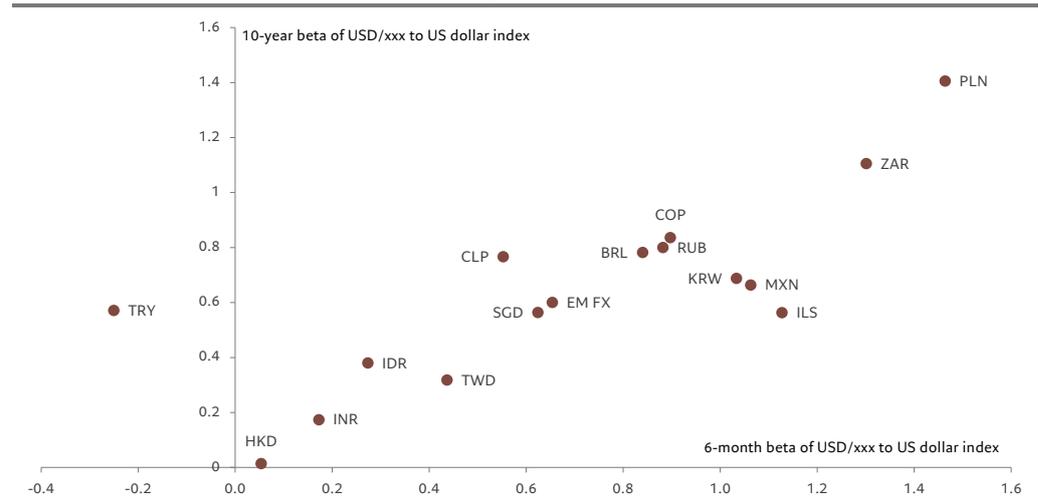
Our central scenario assumes weak economic activity in the first half of 2024 followed by a recovery in the second half. While a US recession, especially if relatively harsh, would likely weigh on EM currencies, a phase of broad improvements in global economic activity in the second half of the year would likely prove a relatively supportive environment for EM currencies. Along with the continuation of a

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moderate recovery in China (helped by targeted fiscal stimulus), global trade and commodity prices could improve.

It is also likely that major central banks in developed economies will start easing monetary policy in 2024, which could lead to lower borrowing costs and stimulate risk appetite. Finally, a decline in US economic activity and a more accommodative Fed should progressively weigh on the overvalued US dollar. Overall, while the first part of 2024 may remain challenging for EM currencies, the second part could be better.

Sensitivity of selected EM currencies (against USD) to US dollar index



Source: Pictet Wealth Management, LSEG, as of 12.12.2023

PREFERENCE FOR THE REAL, ZLOTY AND WON

EM currencies in Latin America have performed particularly well in 2023. But next year, we could see fiercer competition from currencies in other regions.

The Mexican peso could be hurt should the US, its main trading partner by a wide margin, experience a significant economic slowdown. In addition, the large fiscal spending outlined for 2024 by the Mexican government may lead to some medium-term weakness either through fiscal consolidation that weighs on growth in 2025 or through growing concerns over fiscal discipline. While political noise could increase around Mexico's general election in June, we would be more concerned about the outcome of the US elections in November. But any depreciation of the peso may be limited given relatively strong fundamentals and probable tailwinds to economic activity from the rerouting of some US supply chains to Mexico.

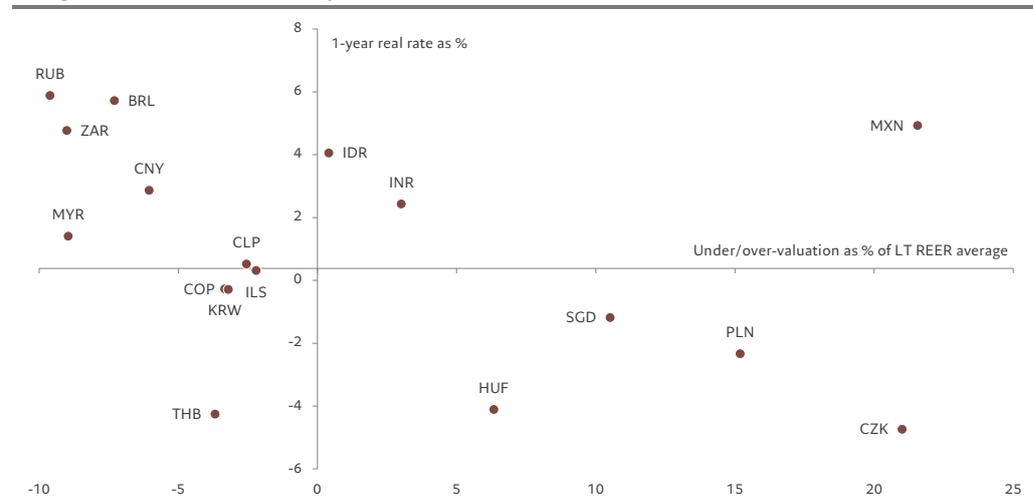
The Brazilian real may perform better than the peso as it also provides a high carry but looks far cheaper. While fiscal slippage remains a risk for the real in 2024, we think it may not derail real outperformance should, as we expect, the external backdrop turn more supportive as the year goes on. The same may hold true for the South African rand, although fiscal concerns may be more acute and general elections may lead to an increase in volatility. The poor fundamentals of the rand make

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it quite speculative, but it is worth remembering that the rand tends to outperform other EM currencies when the dollar depreciates.

Other currencies that may perform well as 2024 progresses could be the Polish zloty and the Korean won. The probable appointment of a new government following last October's election should reduce political uncertainties and frictions with the euro area. Net capital flows from the balance of payments should continue to support the zloty, which, like the rand, is highly sensitive to trends in the US dollar. The Korean won is highly responsive to the global business cycle. Signs of a bottoming-out of Korean exports and probable monetary easing in the US should bode well for the won. The Taiwanese dollar has more or less the same drivers as the won. But tensions with China make it somewhat less attractive, with those tensions unlikely to be eased by the Taiwanese presidential elections in January.

Long-term valuation vs. 1-year real interest rate



Source: Pictet Wealth Management, LSEG, as of 08.12.2023

THE RUPEE AND THE RENMINBI COULD DO WELL SHOULD THE DOLLAR REMAIN STRONG

EM currencies that are closely managed by their central banks such as the Chinese renminbi and the Indian rupee could do well in the first part of 2024 should the US dollar remain strong. The rupee could also benefit in the first part of the year from the Indian economy's relative immunity to a weakening global economy. That said, both currencies may underperform their EM peers as the year goes on. The Reserve Bank of India (RBI) is likely to rebuild its FX reserves should the US dollar depreciate, while foreign investors' reduced exposure to Chinese assets should remain a drag on the renminbi. The Indonesian rupiah looks relatively attractive given a decent carry and Bank Indonesia's focus on keeping the rupiah stable. The onset of the Fed's easing cycle should also help the rupiah. But like India's RBI, Bank Indonesia is likely to rebuild its FX reserves when downward pressure on the rupiah abates, which could limit its upside potential. The Singapore dollar should remain supported by a steep rate of appreciation engineered by the Monetary Authority of Singapore. Because of Singapore's very open economy, the currency should also benefit if the global economic outlook improves in the course of 2024.

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The economic consequences of the war against Hamas are likely to remain a drag on the Israeli shekel. While robust underlying fundamentals should support the currency, geopolitical uncertainties make the outlook particularly uncertain.

The Turkish lira is likely to underperform other EM currencies because of very high domestic inflation. Fundamentals are improving thanks to a more orthodox monetary policy since mid-2023, but the policy rate adjusted for inflation still looks too low to massively curb inflation. Overall, lira depreciation looks likely to continue, although at a more gradual pace than before.

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