International Commentary — June 13, 2022

Emerging Currencies Hit Hard by The Fed

Summary

Our view on emerging market currencies has been simple. Decelerating global growth and a hawkish Federal Reserve should place widespread depreciation pressure on currencies across the emerging market complex. These dynamics are playing out over the course of Q2—emerging currencies have given up a chunk of the gains experienced at the beginning of this year as U.S. inflation is spiraling higher and the Fed likely needs to turn more hawkish to contain price growth. In our view, we expect emerging market currencies to continue to selloff as market participants price sharper Fed interest rate hikes. Currencies associated with weak fundamentals and institutions as well as elevated political risk are most vulnerable in the current environment, and broadly speaking, developing currencies could see another 5%-6% selloff by the end of this year.

Economist(s)

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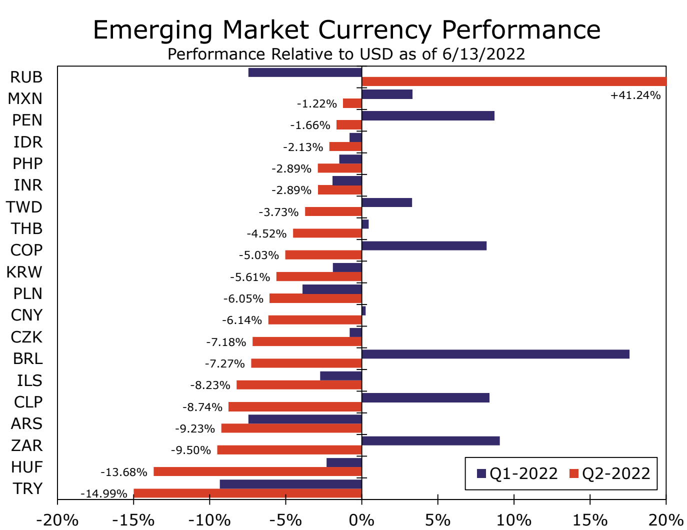
Slower Global Growth + Hawkish Fed = TROUBLE

We have previously shared our view that we expect a downtrend for emerging market currencies early this year. In our view, evidence of a global slowdown in activity and an even more hawkish turn from the Federal Reserve would be the impetus for a broad-based selloff in developing currencies. The global slowdown in activity is certainly underway as the U.S. and Europe struggle with elevated inflation and tighter monetary policy, while China's economy is decelerating amid commitment to COVID-containment policies. Our revised global GDP forecast reflects those dynamics. As of our latest update, we expect global GDP to grow just 2.7% this year. Our global GDP forecast was revised lower multiple times over the course of Q2, and is now down from a forecast of over 4% earlier in the year. Historically, in an environment where the global economy softens, emerging market currencies typically underperform relative to the U.S. dollar. As the global deceleration has intensified, emerging market currencies have started to weaken. Going forward, we believe risks around our global GDP forecast are tilted to the downside, and believe the possibility of even softer global GDP growth will continue to be a source of weakness for emerging market currencies.

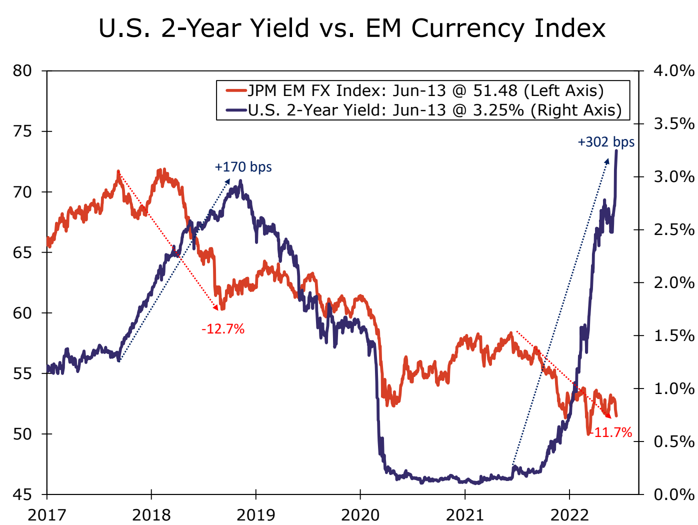
We also believed monetary policy trends would be the largest contributor to emerging currency weakness and continue to maintain a view that central banks will be the key driving force of weaker emerging currencies over the second half of this year. Last Friday's U.S. CPI data was especially noteworthy in this respect. Price growth in the U.S. rose well above consensus forecasts and strengthened the case for the Federal Reserve to turn even more aggressive in its hiking cycle. A more aggressive Fed is a view our U.S. economics team has held for months. Our colleagues forecast 50 bps rate hikes in June, July and September, a view market participants are coming around to after U.S. inflation hit a new 40-year high last week. Markets' recalibration of Fed monetary policy expectations led to turmoil in financial markets last Friday, and that volatility has carried forward to start this week. Global equities are selling off sharply, while U.S. Treasury yields spike and risk-sensitive emerging market currencies are under severe pressure. The combination of less robust global growth and expectations for a more hawkish Fed have placed depreciation pressure on just about all the key emerging market currencies in Q2 (Figure 1). In fact, with the exception of select oil exporting currencies in Latin America and the Russian ruble's capital controls-driven rally, the selloff in Q2 has resulted in some emerging market currencies wiping out gains against the dollar from earlier this year.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

The Selloff Is Underway, But Likely Far From Finished

We believe the selloff we are seeing across emerging market currencies is unlikely to relent in the near future. In fact, in our view, the question is not so much "will EM currencies weaken?", but more "by how much?" The historical relationship between emerging currencies, U.S. Treasuries and global economic activity may provide insight into how deep the EM FX selloff could be from here. In fact, 2018 may act as a good barometer for potential emerging FX performance. In 2018, the macroeconomic environment was defined by the Fed raising interest rates and slower global economic growth as a result of tighter monetary policy and deteriorating U.S.-China trade relations. Against this backdrop, 2-year U.S. Treasury yields rose 170 bps, and the J.P. Morgan Emerging Markets FX Index sold-off almost 13% (Figure 2). While the circumstances for decelerating global growth are different in 2022 vs. 2018, the Fed is certainly more hawkish today than it was in 2018. Since the middle of 2021, around the time the Fed started hinting at tapering asset purchases, 2-year U.S. Treasury yields have risen over 300 bps. Despite a sharper move higher in U.S. yields, the EM FX index has fallen only 11.5% over the same time period. Emerging market currencies have been more resilient to higher yields given the rise in commodity prices this year; however, we believe emerging currencies will catch up with yields and the selloff will continue going forward. If 2018 is any guide, emerging market currencies could have another 5%-6% of broad-based depreciation ahead of them.

As for which currencies could experience the largest depreciation, currencies associated with weak underlying fundamentals, fragile institutions, and political instability could come under the most pressure. In that sense, our emerging markets FX vulnerability framework can be a useful tool to identify currencies most at risk in the current backdrop. Earlier this year, we updated our framework as we believed another "Taper Tantrum" scenario could be imminent. With the Fed set to assess monetary policy this week against rampant U.S. inflation, the risk of a hawkish rate hike is rising. If the FOMC delivers a 50 bps rate hike and signals the need for an even quicker pace of hikes going forward or follows through on a 75 bps hike, markets could respond in "Taper Tantrum" fashion. In that context, risk assets would likely continue to selloff and emerging market currencies would likely plummet. In this scenario, our framework identifies the Turkish lira, South African rand, Colombian peso and Chilean peso as the most vulnerable and the currencies likely to come under the most pressure. Other high beta currencies such as the Mexican peso and Indonesian rupiah could also see depreciation pressure build, while currencies in Eastern Europe may also see sizable selloffs. Lower down on the vulnerability scale, but still exhibiting signs of sensitivity is the Brazilian real. Elevated political risk, elevated inflation and a mature tightening cycle would like result in Brazil's currency coming under similar pressure. On the other hand, our framework suggests currencies in emerging Asia could be less vulnerable. The likes of the Chinese renminbi and Thai baht should be less sensitive against this backdrop, and experience more modest depreciation as economic fundamentals are stronger and local politics are more stable.

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