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Aerial View

Morning Briefing

Nov 20, 2020

Shots in the Arm in EM

- **Carry inflows despite weak external demand, EM FX starting to trigger policy reactions**
- **Caution understandable, but nor can markets ignore reflation**
- **Strong national vaccination mandates may hasten EM normalization**

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The past two months have largely been kind to emerging markets and the carry trade.

EM-led carry trades have performed well, supported by expectations of reflation, low nominal and real rates in the US and favorable valuations. After the risk aversion episodes earlier this year, the renewed pickup in risk appetite and inflows into these economies has largely been a welcome development.

However, the speed of the move amid a still problematic macro backdrop is starting to trigger reactions.

On Thursday, the central banks of Indonesia and Philippines both surprised markets by cutting their benchmark interest rates by 25bps. Both central banks highlighted that inflation risks were tilting to the downside – a development further currency appreciation would only accelerate.

Outside of Asia, the Reserve Bank of South Africa kept rates on hold as expected but the 3-2 decision also points to strong concern over downside growth and price risks.

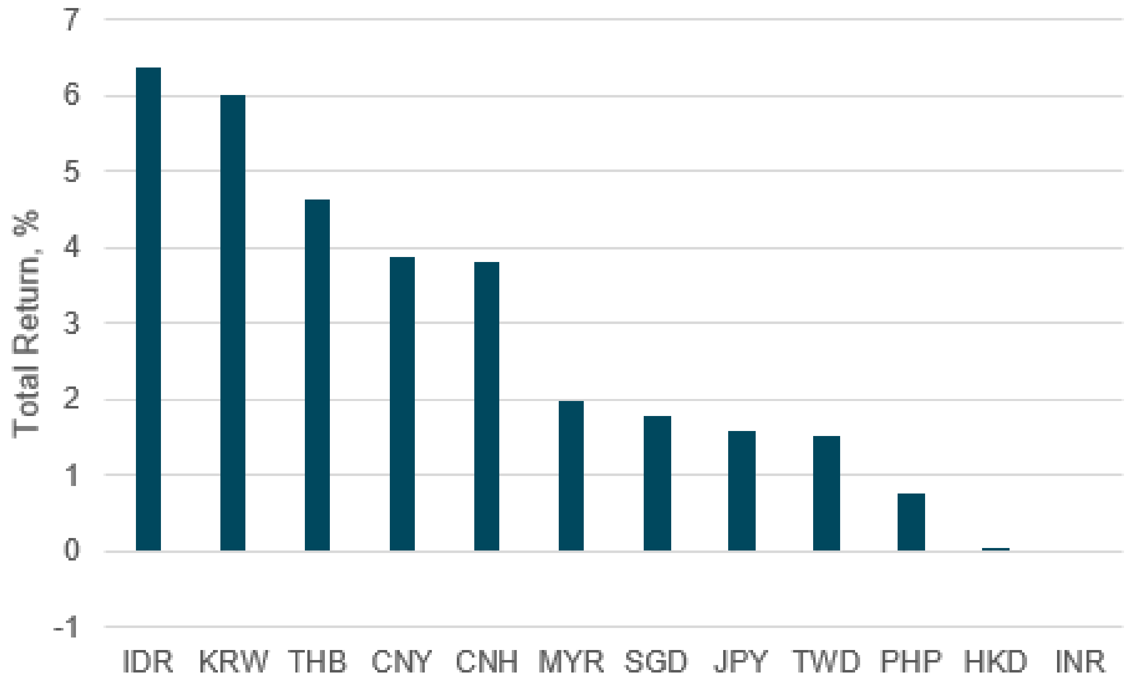
As the chart below indicates, on a total return basis all major emerging market currencies in Asia have strengthened against the dollar so far this quarter.

Indonesia's monetary policy reactions were likely particularly strong because the appreciation in the rupiah in the past six weeks has more than reversed the losses in the three quarters prior. The central bank openly stated that the currency is still undervalued so there should be enough of a buffer, but it also is a matter of pace, especially with the global growth picture still quite uncertain.

The changes in risk appetite over the past few weeks has strongly rekindled carry-based plays designed to capture yield and further reflation. As opposed to previous cycles, Asia's reflation is happening in isolation and the growth divergence only looks set to widen. As a result, the flows into theses currencies and economies risk being disproportionate to what fundamentals could justify.

Some other commodity-based economies, such as South Africa and Brazil, are also considered reflation proxies for Asia, mostly due to their exposures to Chinese commodity demand. With more attractive yields relative to G10 currencies, it is understandable that central banks are worried that inflows are coming at too strong a pace.

Quarter-to-Date (as of Nov 18) Total Return, Select Asian Currencies vs. USD



Source: BNY Mellon Markets, Bloomberg L.P.

> ***It is understandable that some EM central banks are worried that inflows are coming at too strong a pace***

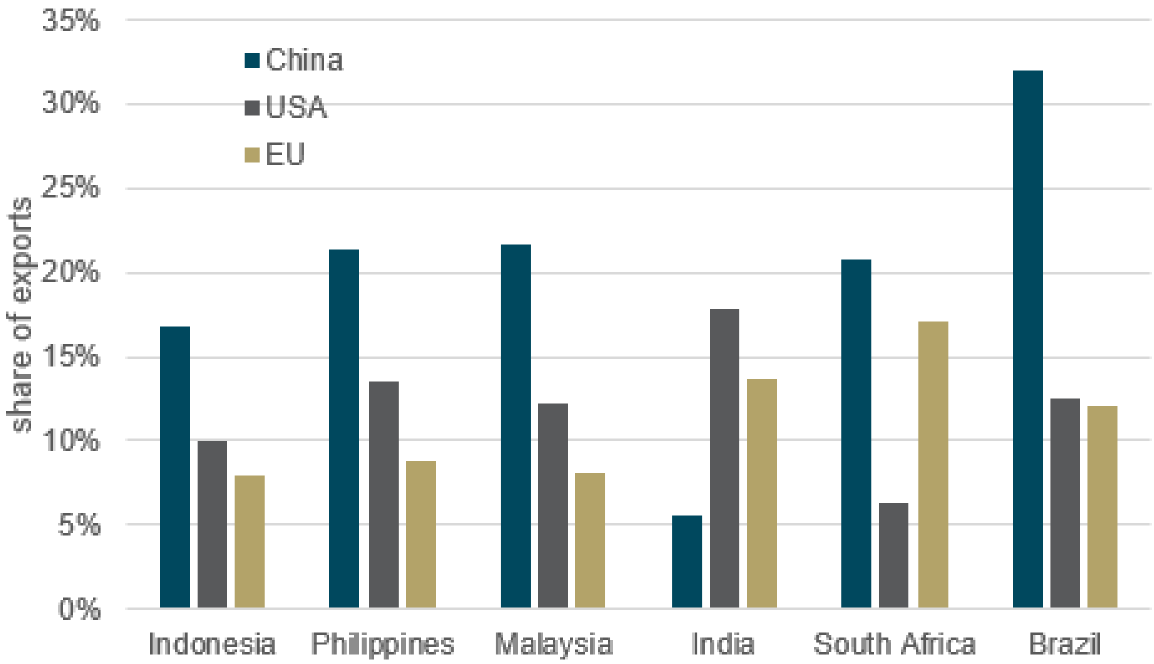
If these countries had enough confidence that Chinese and wider Asian demand can lift the US and EU economies, then greater tolerance for currency strength is possible.

There is some sign of stronger tailwinds in light of strongly-performing European manufacturing. However, looking at the individual export and demand exposures of these economies, we believe that the central banks in question simply cannot take such a risk.

As the chart below shows, while China is the main trading partner for most global emerging market economies, its share is not large enough for policymakers to disregard any demand drag from the US and EU.

At best, stronger China growth might just be enough to make up for further deterioration elsewhere, but even so, external demand is simply standing still. This leaves very little room for error and as Thursday's decisions indicate, caution is clearly rising as the US may follow Europe into more stringent social restrictions, at a cost to growth.

Total Export Exposure, Select Emerging Markets



Source: Bloomberg LP, BNY Mellon

In particular, we would highlight that assuming the supply of doses is not an issue, many emerging market economies are well-positioned to achieve critical mass in vaccination rates.

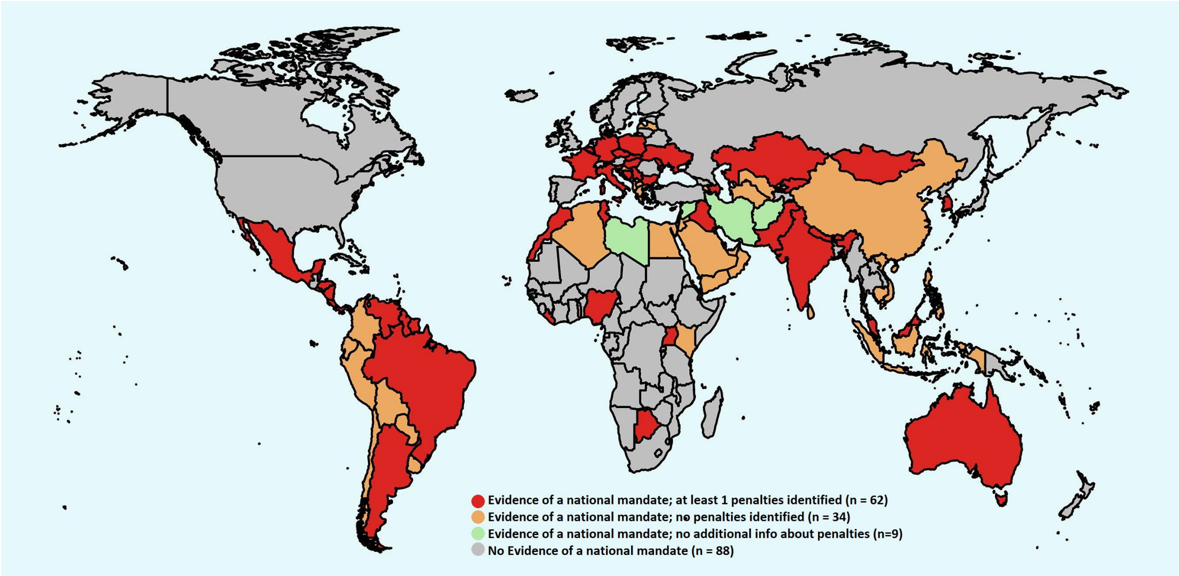
In a recent study conducted by academics based in the US and Canada, Asia and Latin America were identified as the strongest regions with evidence of a national vaccination mandate. In Europe, France, Germany and much of Eastern Europe also possess strong mandates. In contrast, with the exception of Australia, there is no evidence of a national vaccination mandate in the Anglosphere.

These studies matter becomes more central banks are incorporating specific healthcare scenarios into their monetary policy outlooks. The most significant of which is the availability of a vaccine (or other healthcare solution to COVID-19) which could allow societies to normalize quickly. These assumptions are critical because monetary policy would need to be adjusted with these timelines.

However, if availability of a vaccine has no immediate bearing on widespread adoption due to weak national mandates, even if assumptions are correct regarding the vaccine's own timeline, slow take-up means societal, and therefore monetary policy, normalization may yet be delayed.

In contrast, if the resolution is swifter, then many of these emerging market economies may find that financial conditions are far too loose due to excessively low interest rates and undervalued currencies. Rapid tightening will be needed which in itself could also be destabilizing.

Global Distribution of National Mandatory Vaccination Policies



Source: Gravagna et al (Vaccine Journal, October 2020)

> ***More central banks are incorporating specific healthcare scenarios into their monetary policy outlooks***

We continue to favor the Asia-Pacific region as an area of outperformance in both growth and underlying assets.

The fundamental case is compelling, but central banks in the region are clearly showing greater caution and giving preemptive economic shots to the arm in case external conditions remain weak.

This will likely remain the most favored monetary policy framework until the real shots are ready.

Please direct questions or comments to:

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