

“Carry” currencies

The Double Whammy

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- The Emerging Market and commodity currencies (“carry” currencies) have depreciated against USD and EUR in May, in particular AUD and ZAR have been hit.
- We expect stabilisation in China’s data soon, and the Fed is not to end QE in the coming months, which should provide short-term support.
- But going forward, positioning (for carry) suggests the longer-term risks increasing as the global easing reverses, in particular for currencies of countries with large foreign funding needs.
- The worst-case scenario is the reversal of easing not as much a result of strong global growth, but more as a concern over financial stability.

There has been a sharp selloff in Emerging Market and commodity currencies over the past few months. The common denominator is neither commodities nor Emerging Markets: it is the “carry” and thus positioning. The currencies with the largest foreign funding needs, notably current account deficits (like ZAR and AUD) have been hit the hardest (*Figure 1*). Usually the currencies that have the largest funding needs (current account deficits) also have the highest yield. And thus over the past few years of global monetary easing, they have been attractive targets of the “chase for yield”, creating the positioning bias. The latter explains sharp movements, once things changed. So what changed?

There have been several catalysts of the depreciation of EM/commodity currencies recently. Firstly, Chinese and other Asian data (which we counted on as the engine of global growth) disappointed, for example the Australian export PMI index falling to all-time lows. Secondly, the major central banks turning less stimulative in their monetary policies. The ECB is already passively exiting as the balance sheet is contracting rather quickly, as close to 300bn in 3Y LTROs have been repaid this year. The UK and Switzerland are “on hold” with monetary expansion. Most importantly, the Fed is mulling the tapering. And even the most aggressive central bank, the BoJ, is now getting uneasy with the volatility in the bond market that the aggressive intervention has contributed to.

Short term – overreaction

It seems the markets have overreacted a bit, and thus there is a fair chance the “carry” currencies will recover in the near term if our official macro view is right. For example, the Chinese economic surprise index is already at very low levels (*Figure 2*), suggesting less potential to surprise on the downside in the coming months. And some indicators like money supply growth suggest China will not decelerate further (If anything, there has been a tendency for Chinese new export orders to disappoint into the summer over the past few years). The overall global growth picture is also gradually improving (*Figure 3*), as even Euro-zone industrial production and consumer confidence have picked up from lows. This, coupled with seasonality factors, should support oil and metal prices. Last, but not the least, we expect the US Fed is to keep QE3 alive over the summer in its current form, as more signs of weakness emerge in household data.

Longer term – warning sign

Admittedly, the Chinese data remain a mystery, and the impact of the BoJ’s experiment is yet to be seen. **If** Chinese GDP growth falls below 7.5% (psychological mark due to policy target), the commodity currencies will suffer and other Emerging Markets will tag along.

While we do have hopes that Asia will pick up speed again, the global easing cycle is getting to the end, sooner or later. The years of excessive stimulus are over (*Figure 4*), and thus expectations of Fed exiting, on and off, will still prevail in the months ahead. There are several scenarios and thus implications for “carry” currencies. The **worst-case scenario**: the US Fed (and others) having to tighten not so much because of economic situation, but more due to concern about financial stability (bubbles or exit impact) or, worse yet, credibility/inflation expectations getting out of hand. The **best-case scenario** is normalisation in the global growth cycle, where both developed and emerging markets come out of the easing cycle synchronised, ie there is less motivation to abandon the EMs, retaining the growth and “carry” advantage.

Admittedly, we will probably end up somewhere in-between the two (our baseline), but the risks are skewed to “worst-case”, as the global labour markets are in the worst shape for decades and we have probably permanently shifted to a lower growth environment. We are in unprecedented times with unprecedented global easing. Not only the Fed’s Bernanke has mentioned “search for the yield” lately, but also the ECB has mentioned it in its May [Financial Stability Review](#). If the ECB is getting worried, there is simply no way for us not to follow suit. *The fear of the unknown is the greatest fear of all.*

All “carry” currencies are at risk, but some more so than others. May gave a good idea of which is the most sensitive. South Africa and Australia have been rightly hit, as both have some of the largest current account deficits (>5%), and therefore the largest foreign funding needs. But New Zealand is in the same camp as well (>7% CA deficit). Even more mature commodity economies (Norway, Canada): still hot housing markets make them not much of a safe-haven case for the coming years. The USD and EUR will likely prevail.

What to do?

Most importantly, panic is no the option. The long USD positions are already at record highs. If the green shoots in the global economy re-emerge, as we expect, and the Fed postpones tapering, the rush to short “carry” is premature. The “long EM” case, at least selectively, will still be there for investors regardless of whether the Fed tapers QE3 or not, this year or the next. But for hedging purposes, it is advisable not to leave the long EM/commodity currency exposure open against both the EUR and the USD for horizons longer than three months. FX implied volatilities even after the recent pick-up are still at post-Lehman lows, making even plain vanilla FX options an attractive tool to manoeuvre in the current situation.

Figure 1. FX vs current account balance

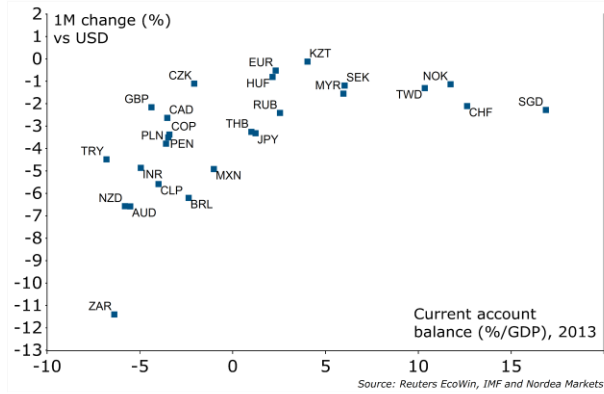


Figure 2. China cannot disappoint much more?



Figure 3. Global growth not stalling



Figure 4. End to easy money

