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Currency Comment

Stable outlook for USD

After firming across the board for much of 2018 and 2019, the USD is perhaps set for a period of consolidation as growth moderates in the US and interest rates remain low or decrease even further.

The index levels below mask wide potential divergences across regions. The domestic situation in the US is such that the push and pull factors appear to be broadly in balance, and the possibility of a strong move in the USD in either direction, on its own terms, looks small. That does not mean that due to more specific factors, other currencies will be equally docile.

US Dollar Trade-Weighted Index 1997=100

Source: Bloomberg

Asia, the trade war and the CNY

A key risk faced by Asian economies in 2020 will be the ongoing disruption caused by the trade war between China and the USA. Asia is in many ways an innocent bystander here. Overall growth in trade volume in 2018 was already slower than the year before, growing by 4% compared to 7.3% in 2017 – as reported by the Asian Development Bank recently. All indications are that the number will be lower for the full year 2019 again, as the impact remained noticeable and appeared, in fact, to intensify in the third and fourth quarter of 2019.

Notably, the overall trade surplus run by China against the US still has not really moved in the direction that Mr Trump would prefer. By the end of 2019 the trade surplus with the USA was close to $26.5 billion, virtually unchanged from two years earlier. The announcement of tariffs at the end of 2018 had a major impact, but only temporarily. The size of the Chinese surplus returned to earlier levels quickly, even though overall volume between the two countries has declined.

For a long time the People's Bank of China was viewed as having a "soft" limit on CNY depreciation beyond the level of 7 to the USD. This level was breached in July but after a period of weakening it has now returned again to levels just above 7. While the current mood in the market is optimistic about the prospects of a trade thaw, we do not rule out the possibility of the odd spate of renewed weakness in the CNY, should there be episodes of trade war escalation – to be expected in the turmoil that will be the order of the day as we approach the US presidential elections at the end of the year.

EM Currencies: Selective Opportunities

While the trade war has been a very clear dampener for the outlook for the broader emerging market complex, the impact is not expected to be uniform over time or across the various regions. The trade dependency of Asian countries on Chinese trade with the USA is very well documented and understood. The second half of 2019 has proved to be challenging for several of the economies in South-East Asia as trade volumes were very clearly negatively impacted. Economic growth has suffered, and in response monetary policy has been eased.

In other regions, the trade impact has not been the main driver: domestic issues have been a bigger driver across Latin America, where Argentina grabbed headlines for all the wrong reasons by wiping out sovereign debt holders for the umpteenth time as political developments turned toxic.

Even so, 2020 might provide an opportunity for investors to take some exposure to emerging markets through foreign exchange: the carry play. Many investors have bad memories of taking exposure to emerging market currencies for the sole purpose of harvesting the local interest rate on these. The risk is seldom default of some underlying credit bond, the risk is simply that the local currency weakens more than the interest that the investors are being paid. So, the idea is not to overexpose portfolios to any one country, but instead try to take advantage of a stable dollar environment and add conservative exposure across some of the more attractive currencies.

A good example is the Russian rouble. Much the same as the GBP, the rouble stands to potentially benefit from several factors. First, the domestic equity market is pricing at interesting levels. Granted, it is up more than 20% so far in 2019, but it is still trading at a mere 6 times forward multiple and at a dividend yield of 6.2%. Such valuations could support a steady inflow of capital.

Opportunity in GBP?

Similar arguments apply to UK assets as to those in Russia. With a stock market that has performed poorly against global peers and an economy that has been partially paralysed by the Brexit-induced uncertainty, it is not much of a surprise that UK assets have become quite unloved in the global investment community.

GBP in recovery mode?

Source: Bloomberg

In the run-up to the Brexit referendum, the currency was trading far stronger than today. The uncertainty and risk introduced by the referendum outcome caused an instant and sustained devaluation of sterling. As we argue elsewhere, there is no reason to expect the path to the proper resolution of all the outstanding issues between Britain and the EU to be smooth, or, for that matter, quick. Nonetheless, the process should gradually begin to clear the fog. It opens the possibility of a gradual but sustainable re-pricing of sterling. It is optimistic to suggest that it will recoup all of the losses suffered since 2016, but the direction appears to be for strength, not weakness.

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