With improved growth leading to a decrease in the need for foreign capital to finance current account deficits across emerging markets, capital inflows are now driving currency appreciation. Here, *Insight Investment* head of emerging market debt Colm McDonagh outlines the currency outlook across key emerging markets and the challenges they face over the next year.

It has, to date (August 2017), been a positive year for investors in emerging market (EM) local currency assets, especially those with a U.S. dollar base. Currency returns only partially explain this move, with income and bond price appreciation also important factors for some markets.

During 2015 and 2016, emerging markets experienced a period of significant capital outflows as markets adjusted to the prospect of higher U.S. interest rates, causing the U.S. dollar to broadly appreciate. This led to a divergence in valuation among emerging market currencies, with many Asian currencies tracking the U.S. dollar upwards while currencies in Latin America as well as Central and Eastern Europe became undervalued based on their real effective exchange rate. In part, the move in 2017 has been a reversion to mean, with some previously undervalued currencies moving back towards historical average levels. This has caused a virtuous cycle in some markets, with currency appreciation dampening inflation and allowing central banks to reduce interest rates, in turn causing bond prices to rise and driving further currency appreciation.
There are many reasons to believe this shift in valuations is more than just a short-term fluctuation and has deeper foundations. As we have progressed through 2017, it is becoming clearer that the world is experiencing a broad-based economic recovery. In the U.S., the economy continues to perform well, despite uncertainty surrounding the prospect of fiscal stimulus. In Europe, growth has improved markedly, with unemployment now rapidly declining in formerly crisis-hit countries such as Spain and Ireland. Within emerging markets, China has proved more resilient than previously expected, despite authorities taking measures to limit the shadow banking sector and reduce overcapacity in some sectors. Two other significant economies, Brazil and Russia, are now in the process of returning to growth after a period of deep recession.

FUNDAMENTAL OUTLOOK

This improvement in the global growth outlook has led capital to return to emerging markets. According to research from the Institute for International Finance, net capital inflows to emerging markets could total US$78B in 2017, accelerating to US$167B in 2018.

Before the recent period of capital outflows, some emerging markets had built up significant external imbalances and were thus left vulnerable to outflows. The International Monetary Fund (IMF) estimates that the aggregate current account deficit of Brazil, India, Indonesia, South Africa and Turkey (nicknamed the “fragile five” during the taper tantrum) peaked at US$255B in 2012 but remained well in excess of US$200B even by 2014. Currency devaluations, combined with various policy measures in individual countries, reduced this metric to just over US$100B by 2016. With less need for foreign capital to finance current account deficits, capital inflows are instead driving currency appreciation.

To establish whether this move can be sustained over a longer period, we need to consider the outlook for global growth. If the global economy continues to experience relatively broad-based growth, this should maintain support for emerging market assets. On this issue we take an optimistic view. Inflation remains at only moderate levels, which we believe should grant developed market central banks considerable

![Breakdown of EM Bond Returns in 2017](chart.png)


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time to slowly normalize interest rates, lowering the risk of policy error. Global corporate
profits have grown strongly over the first half of 2017 and this is generally a good forward
indicator for future global capital expenditures and job creation.

The IMF forecasts that the gap between emerging and developed market growth reached
its lowest level in 2015 and that emerging market growth should steadily accelerate in
coming years. Although the differential is expected to remain well below the pre-financial
crisis highs, it should nonetheless be a driver of future capital flows away from developed
markets and toward emerging markets.

**FINDING ALPHA**

Despite this potentially positive outlook, challenges certainly remain for emerging
markets. Political uncertainty has been a problem for the world in recent years and shows
little sign of abating. This will almost certainly continue to be a source of future volatility,
both for individual markets impacted by specific events and more broadly if policy
missteps from the U.S. or Europe affect global sentiment. It is also critical for emerging
markets not to repeat the policy errors of recent history.

As some economies return to stronger, more sustained growth, the potential for a
rebuilding of external imbalances rises. It is notable that policymakers in many emerging
markets have become comfortable with using currency markets as a buffer to insulate
their economies from negative shocks. One of the first lines of defense against any
political, economic or external shock is to allow currency weakness, with authorities only
stepping in to counter falls once they become significant enough for inflation pass-
through to become a concern. As long as local bond markets are not disrupted, such a
policy can have economic benefits.

One possibly important factor will be global commodity prices. The growth of U.S. shale
oil production is likely to constrain gains in global oil prices, and many other commodities
are still working through overcapacity issues. If commodity prices remain well below
historical highs, pressure is reduced on countries which are net commodity importers; at
the same time, commodity exporters are encouraged to diversify their economies.
The dispersion of value across emerging market regions and countries is one which can provide significant potential for alpha generation. If currency valuations continue to revert towards longer-term averages, high returns from some markets will likely be counterbalanced by losses in others. This would currently favor currency investments in Latin America and Central and Eastern Europe over investments in Asia. Careful consideration is thus necessary to establish which markets within those regions have the potential for further adjustment and which will be constrained by politics or country-specific issues.

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All investments involve risk, including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. Bonds are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. Currencies are subject to the risk that those currencies will decline in value relative to a local currency, or, in the case of hedged positions, that the local currency will decline relative to the currency being hedged. These risks may increase fund volatility.

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