Emerging Markets FX Monocle

Differentiation

25 March 2014

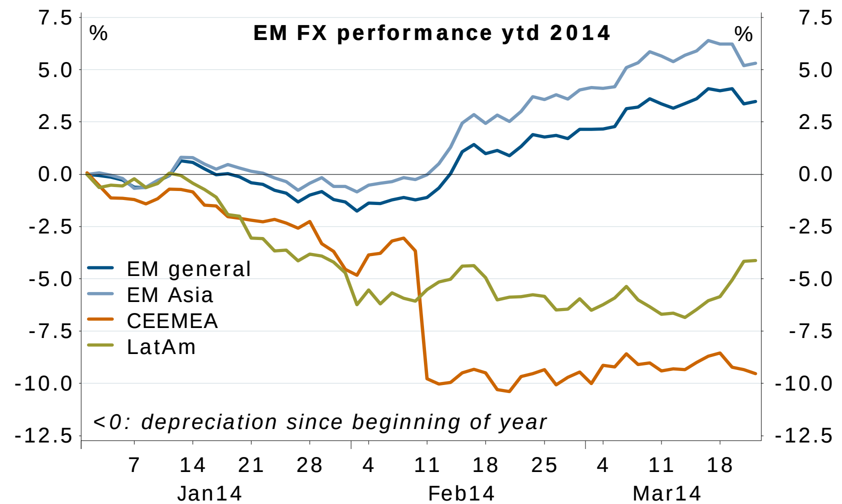
Markets

EM FX: Differentiation

Emerging Market FX remains vulnerable to bouts of risk aversion as global financial conditions tighten and fears of a hard landing in China resurface. However, vulnerabilities differ across the EM universe.

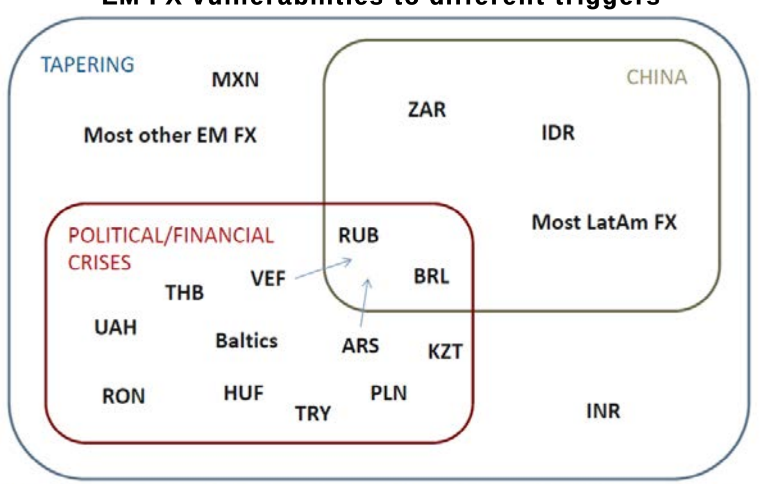
- We continue to expect increased EM FX volatility in 2014 driven by the Fed's tapering and uncertainties regarding China, but accelerating on the back of domestic growth and stability concerns.
- However, with the Fed staying the course on tapering, we expect to see less volatility on that account.
- Instead, we expect local catalysts to become increasingly more important in determining the direction of EM FX. This will bring about increased differentiation in the EM universe.
- Local catalysts include elections (TRY, ZAR, BRL, INR) and geopolitical tensions (RUB, UAH).
- The crisis in Ukraine/Russia will likely weigh on the CEE currencies, while fears of a slowdown in China put pressure on the LatAm currencies.

Local catalysts gaining importance



Source: Reuters Ecowin and Nordea Markets

EM FX vulnerabilities to different triggers



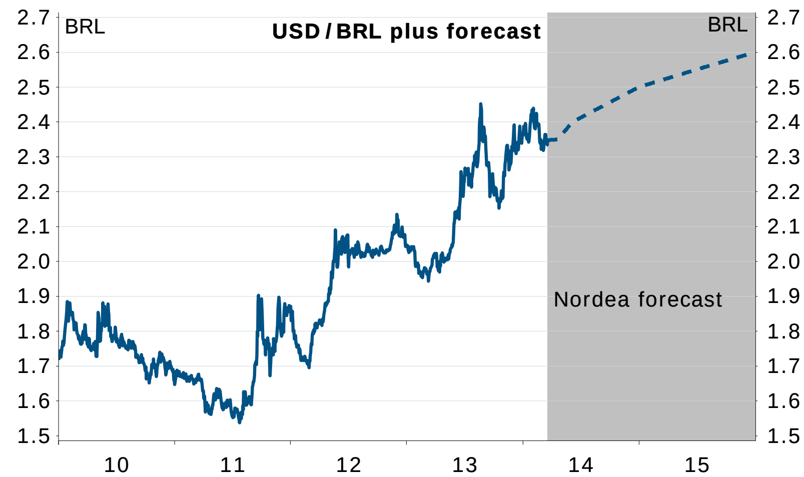
*Please note that currencies in more than one "box" are not necessarily more vulnerable.

BRL: Hiking cycle coming to an end

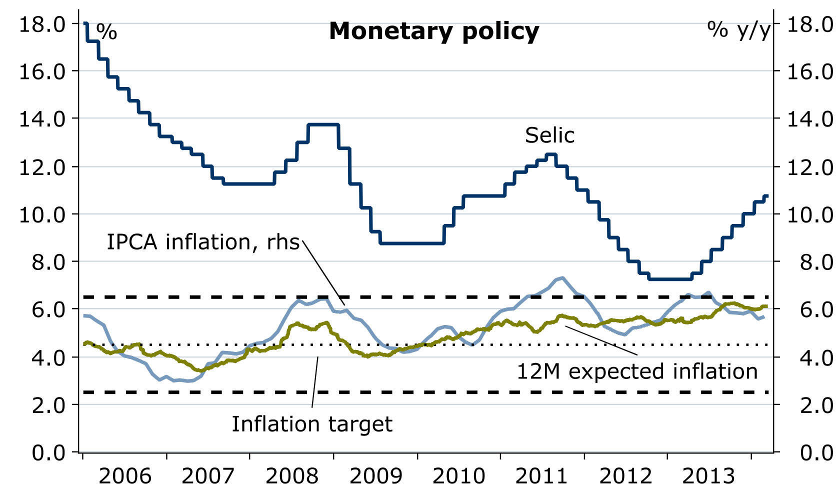
The Brazilian real continues to be under pressure as fears of a hard landing in China resurface and the Fed surprised markets with a more hawkish stance. Internally, Brazil is struggling with sluggish growth.

- The BRL is vulnerable to a number of factors, including external financing risks and a slowdown in China. On the back of higher interest rates and still-sour business and consumer sentiment, we expect growth to decelerate in 2014 to 1.6%.
- Banco Central do Brasil is inching closer to ending its tightening cycle that has taken the Selic rate to 10.75% from 7.25%. We believe the BCB will deliver one last 25 bp hike before going on hold until after the October elections – as a courtesy to President Rousseff, who is likely to win.
- Slower growth, higher interest rates and a weaker BRL are crucial for external rebalancing and bringing down the C/A deficit, which has remained stuck around 3.5% since mid-2013.
- We expect USD/BRL to reach 2.50 by end-2014.

On a weakening trend



Source: Nordea Markets and Reuters Ecowin

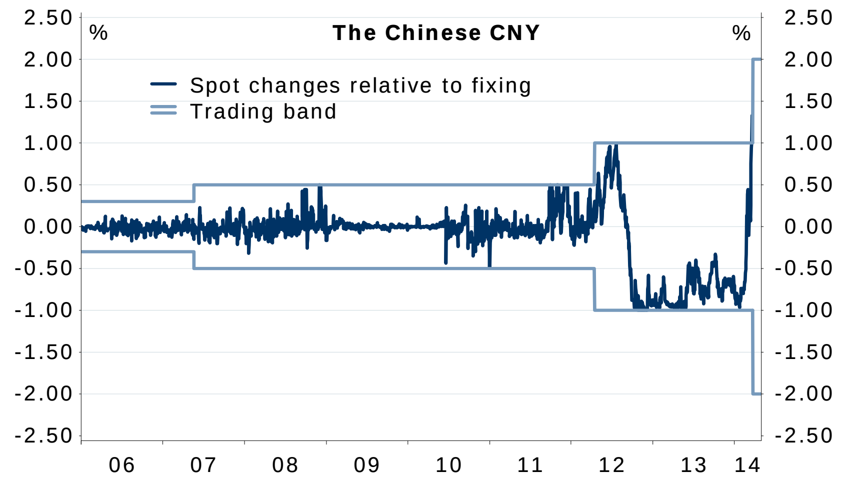


Source: Nordea Markets and Macrobond

CNY: Two-way flexibility

The CNY weakening since February was partly a preparation for the trading band widening and partly to curb hot money inflows. Market forces also played a role. We still see a stronger CNY on a longer horizon.

- On 17 March the daily CNY trading band between the spot CNY and the PBoC fixing rate was doubled to +/- 2%. This is another step in liberalising China's financial system.
- In the weeks up to the policy change, the PBoC caused the CNY to weaken by intervening through the large state banks. This way it could narrow the gap between the spot and the fixing rate, making the band widening less volatile. It also hoped to curb speculative inflows with a weaker yuan.
- Interestingly, the CNY continued to track the trade-weighted currency basket closely, suggesting that market forces also played a role in the recent CNY movements.
- The downside risk remains for the CNY in coming weeks, but it will eventually return to an appreciation trend.



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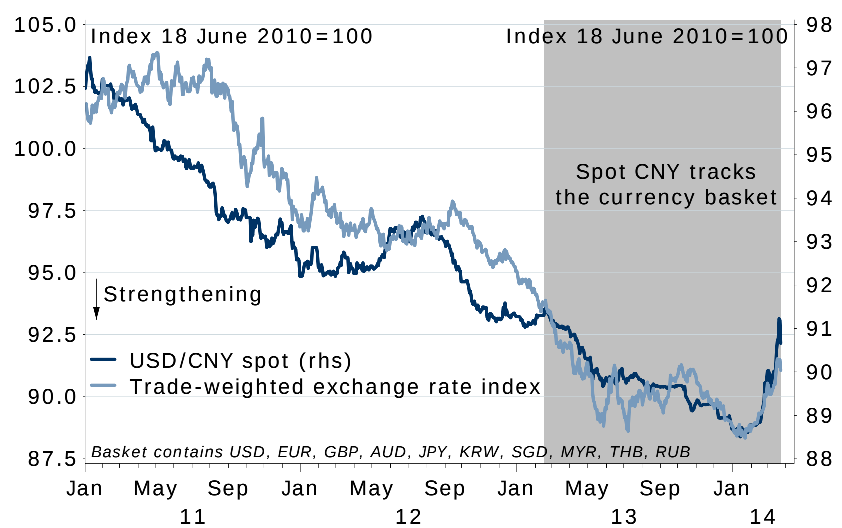


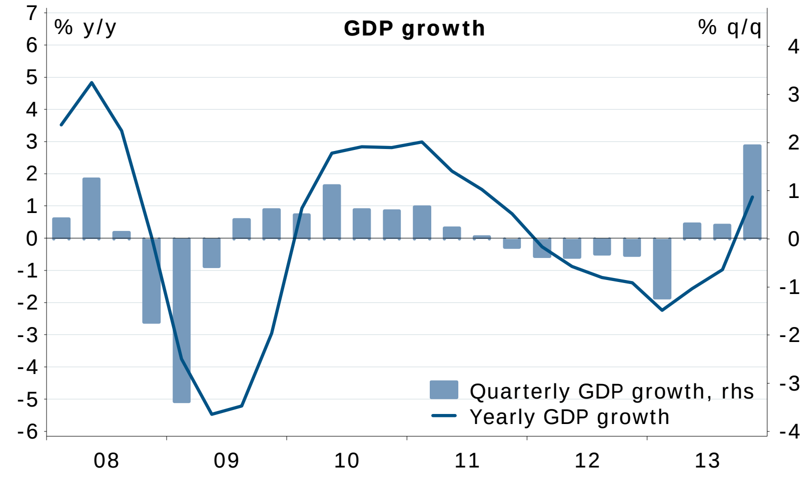
Downside risk to CNY limited to short term

CZK: Strong economic rebound

The Czech economy has finally turned a corner and recovered from recession. The recovery seems, however, to be one without inflationary pressures and the Czech koruna will therefore likely remain floored.

- The Czech economy has finally emerged from a 6-quarter long recession! GDP growth was mainly driven by fixed investment, while household and public spending remained flat.
- Business and consumer confidence indicators have been on the rise over the past three quarters, hinting at a continued recovery in H1 2014.
- In November, concerns over deflation led the central bank to implement a Swiss-type floor aiming at weakening the CZK to around 27/EUR.
- Continued weak domestic demand bodes ill for inflation, which is still on the verge of deflation.
- We believe that the CNB will keep EUR/CZK around 27 until inflation increases significantly, which is unlikely to happen before early 2015.

Risks of deflation keeps CZK pegged



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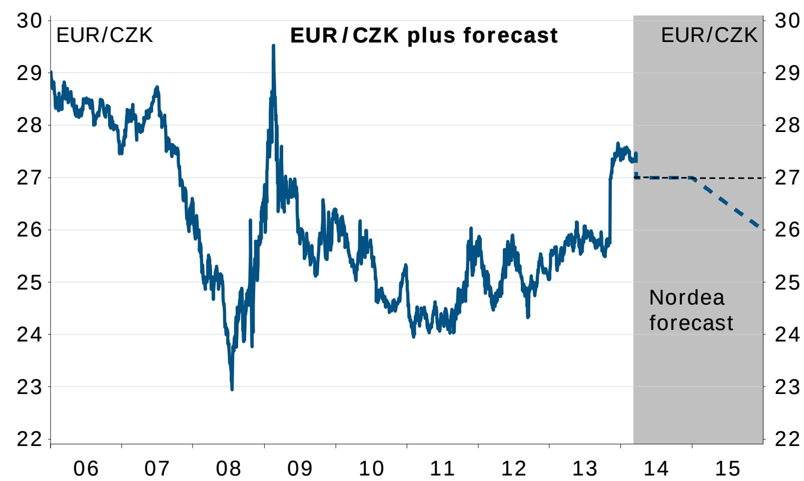


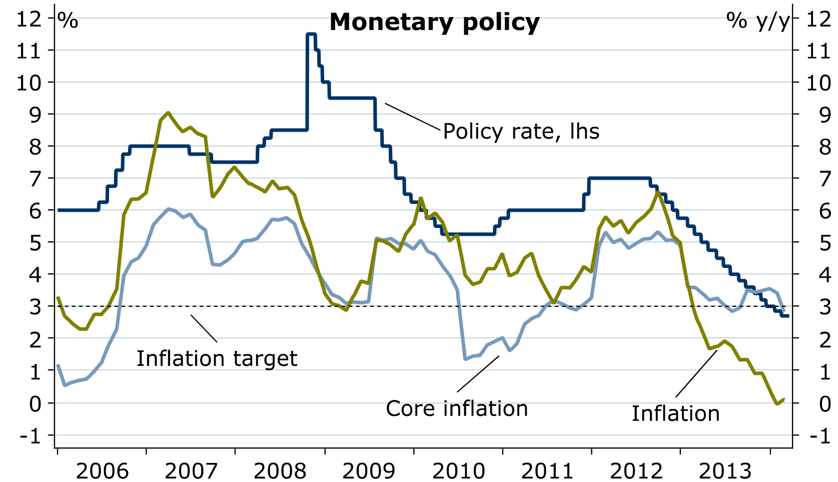
Source: Reuters Ecowin and Nordea Markets

HUF: Vulnerable to intensifying geopolitical risks

The Hungarian forint is vulnerable to intensifying geopolitical risks – despite a large C/A surplus. The Hungarian economy has rebalanced and is finally growing.

- A large stock of external debt mainly denominated in foreign currency plus lower rates keep the HUF vulnerable to geopolitical risks.
- Inflation remains subdued due to large cuts in regulated prices and a negative output gap. In January inflation hit a record low of 0% y/y, representing a turning point from which inflation should gradually increase throughout 2014.
- We expect the central bank to deliver another 10 bp cut in March, bringing the policy rate to 2.60%, before going on hold. We do not believe that emergency hikes are on the table – yet!
- Looking ahead, the large C/A surplus, together with stronger growth, should help shield the HUF from external shocks. Risks are, however, tilted towards a weaker HUF in the near term.

No emergency hikes just yet



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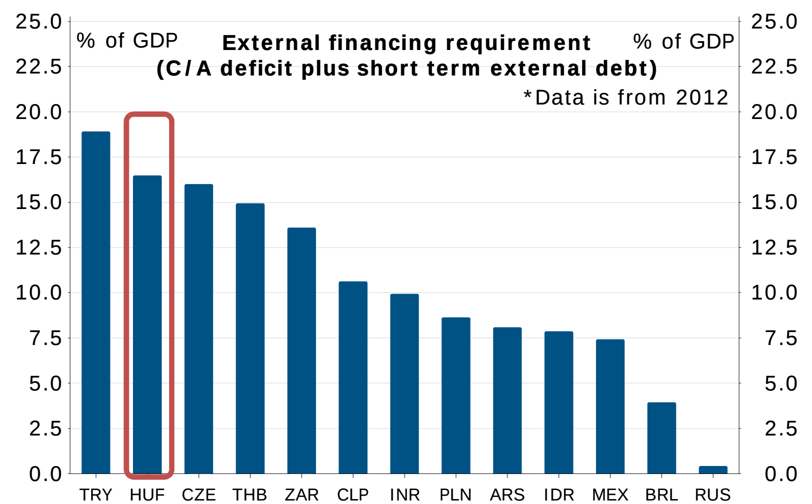


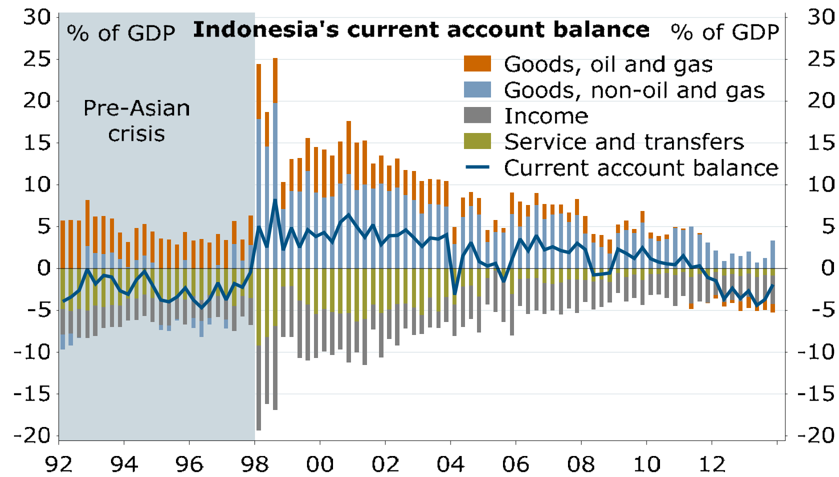
Source: Nordea Markets, IMF and World Bank

IDR: Not so fragile after all

Finally a correction in the IDR has occurred thanks to the improvement in the C/A balance and the return of flows. However, downside risks are not completely gone.

- We have argued for several months that the sharp weakening of the IDR since May 2013 was overdone and not justified by fundamentals. Capital flows have now returned and the IDR has gained 8% since February.
- After the correction has set in, which may last a while yet, the IDR will still be subject to some downside risks, especially in H2 after the elections. The first reason is that the reduction in the current account deficit in Q4 may not be sustain as export competition will remain tough.
- A second reason for downside risks is of a political nature. Indonesia will go to the polls twice this year, in April and July. If the popular Jokowi, a promising candidate for presidency, disappoints in handling economic challenges and fighting corruption, confidence in the country may dwindle again.

April election is the event to watch



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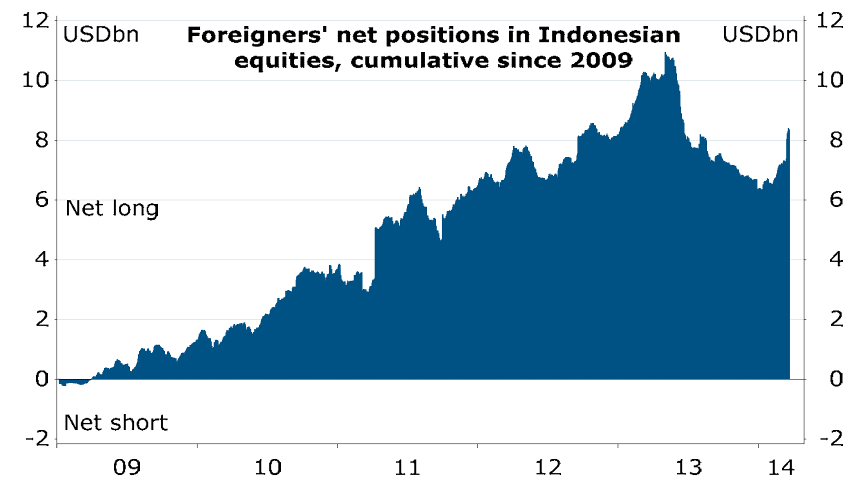


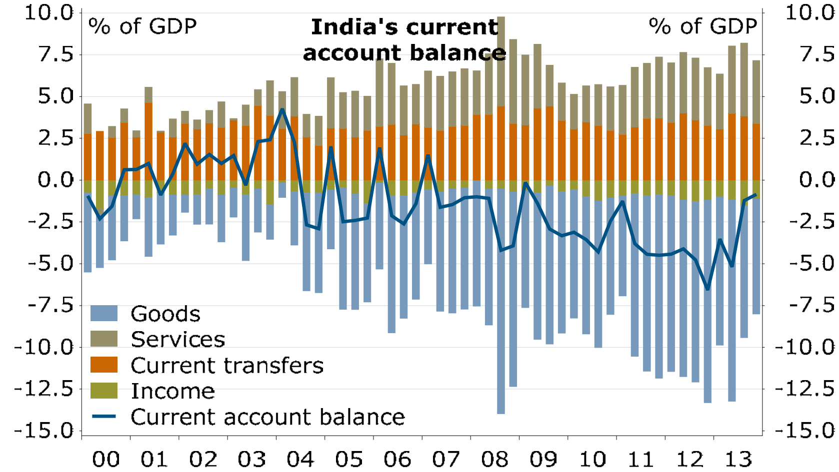
Source: Reuters Ecowin and Nordea Markets

INR: From zero to hero

Reduction of the C/A deficit, a credible central bank governor and the prospect of a reform-friendly premier may be just the cocktail that India needs to rise from zero to hero.

- India's Achilles heel has been its large C/A deficit (5.1% of GDP in 2012), which caused it to be included in the fragile five group.
- Since then, tough restrictions on gold imports halved the deficit to just 2.7% of GDP in 2013. About 75% of the C/A deficit can be attributed to gold imports, so this was an effective tool. The finance minister vowed to continue the ban.
- The political development is also favourable to the INR in the medium term. First, the possible move to target CPI inflation at 4% may boost the central bank's credibility and help attract global investors.
- In addition, India is likely to get a pro-business premier (Narendra Modi) who is not afraid of aggressive reforms. This will also benefit the INR.

INR may be a top EM FX performer this year



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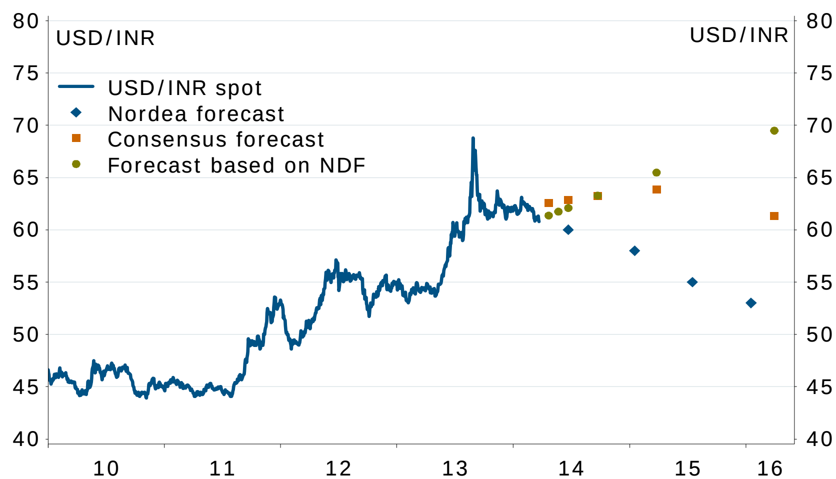


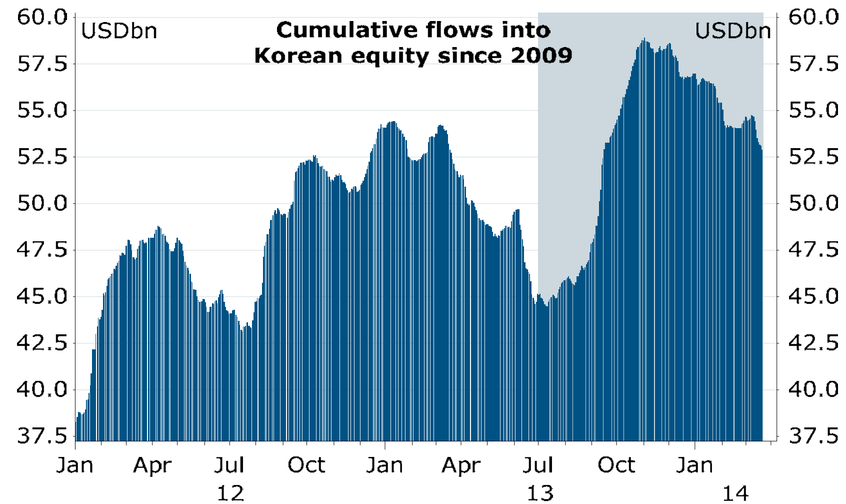
Source: Nordea Markets and Reuters Ecowin

KRW: A bitter pill to swallow

South Korea must accept the downsides accompanied by its economic strength. The authorities will keep intervention in place to cap the KRW upside.

- With North Korea firing missiles on the one side and Japan conducting beggar-thy-neighbour policy on the other, the South Korean finance minister has bluntly said that the JPY weakness was worst.
- South Korean competiveness in the auto and electronics sectors is hurt by the 25% gain in the KRW vs the JPY since October 2012.
- This is a bitter pill South Korea needs to swallow because of its domestic strength. Growth has recovered nicely. The country also runs current account and budget surpluses, which is the reason for the modest capital flight during the EM sell-offs.
- However, the authorities have no interest in continued KRW strength vs the JPY, so intervention will remain in place to keep the USD/KRW resistance level of 1.060.

Resistance level of 1,060 will remain intact



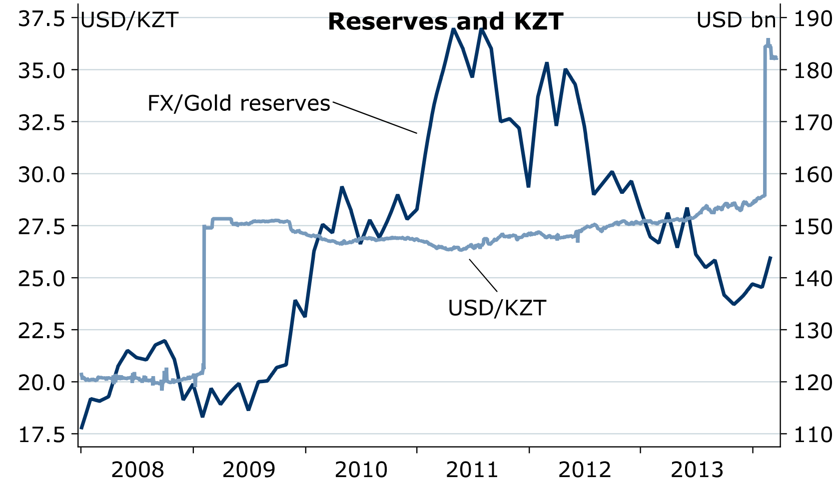
Source: Reuters Ecowin and Nordea Markets

Source: Nordea Markets and Reuters Ecowin

KZT: Stability after devaluation

After the central bank of Kazakhstan devalued its currency, the KZT may continue to stay stable given relatively strong fundamentals; no more devaluation is expected.

- The central bank of Kazakhstan (NBK) devalued the KZT by 19% to 185/USD in February following pressure from the Fed tapering and dynamics in other EM currencies.
- One of the major arguments was to adjust the exchange rate to the currency of the biggest trading partner – Russia.
- Near the new levels, the central bank of Kazakhstan will likely control the float of its currency by intervention. Since the beginning of March KZT has hovered around 182.5 vs the USD.
- The level of reserves is sufficient for the central bank to support the current pace of intervention, keeping the KZT not far from current levels.
- The KZT may stay relatively stable in the mid term as healthy public finances, the growing economy and relatively stable oil prices support the currency.



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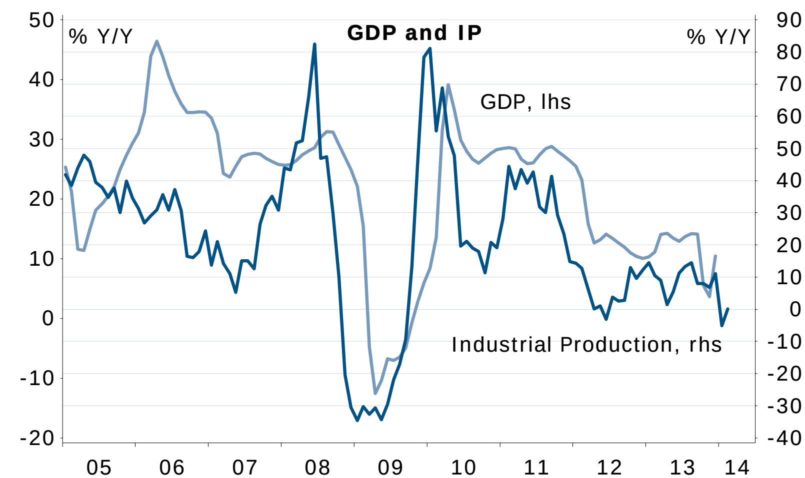


Source: Nordea Markets and Reuters Ecowin

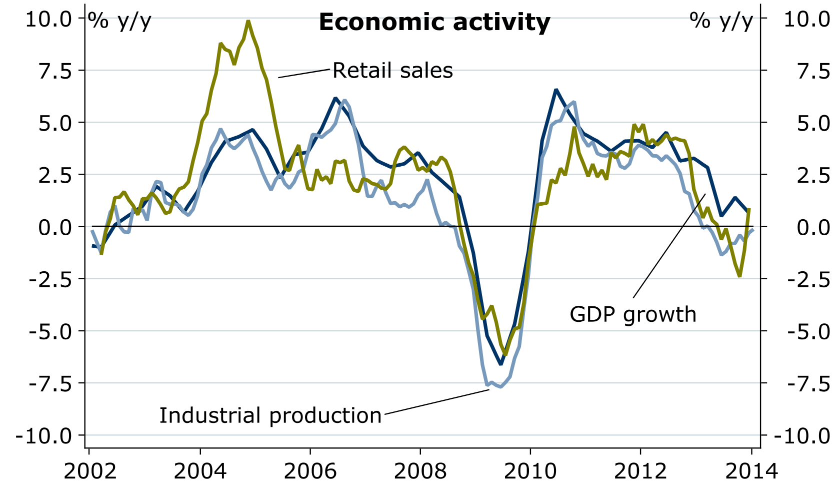
Stability after devaluation

MXN: Too optimistic?

Like other EM currencies, the MXN remains vulnerable to the Fed's tapering, despite relatively sound fundamentals. On the positive, the MXN is fairly resilient to the risk of a slowdown in China and should gain from the economic recovery in the US.

- We have revised down our forecast for USD/MXN and now expect the MXN to strengthen only moderately towards end-2014.
- Real GDP grew a weak 1.1% in 2013, down from 3.9% in 2012. The CPI is running a bit high, but the core CPI remains well anchored at the central bank's target of 3% y/y (+/- 1%).
- Negative real interest rates weigh on the MXN.
- The central bank has been on hold since October 2013. We do not expect hikes in the foreseeable future as the central bank appears comfortable with its current policy stance.
- Looking ahead, the MXN will benefit from strong fundamentals, a disciplined policy stance and optimism spurred by promising reform prospects.

Still strengthening potential



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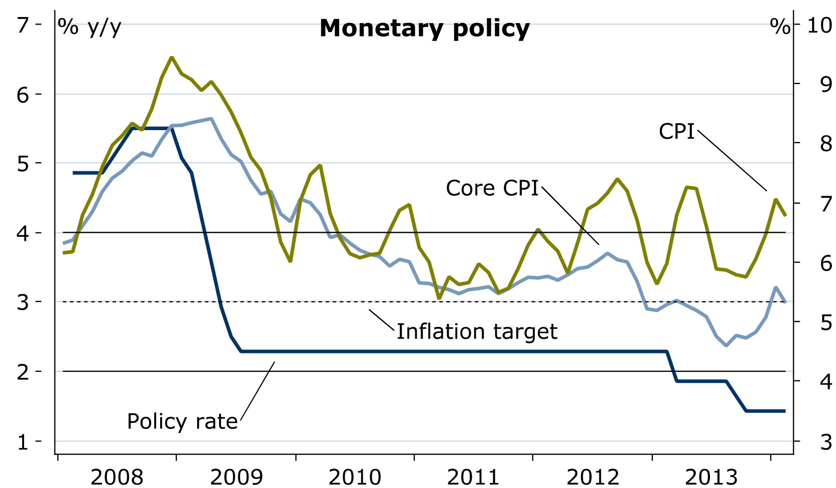


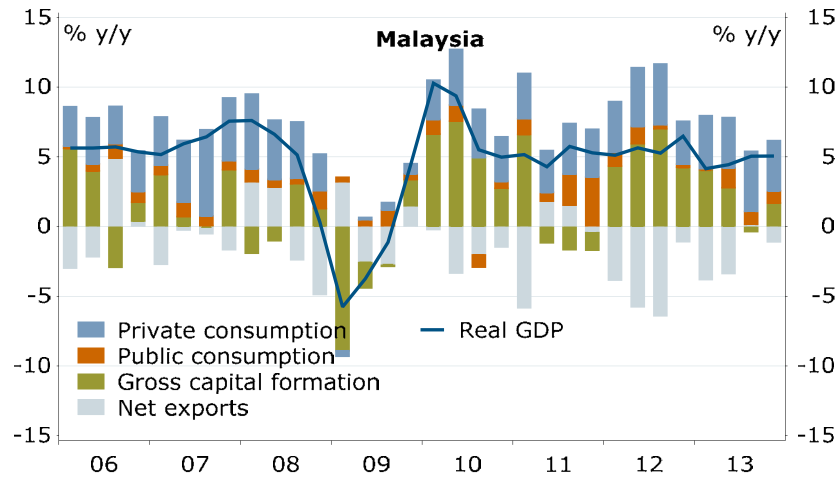
Source: Nordea Markets and Macrobond

MYR: Muddling through

Robust growth and a healthy external balance put a limit to the extent the MYR can weaken, but a large fiscal deficit and commodity price sensitivity are negatives.

- The Malaysian economy has remained resilient to the EM slowdown in the past year thanks to robust household consumption and fixed investment. Both drivers are expected to continue this year, lifting growth to 5%.
- The strong growth outlook and the healthy external balance provide a floor for how much the MYR could weaken during uncertain times.
- The biggest concern on the downside is over the large public deficit, which at 4% is among the largest in Asia. A potential rating downgrade could undermine investor confidence in the MYR.
- In addition, the MYR has been very sensitive to palm oil prices because Malaysia is the world's second-largest palm oil producer. We are generally less bullish on commodity currencies this year, as the commodity boom is likely a closed chapter.

Higher downside risks short term



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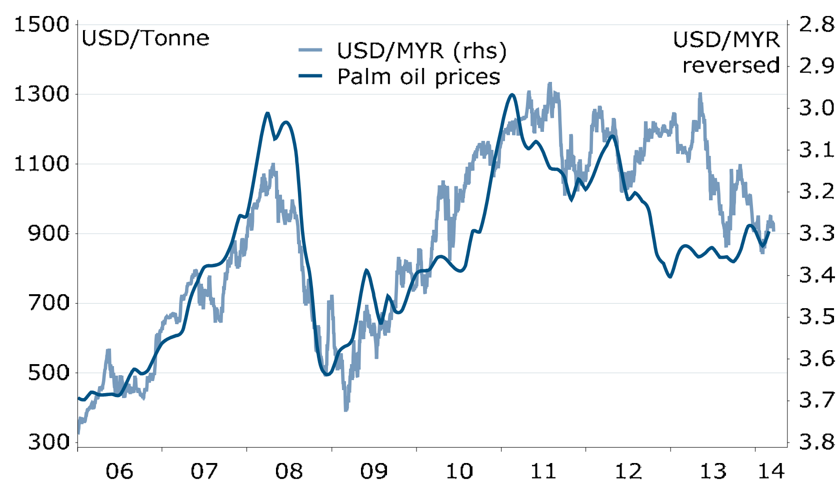


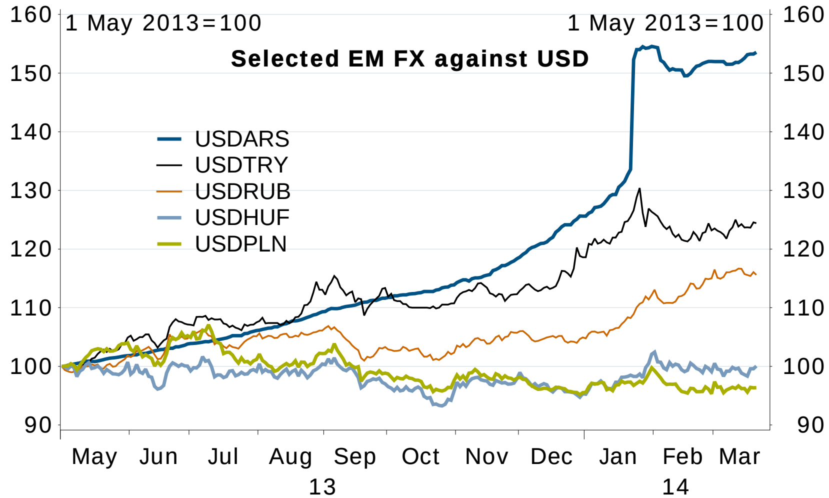
Source: Nordea Markets and Reuters Ecowin

PLN: Barely touched by EM rout and Ukrainian crisis

The recent EM rout in late January and the market reaction to the Ukrainian crisis in March have harmed the PLN, but the Polish currency seems to be barely touched when seen in a wider perspective of relative performance within the EM FX universe. We keep our constructive view on the PLN given the strength of local fundamentals.

- With an over 40% share of foreign investors among the holders of local bonds, Poland is potentially vulnerable to possible outflows of portfolio capital from EMs connected with Fed's QExit, but with the strength of local fundamentals (a bright growth outlook, a considerably improved balance of payments position, a healthy financial system, prudent macroeconomic policies) a positive view on Polish assets and the PLN is maintained.
- Poland's growth outlook is not going to be significantly affected by the Ukrainian crisis as trade and financial linkages between Poland and its eastern neighbours are weak, and a potentially dangerous scenario of disruptions to the supply of natural gas from Russia seems to be very unlikely.
- Even though the Polish MPC has recently extended its forward guidance (rates to be kept on hold at least until the end of Q3 2014), Poland's monetary policy remains relatively conservative, especially against CEE peers (continued rate cuts in Hungary and FX intervention to weaken the CZK in the Czech Republic), which is positive for the PLN.

PLN set to moderately appreciate



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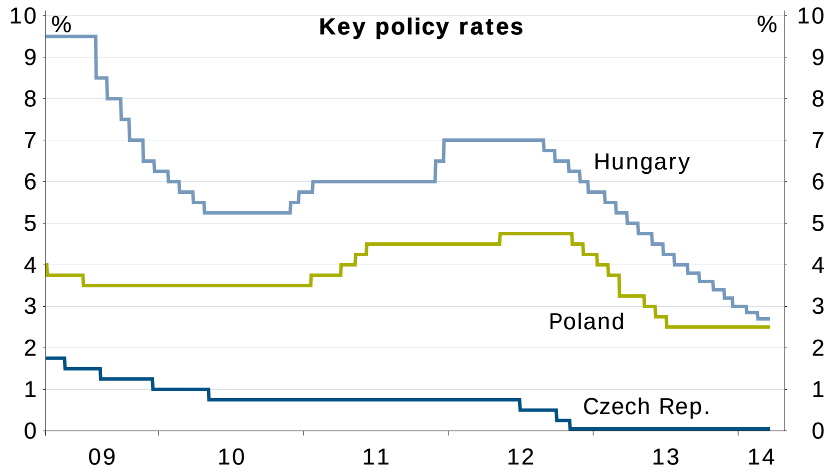


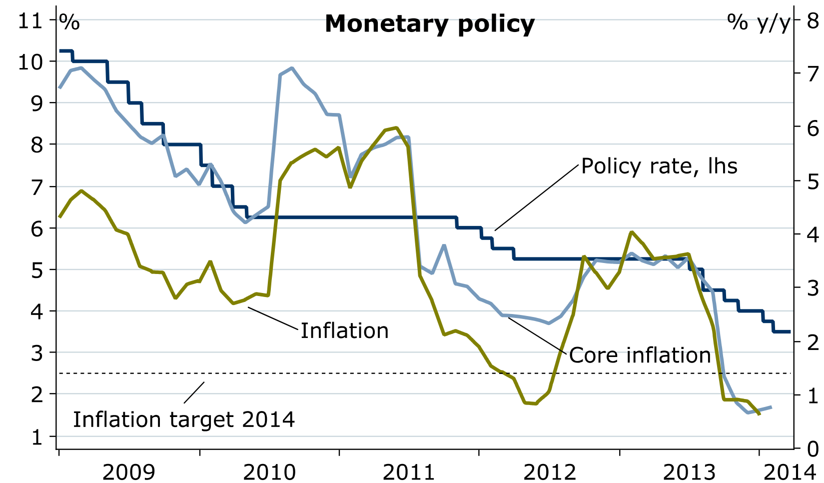
Source: Reuters Ecowin and Nordea Markets

RON: End to easing cycle

The Romanian leu has been trading sideways since the August sell-off with little sign of major changes. Accelerating growth and an improving C/A balance should help shield the RON from external shocks.

- GDP growth is set to improve in 2014 and 2015, driven mainly by improvements in the external environment and a recovery in domestic demand.
- After having cut the policy rate by 175 bp to 3.50%, the central bank is now signalling an end to its easing cycle. However, the inflation/growth outlook still justifies further easing, which will likely be delivered via cuts to the minimum reserve requirements.
- The C/A deficit narrowed to 1.1% of GDP in 2013 from 4.4% in 2012 on the back of improving trade. 2014 could see C/A surpluses.
- Looking ahead, we expect growth acceleration to support trend appreciation in the RON, which in terms of fair value should reach 4.25 against the EUR over the forecast horizon.

Trading sideways



Source: Nordea Markets and Macrobond

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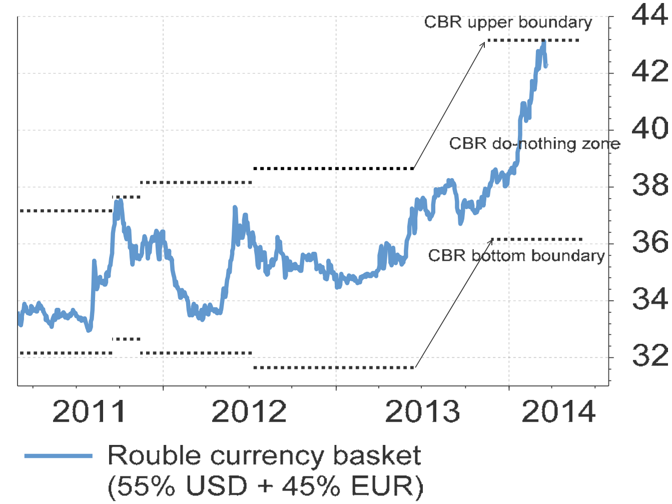
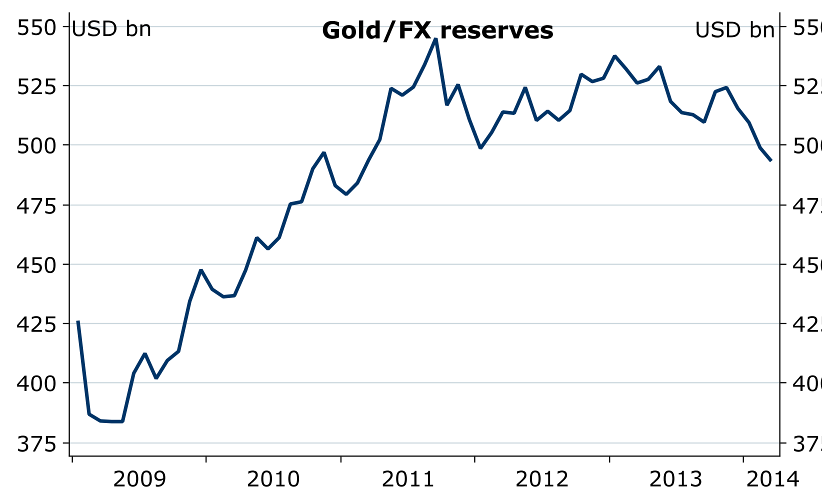
RUB: Sanctions bring uncertainty

The rouble has decoupled from the commodity market and other usual factors given geopolitical tensions over Ukraine. However, markets may revert to looking at fundamentals in the coming months.

- In January the RUB followed other EM currencies under pressure from the Fed's tapering and growth concerns. In Feb-Mar pressure on the RUB increased given tensions over Ukraine after the Crimea referendum and subsequent sanctions. The RUB lost >10% in Jan-Mar vs the currency basket.
- The capital outflow increasing to USD 50bn in Q1 2013 on uncertainties over sanctions is the major factor for the RUB currently. The Russian central bank was forced to increase key rates and to increase intervention to cap RUB losses. The RUB may stay volatile in the coming months.
- In the long run the RUB will likely revert from geopolitics to fundamentals as we do not expect an escalation of the conflict between Russia and Ukraine. The RUB may recouple with oil market dynamics. Our oil price forecast of USD 103-108/bbl for 2014-2015 is RUB-supportive.





Source: Nordea Markets and Macrobond

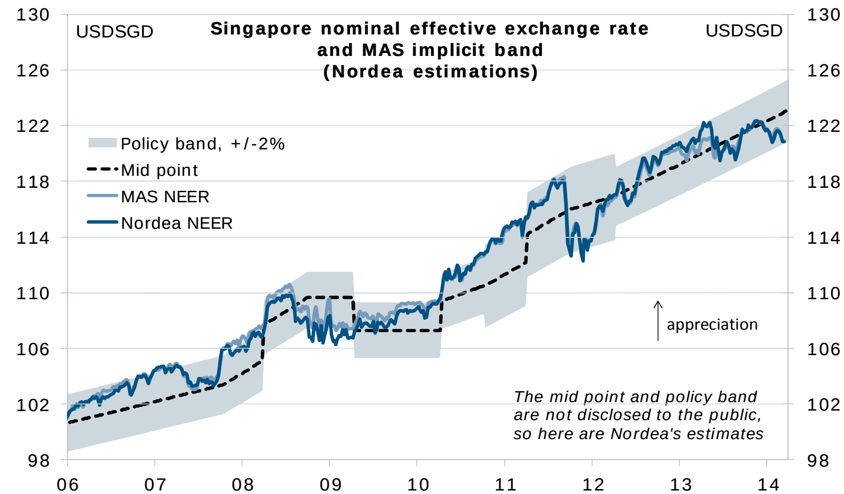
Market ignores fundamentals; focus on geopolitics

SGD: Bulletproof to tapering

The SGD has moved sideways in the past few months, averaging 1.25 vs the USD. The MAS supports a steadily appreciating SGD.

- The SGD is in a managed float regime against a weighted basket of currencies. The authorities focus on the nominal effective exchange rate (NEER), which they commit to appreciating gradually within a policy band that is estimated at +/-2%.
- The spot SGD has always tracked the NEER.
- During the tapering-initiated EM sell-off in May 2013, the SGD proved quite resilient. It averaged 1.25, a level we expect it to fluctuate around in the coming few months.
- Singapore is seen as a regional safe haven in Asia due to its impressively large surpluses. This provides upward pressure to the SGD vs other currencies.
- In addition, Singapore is expected to deliver robust growth this and next year (3.8% and 3.9%) according to a central bank survey; also positive for the SGD.

Regional safe haven status remains intact



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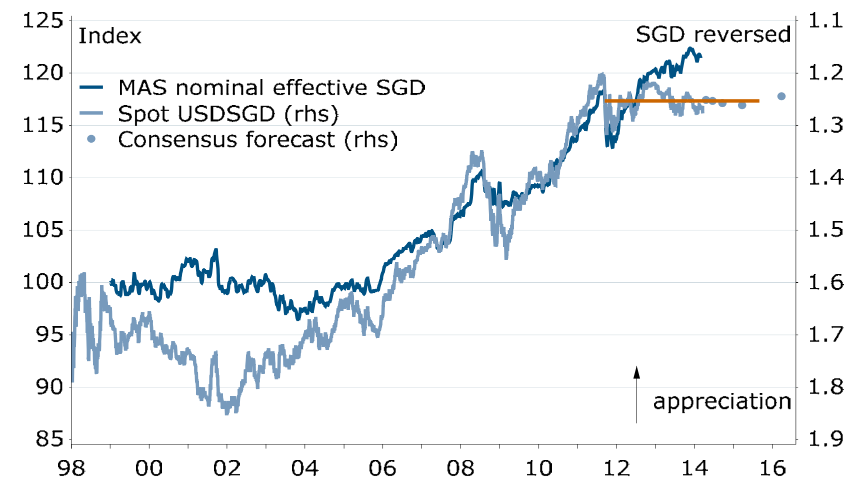


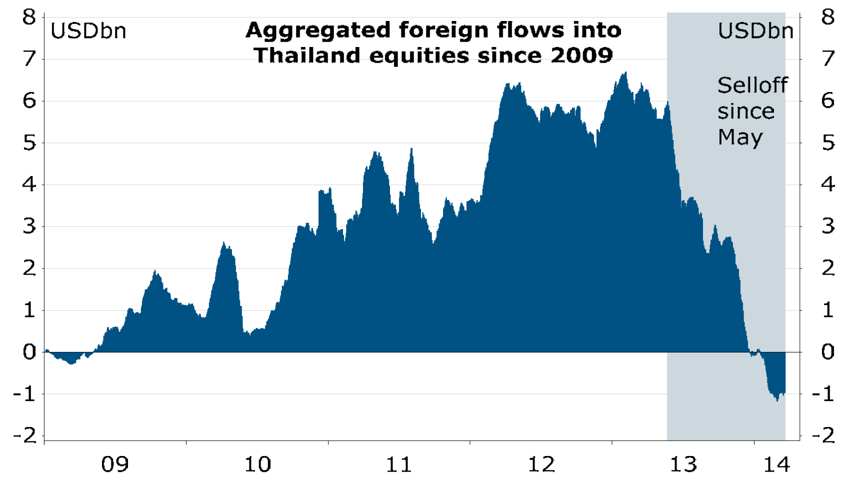
Source: Reuters Ecowin and Nordea Markets

THB: Triple whammy continues

The months' long political impasse seems to have eased in recent weeks, but the case remains open-ended and its outcome uncertain. The THB is unlikely to return to the pre-crisis level of 31 before a solution is found.

- Despite relatively strong fundamentals, the THB is subject to more downward pressure from three negatives: political turmoil, growth deceleration and the residential impact from tapering, with the political situation dominating the THB movements in the short term.
- Thailand's political riot since November has still not been fully resolved. The government needs to complete a general election to stay in power, which may give rise to another riot.
- Foreign capital outflows have been quite massive, all foreign equity inflows since 2009 have gone and the capital flight continues.
- Against this backdrop, we remain bearish on the THB, despite the recent improvement, which was mainly led by stock market gains.

The political crisis has dampened but is not over



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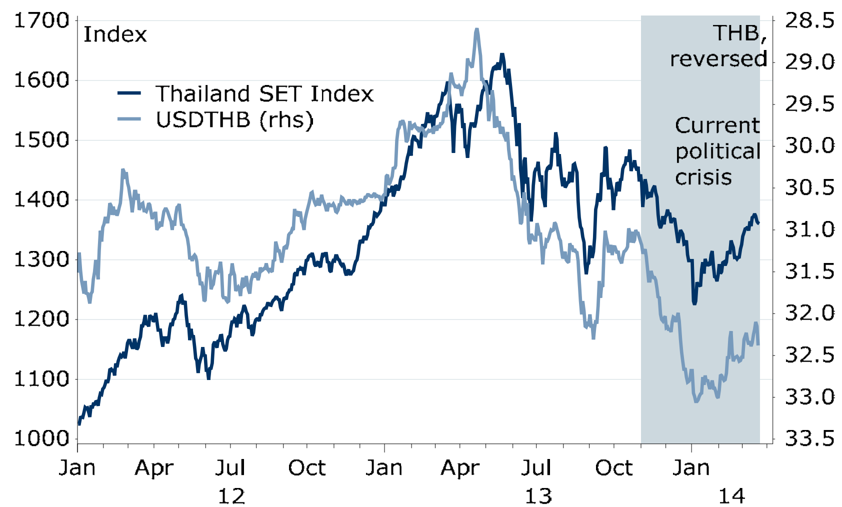


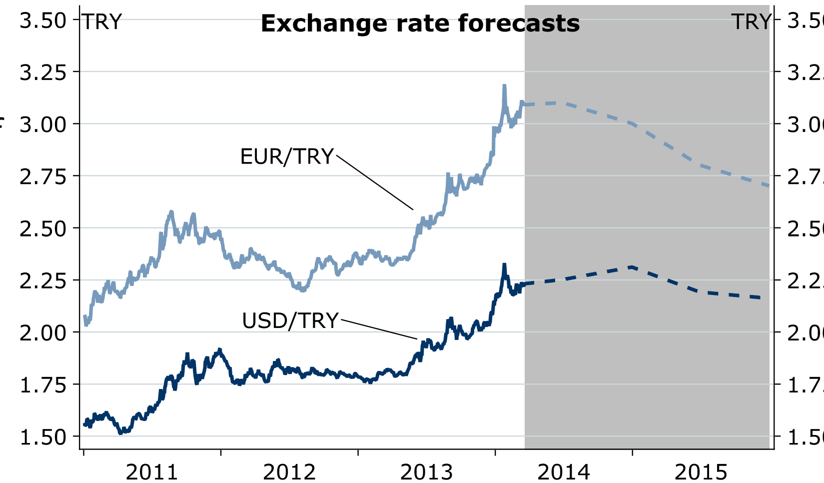
Source: Nordea Markets and Reuters Ecowin

TRY: Strong Erdogan – or no Erdogan

The Turkish lira continues to be weighed down by large external financing risks, but the real risk is that of a political one. Local elections on 30 March will be of great importance for the future political path.

- Local elections are of historic importance, but this time even more so as Prime Minister Erdogan has announced his exit if his AK party has a "weak" election: Strong Erdogan, or no Erdogan!
- Erdogan's government has been caught up in a corruption scandal since December, and the local elections will serve as a trust test for the ruling AKP.
- Judging from the polls, the most likely outcome is an AKP victory. We believe this will lead to a decline in the political risk premium and could prompt a small relief rally in the TRY.
- On the monetary side, massive TRY pressure during January prompted the central bank to hike rates by as much as 550 bp. As a result the TRY recovered some of its losses and has since then stabilised. CBRT to be on hold in the near term.

CBRT to adopt a strong stance against TRY weakness



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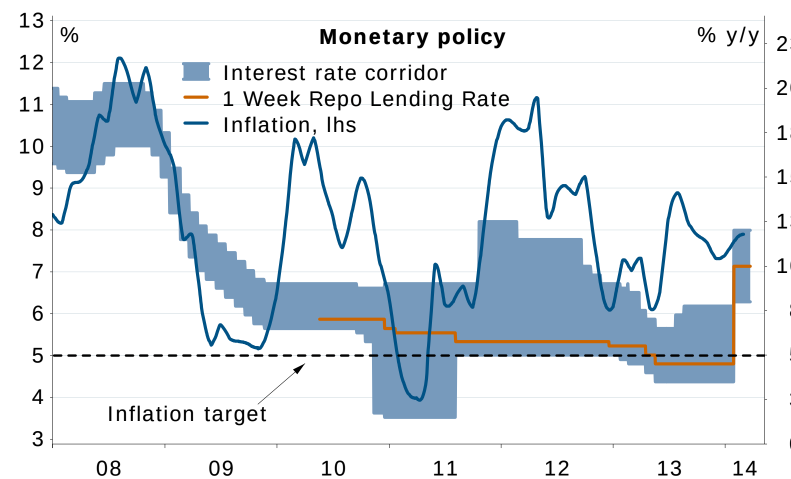


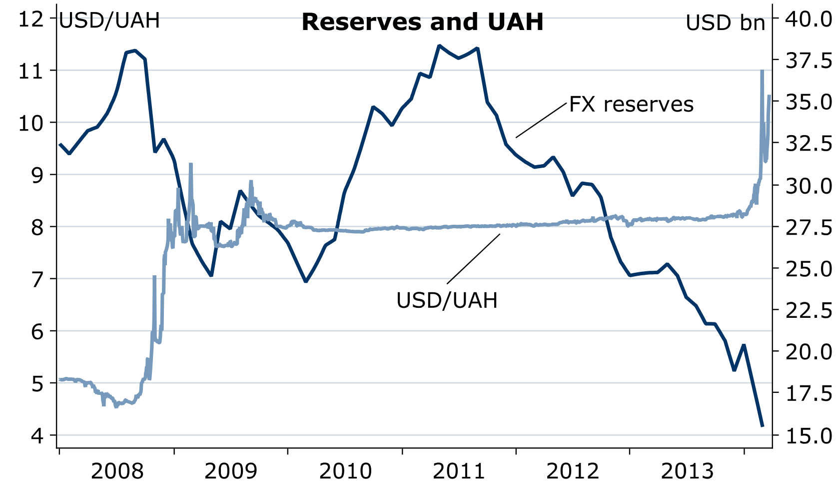
Source: Nordea Markets and Reuters Ecowin

UAH: Internal and external factors play against the currency

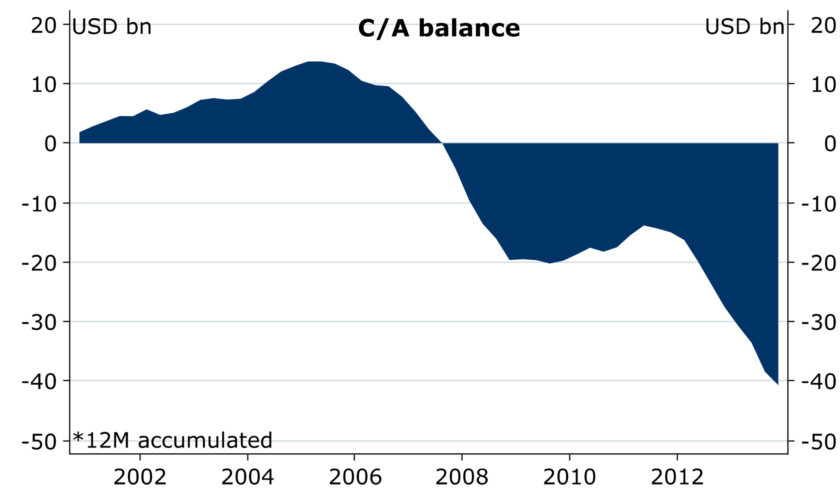
The Ukrainian hryvnia has been under pressure as the country is stuck in a political and economic crisis.

- Political instability and intensified geopolitical risks are weighing on the economy and the UAH.
- USD/UAH has fallen by 28% since the beginning of 2014.
- FX reserves have decreased by 25% during the past three months and currently cover less than three months' imports.
- The quickly deteriorating FX reserves forced the central bank to ease its grip on the currency and UAH slumped.
- Tensions with Russia add geopolitical risk, which also weigh on the UAH. The situation may start to improve after the presidential elections on 25 May.
- In the long term the widened current account deficit will continue to weigh on the UAH, which will likely continue its weakening trend against the USD and the EUR.

Vague perspectives



Source: Nordea Markets and Macrobond



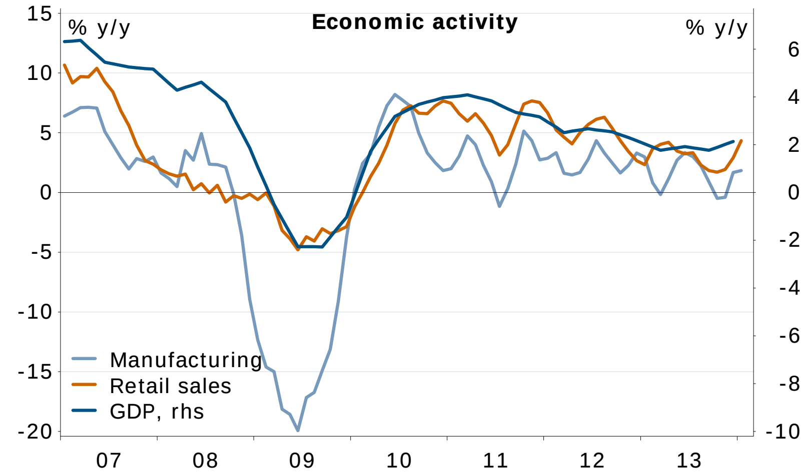
Source: Nordea Markets and Macrobond

ZAR: Soft turning point for the economy

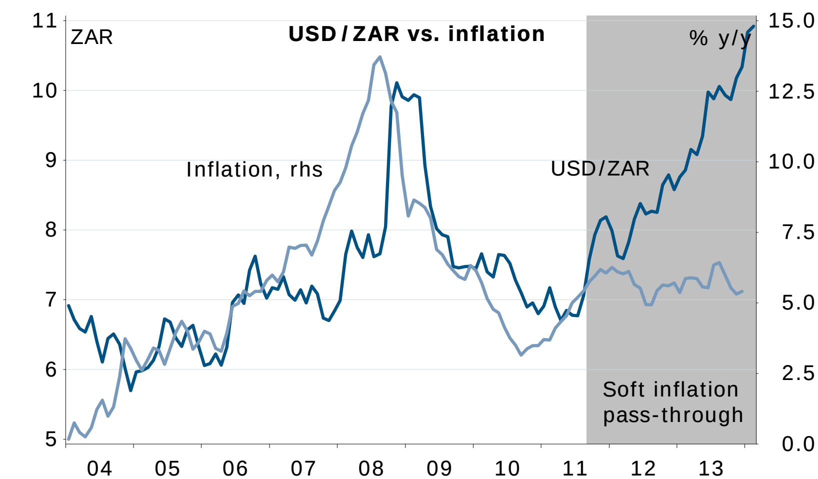
Domestic uncertainties, external imbalances and weak global demand will continue to weaken the South African rand. This will help reduce the current account deficit going forward.

- After recording the lowest quarterly GDP print since 2009 in Q3 2014, the South African economy surprised on the upside and accelerated to 3.8% q/q from 0.7% q/q.
- The main push factor for GDP growth was a strike unwind, causing a bounce back in manufacturing production growth. However, energy constraints, domestic unrest and still-weak activity in Europe will continue to weigh on growth in 2014.
- In January, the SARB surprised by a 50 bp hike, bringing the policy rate to 5.50% in an attempt to curb ZAR weakness. Sustained ZAR depreciation poses a challenge to the inflation outlook – and this is the main concern of the SARB.
- Looking ahead, the C/A deficit will only gradually improve helped by the weaker currency.

More room for rate hikes



Source: Nordea Markets and Reuters Ecowin



Source: Nordea Markets and Reuters Ecowin

Nordea FX forecasts

Exchange rates vs. EUR

	25/03/2014	3M	31/12/2014	30/06/2015	31/12/2015
EUR/USD	1.38	1.38	1.30	1.28	1.25
EUR/JPY	141.31	133.86	133.90	134.40	137.50
EUR/DKK	7.46	7.46	7.46	7.46	7.46
EUR/SEK	8.86	8.70	8.50	8.40	8.40
EUR/NOK	8.34	8.40	8.35	8.25	8.10
EUR/GBP	0.84	0.83	0.78	0.78	0.78
EUR/CHF	1.22	1.25	1.30	1.32	1.35
EUR/PLN	4.20	4.10	4.05	4.00	3.95
EUR/CZK	27.43	27.00	27.00	27.00	26.00
EUR/HUF	312.57	310.00	310.00	305.00	300.00
EUR/RON	4.47	4.50	4.45	4.40	4.25
EUR/TRY	3.10	3.10	3.00	2.80	2.70
EUR/KZT	252.14	255.30	234.00	227.20	218.75
EUR/RUB	49.39	48.30	44.85	43.52	42.13
EUR/LTL	3.45	3.45	3.45	3.45	3.45
EUR/ZAR	14.98	15.18	14.56	14.40	14.13
EUR/CNY	8.58	8.35	7.74	7.55	7.25
EUR/INR	83.71	82.80	75.40	70.40	66.25
EUR/BRL	3.21	3.31	3.25	3.26	3.25
EUR/MXN	18.24	18.22	17.03	16.13	15.25

Exchange rates vs. USD

	25/03/2014	3M	31/12/2014	30/06/2015	31/12/2015
USD/JPY	102.17	97.00	103.00	105.00	110.00
USD/DKK	5.40	5.41	5.74	5.83	5.97
USD/SEK	6.41	6.30	6.54	6.56	6.72
USD/NOK	6.03	6.09	6.42	6.45	6.48
GBP/USD	1.65	1.66	1.67	1.64	1.60
USD/CHF	0.88	0.91	1.00	1.03	1.08
USD/PLN	3.03	2.97	3.12	3.13	3.16
USD/CZK	19.83	19.57	20.77	21.09	20.80
USD/HUF	225.98	224.64	238.46	238.28	240.00
USD/RON	3.23	3.26	3.42	3.44	3.40
USD/TRY	2.24	2.25	2.31	2.19	2.16
USD/KZT	182.30	185.00	180.00	177.50	175.00
USD/RUB	35.71	35.00	34.50	34.00	33.70
USD/LTL	2.50	2.50	2.66	2.70	2.76
USD/ZAR	10.83	11.00	11.20	11.25	11.30
USD/CNY	6.20	6.05	5.95	5.90	5.80
USD/INR	60.52	60.00	58.00	55.00	53.00
USD/BRL	2.32	2.40	2.50	2.55	2.60
USD/MXN	13.19	13.20	13.10	12.60	12.20

Nordea rates forecasts

3-month rates

	Spot	3M	31.12.14	30.06.15	31.12.15
United States	0.24	0.30	0.55	1.05	1.60
Euroland	0.29	0.30	0.30	0.30	0.80
Denmark	0.30	0.35	0.45	0.55	1.05
Sw eden	0.93	1.00	1.35	1.70	2.05
Norw ay	1.71	1.70	1.70	1.70	1.70
United Kingdom	0.52	0.55	0.60	0.90	1.40
Poland	2.71	2.75	3.00	3.50	3.75
Russia	9.06	8.30	7.20	6.80	6.60
Latvia	0.26	0.20	0.20	0.35	1.00
Lithuania	0.41	0.40	0.40	0.30	0.80

10-year government

Country	Spot	3M	31.12.14	30.06.15	31.12.15
United States	2.70	2.90	3.25	3.60	3.90
Euroland	1.60	1.75	2.20	2.45	2.65
Denmark	1.68	1.80	2.30	2.55	2.75
Sw eden	2.20	2.47	3.00	3.15	3.30
Norw ay	2.96	3.19	3.60	3.59	3.62
United Kingdom	2.74	2.90	3.25	3.45	3.70
Poland	4.19	4.35	4.70	4.85	5.00

Monetary policy rates

Country	Spot	3M	31.12.14	30.06.15	31.12.15
United States	0.25	0.25	0.25	0.75	1.25
Japan	0.10	0.10	0.10	0.10	0.10
Euroland	0.25	0.25	0.25	0.25	0.75
Denmark	0.20	0.20	0.40	0.50	1.00
Sw eden	0.75	0.75	1.00	1.25	1.50
Norw ay	1.50	1.50	1.50	1.50	1.50
United Kingdom	0.50	0.50	0.50	0.75	1.25
Sw itzerland	0.05	0.05	0.05	0.05	0.50
Poland	2.50	2.50	2.75	3.25	3.50
Russia	5.50	7.00	5.50	5.25	5.00
China	6.00	6.00	6.00	6.25	6.25
India	8.00	8.00	8.00	7.75	7.50
Brazil	10.75	11.00	11.00	12.00	12.00
Czech Republic	0.05	0.05	0.05	0.05	0.50
Hungary	2.70	2.60	2.60	2.60	3.00
Romania	3.50	3.50	3.50	3.50	3.50
Turkey	10.00	10.50	11.00	12.00	12.00

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