Drobny Guest Research

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Market liquidity seems to have suddenly dried up. Just look at the violent moves in US high yield, some commodities, equities or FX. Greece, the US fiscal cliff and fears of economic slowdown have combined to make for a dangerous environment. This manager argues that something big has only just started in EMG FX. - *Andres Drobny*

Paradigm Shift: Emerging Market FX

Anonymous U.S. based macro manager

We are at the dawn of a new era in FX markets. For the last decade we were meant to buy EM FX on dips. Attractive growth rates, high real interest rates, solid trade dynamics, and modernization of capital markets were amongst the primary drivers. This dynamic was especially true with regard to Asian FX (ADXY Index, below).

But, now I believe that we are meant to sell EM FX on rallies. I am referring to the USD as the other side. This view would clearly be challenged in a world of further US QE but I am not certain of that. The unabated bull move for emerging markets is over as I see it.

Either:

1) A US economy that has a more sustainable recovery relative to the rest of the world (which should be more bullish USD) or

2) A US economy that doesn't sustain its recovery which leads to risk-off, fewer flows into EM and, in the worst circumstances, an EM rout.

Adding to the changing dynamics for emerging markets is China. Chinese FX is no longer a 1-way trade (the market's collective wisdom aka "the market price" shows that CNY will depreciate slightly in 2 year's time) which should be less bullish EM. And, the idea of rebalancing Chinese growth means, if achieved, that growth in China over the next decade will be sourced more from internal growth rather than from export markets (i.e. less of a trade balance pushing CNY stronger).

At the same time, countries like Brazil and Turkey are using an unorthodox policy mix that will make people reevaluate their long-term desire to invest in emerging markets. I don't know whether these policies are right or wrong. But I do know that in the last decade, the marginal flow of funds has gone to EM en masse. According to the figures I have seen, prior to 2008 something like 80billion flowed into emerging market funds. Post-2008, the figure is an astounding 210billion!! Did the post-2008 developed market policies of near-zero interest rates have the unintended consequence of forcing yield chasing in EMG? Does this not leave EMG exposed to a similar fate we witnessed in the developed market credit space in 2007-2008?

Bovespa

Emerging Market Bond Spreads

And, market prices do not reflect the range of uncertainties that continue to plague many of the emerging markets – corruption, unequal application of the law, lack of respect for property rights, unorthodox monetary policy, credit-driven growth, overreliance on exports and unsustainable social dynamics.

In a recent internal memo, I presented these ideas in a slightly less serious way as follows:

South Africa

•Criminal in Charge
•Currency Volatility
•No respect for ownership/property rights

Hungary

•Corruption and questionable application of the rule of law
•According to a committee set up to investigate allegations of plagiarism by President Schmitt, he lifted 17 pages of his doctoral thesis "wholesale from a paper written by Klaus Heineman, a German sports sociologist. A further 180 pages were party copied from Mr. Georgiev's work." Despite the overwhelming evidence, the committee found that President Schmitt should not be blamed. The problem lay rather with his supervisors who did not do their jobs properly. Mr. Schmitt's thesis met the formal requirements of the time. He will keep his degree."

India

•Valuations – if you can't drink the water, you shouldn't pay a higher multiple than the SP500.

Sensex:

Turkey

• Three words that will never stand the test of time: "Unorthodox monetary policy"

Brazil

• Nominal GDP growth and rates are destined to cross paths – question is whether this will occur at 2%.
• Price of $1 in R$2.04
• Price of 1 share of Petrobras $20.31
• Cost of Brazilian 5yr CDS 152bps
• Value of an option betting BRL continues to depreciate?....priceless

Argentina

• YPF as in, "Y did I ever invest in Argentina?"

Greece

• Only the Greeks could restructure their debt and still be at 2X the Maastricht Treaty limit – post-default

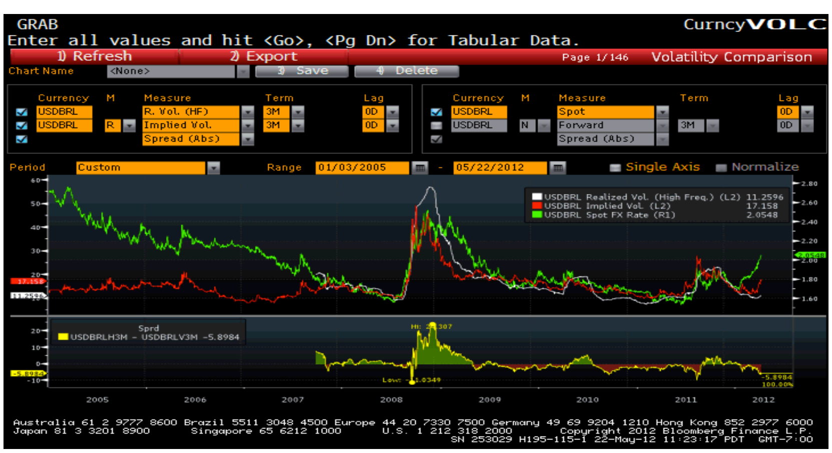
Add all this up and you get the theme: we seem to be taking down the EM fortress, one BRIC at a time.

More seriously, my sense is that we are at a crossroads and that is partly why FX trading has seemed so difficult. The old ways are resisting this change so you have pockets of EM strength but these are just countertrend rallies in a new USD bull trend. There will obviously be opportunities to go both ways in this trade or in specific pairs but I think that we should be short EM FX generally and if long, we should be paired off against other EM currencies.

Which currencies to sell right here and now? Everyone has their favorites. I note that the IDR looks on the verge of breaking out (1st overleaf). And USD/ZAR also looks capable of moving a long way (2nd).

But for me, it's the Brazilian Real that is one of the most overvalued of the emerging market currencies. The standard argument in favor of BRL is the attractiveness of the yields available in the domestic bond market. But, increased volatility, uncertain fiscal and monetary policies, changing trade dynamics, and overvalued domestic equity assets may cause investors to question whether they are being compensated for these risks. My favorite expression of the theme is to simply buy a USDBRL call or call spread.

Is the timing lousy for this trade given the recent sell off? In part, that is why I would express the trade through options. As shown below, despite the recent sharp sell off in the BRL, implied volatilities are only a couple of vols higher (implieds in red). And, skews for the 10d/25d 3mo calls are in the middle of the range. Also, according to State Street, as recently as last week real money flows into BRL continue to be neutral -- hardly a sign of panic……….yet.



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