# MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 083 // **September 19, 2022**

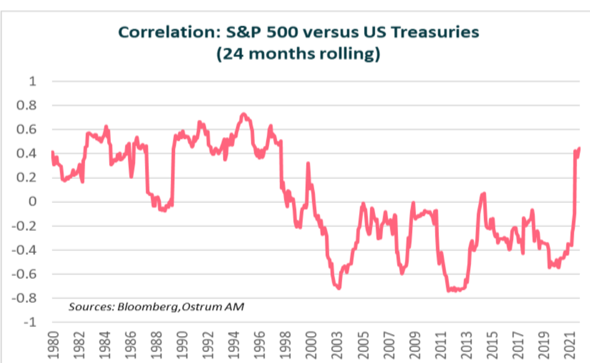

## Topic of the week: King Dollar spells trouble for Emerging Markets

- **The broad effective exchange rate of the dollar remained relatively stable against emerging currencies;**
- **However, in the current context of high food and energy prices, the strong dollar is putting pressure on heavily indebted countries to choose between feeding themselves and paying off their debts;**
- **Bilateral support from the IMF and China alleviates default concerns;**
- **This is a “game changer” for the external sovereign asset class.**

## Market review: The infernal cycle

- **US inflation sparked expectations of further tightening**
- **Sharp drawdown in US equities after the CPI release**
- **US yield curve inverts further**
- **Credit trying to find equilibrium**

## Chart of the week




For two decades, the Treasuries were a hedge against falling stocks, that is no longer the case today.

The Fed’s "hawkish" comments increased volatility between asset classes. The change in the inflation regime is also useally associated with a reversal of correlation matrix.

## Figure of the week

**70**

70%, the percentage of European CPI components accelerating. No signs of slowing down.

Source : Ostrum AM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## Topic of the week

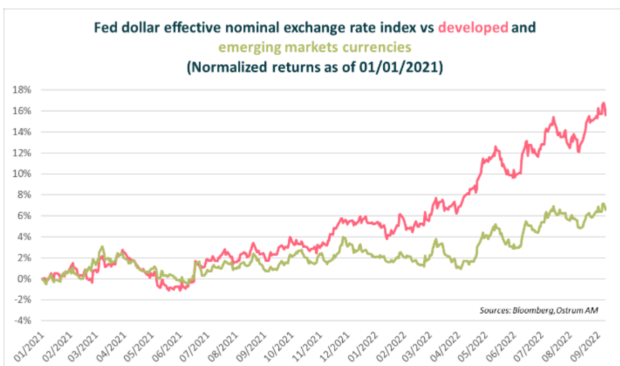
# King Dollar spells trouble for Emerging Markets

**High food and energy prices, slowing global trade, recession in China, geopolitical tensions… Rising global risks are putting pressure on emerging markets. The strengthening of the dollar further complicates the situation for heavily indebted countries. In this note, we identify investment opportunities in EM currencies and external sovereign debt.**

## In the current context of high food and energy prices, strong dollar is a serious threat to EM

### Developed currencies suffered the most from the rise of the dollar king

The dollar has reached a high since 1985, according to the Fed's nominal effective exchange rate index. However, it is interesting to note that the greenback has appreciated more against developed currencies than against emerging currencies, as shown in the chart below.




Rather, the dollar has stabilized against emerging currencies. This is due to real interest rates. Indeed, this time, the emerging central banks tightened their monetary policies before the Fed, to fight inflation. Thus, the positive real interest rate mattress served as protection against strengthening the greenback. However, in the current context of high food and energy prices, the strengthening of the greenback could complicate the situation of the most fragile countries, that is, the most indebted.

### Feeding or paying down debt… …

The strengthening of the dollar increases pressure on heavily indebted countries, which are already in turmoil, such as Sri Lanka and Pakistan. In the current context of high food prices, these countries must make a choice between feeding themselves or paying off their debts. Food shortages are catalysts for violent social tensions in emerging countries, such as those that have erupted in Sri Lanka. Moreover, these countries cannot borrow in their own currencies because of the volatile nature of the latter, which discourages international investors. These countries also have high dollar indebtedness which increases as the greenback appreciates against their currencies. The table below ranks countries in descending order of vulnerability[1].

The higher the ranking score, the more robust the country is. A low score reveals the vulnerability of the country.

| | USD sovereign yield (%) | CDS 5 year | Interest expenditure 2022 (% GDP) | Public debt (% GDP) 2022 | Ranking |
|---|---|---|---|---|---|
| Ghana | 25.59 | 3399.4 | 7.199 | 84.571 | 4 |
| El Salvador | 27.05 | 3327.64 | 4.891 | 82.561 | 5 |
| Egypt | 12.64 | 1085.16 | 8.168 | 93.984 | 5.5 |
| Tunisia | 29.03 | 1343.89 | 3.041 | 87.282 | 6.5 |
| Pakistan | 19.42 | 2265.7 | 4.773 | 71.288 | 8 |
| Kenya | 12.524 | 983.79 | 4.44 | 70.3 | 11 |
| Argentina | 27.56 | 5051.98 | 1.69 | 74.431 | 11.5 |
| Ukraine | 41.56 | 3657 | 2.859 | 49 | 12.75 |
| Bahrain | 7.036 | 285 | 4.53 | 116.547 | 13.75 |
| Namibia | 8.183 | 638.3 | 4.174 | 69.648 | 14.75 |
| Brazil | 6.33 | 253 | 7.182 | 91.888 | 15.25 |
| Angola | 11.7 | 482.166 | 4.046 | 57.901 | 16.75 |
| Senegal | 9.62 | 578.66 | 2.118 | 75.265 | 16.75 |
| Gabon | 11.99 | 737.24 | 2.398 | 57.441 | 17.75 |
| Ecuador | 18.93 | 908.81 | 1.274 | 62.2 | 18.75 |
| Dominican Republic | 7.77 | 390.53 | 2.917 | 59.368 | 19.25 |
| Turkey | 9.73 | 762.5 | 2.979 | 43.692 | 19.25 |
| Ethiopia | 35.876 | 3167.63 | 1.092 | 48.32 | 19.5 |
| Morocco | 6.71 | 250 | 2.381 | 77.119 | 20.5 |
| Nigeria | 12.67 | 870 | 2.31 | 37.428 | 20.75 |
| Costa Rica | 8.02 | 38 | 5.218 | 69.446 | 21.25 |
| Colombia | 7.72 | 142 | 2.943 | 60.6 | 22.5 |
| Mexico | 7.75 | 82 | 4.545 | 58.401 | 22.75 |
| Côte d'Ivoire | 8.22 | 433 | 1.954 | 51.805 | 23 |
| Hungary | 5.89 | 212 | 1.558 | 75.935 | 25.25 |
| Iraq | 13.35 | 890 | 0.694 | 35.042 | 25.5 |
| Serbia | 6.46 | 310 | 1.73 | 55.645 | 26 |
| South Africa | 7.69 | 274.5 | -6.365 | 70.212 | 26.75 |
| Uruguay | 4.73 | 100.661 | 2.386 | 65.653 | 28 |
| Panama | 5.84 | 149 | 2.151 | 56.037 | 28 |
| Romania | 4.73 | 295 | 1.615 | 55.994 | 29.25 |
| Oman | 6.482 | 250 | 1.534 | 43.959 | 30.25 |
| Indonesia | 5.22 | 122.75 | 2.616 | 42.707 | 31 |
| Malaysia | 4.48 | 82 | 2.177 | 69.25 | 30.75 |
| Philippines | 4.69 | 111 | 2.078 | 60.039 | 30.75 |
| China | 5.31 | 74 | 0.979 | 77.84 | 31 |
| Croatia | 3.89 | 97.5 | 1.28 | 78.124 | 31.5 |
| Guatemala | 6.2 | 31 | 1.72 | 30.591 | 37 |
| Chile | 5.45 | 268 | 0.355 | 38.27 | 35 |
| Kazakhstan | 6.49 | 255 | -0.242 | 27.616 | 35.25 |
| Peru | 5.57 | 121 | 1.311 | 34.364 | 36 |
| Poland | 3.75 | 145 | 1.292 | 53.293 | 35.75 |
| Vietnam | 4.47 | 148 | 0.994 | 41.261 | 38 |
| Qatar | 4.496 | 47.5 | 1.42 | 46.014 | 38.25 |
| U.A.E | 4.713 | 4.713 | 0.692 | 31.682 | 42.75 |
| Saudia Arabia | 4.61 | 48.5 | 0.333 | 24.059 | 43.5 |
| Koweit | 3.442 | 60 | -11.043 | 12.304 | 45.75 |
| | | | | Sources: Bloomberg,Ostrum AM | |

The most vulnerable countries are at the top of the table, such as Ghana, El Salvador, Egypt, Pakistan, and Kenya. These are highly indebted countries that no longer have access to external financing because of their soaring borrowing costs in dollars. For Ukraine, the debt data ends in 2021, not yet considering the war dimension.

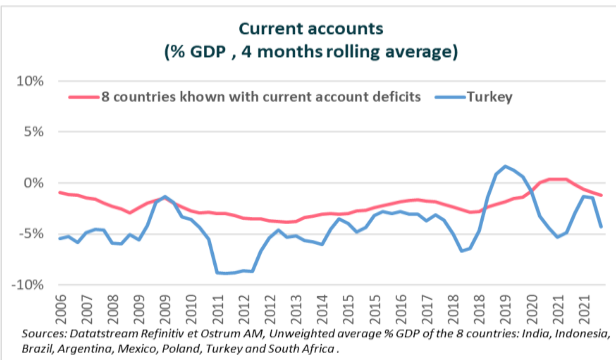
On the other hand, at the bottom of the ranking are the Gulf

[1] Ranking calculation: ranking for each country of the 4 indicators from the worst to the best and calculating an average of the different rankings. A high ranking indicates that the country is robust, a low ranking indicates that the country is vulnerable.

countries, major producers of fossil fuels, which are the least vulnerable. High energy prices are rapidly improving their growth and fiscal prospects.

### Current account positions of net commodities importers are deteriorating…

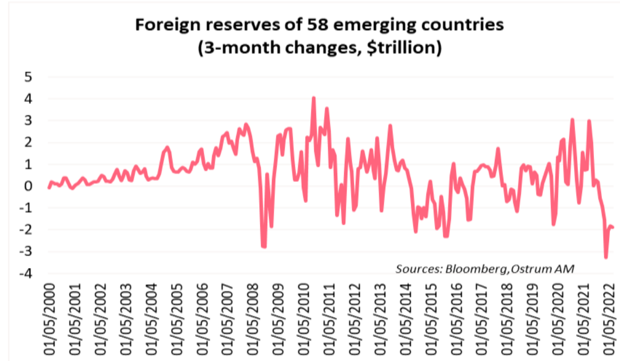
One of the reasons emerging markets have been resilient so far has been their current accounts surpluses. The pandemic allowed them to recover quickly, reflecting the closure of their economies that resulted in a contraction in imports. This is no longer the case today. The chart below shows the current account balance for the eight known countries with current account deficits.




Current account deficits began to widen as early as 2021, reflecting the reopening of economies following the lifting of mobility restrictions, causing a rapid recovery in imports, deepening current account deficits. Over the recent period, deficits are widening for net importers of raw materials, especially food and energy. Indeed, the strengthening of the dollar increases energy and food bills. This is the case for Turkey, which imports more than 60% of its energy needs and whose falling pound increases its energy bill. The current account widened to 4.3% of GDP in May 2022. On the other hand, external positions are improving for the net producing countries whose economies depend heavily on tourism.

### … As well as liquidity cushions

Rising food and energy prices have put the central banks of poor countries in the face of difficult choices to use their foreign exchange reserves: to feed themselves or to repay their debt. The chart below shows that foreign reserves in 58 emerging markets (including China) have recorded their largest decline since 2008.

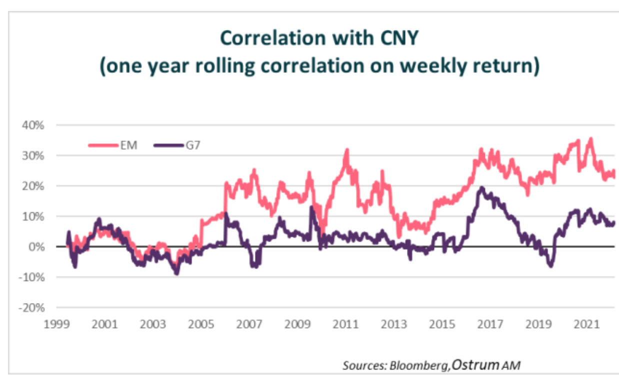



As risks increase (strong dollar), EM's Central Banks burn their foreign exchange reserves to defend their currencies against the greenback. If the upward trend in the dollar continued, it would put additional pressure on poor countries, whose cash mattresses are melting like snow in the sun.

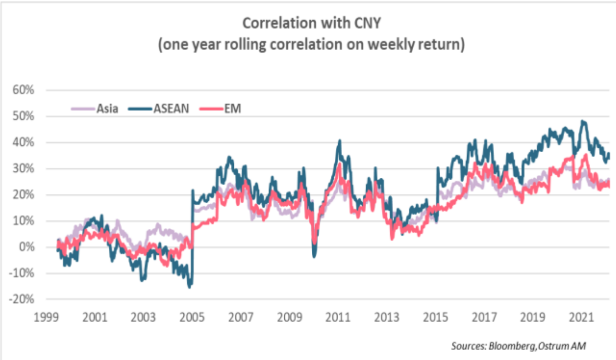
## The yuan has emerged as a new risk for EM

The Chinese currency did not resist the strength of the greenback. The yuan has depreciated more than 8% against the dollar since the beginning of the year. The parity of the yuan against the dollar is approaching 7, close to the 7.2 threshold that had in 2019 and 2020 forced the Chinese authorities to curb the depreciation of their currency.

However, the weakness of the yuan vis-à-vis the dollar is an additional factor of pressure on EM currencies. The chart below shows the correlation between the Chinese currency and other currencies.



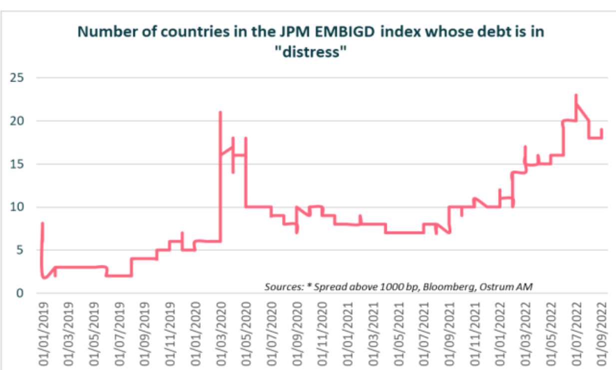

The correlation is most significant with emerging markets currencies, around 25%, while it is only 10% for developed countries. We note that the correlation with emerging markets currencies increased significantly in 2015, year of the depreciation of the yuan that had shaken the world financial markets. The correlation is particularly strong, close to 40%, with ASEAN currencies, as shown in the chart below.




The opposing monetary policy orientations between the Fed and PBoC should weigh negatively on the Chinese currency by increasing its volatility. This is an additional factor of instability for emerging markets currencies. Emerging markets currencies find themselves torn between the strength of the dollar and the weakness of the yuan.

# Bilateral IMF and China support alleviates default fears

The number of countries in the EMBIGD JPM Index whose debt is in "distress", i.e., whose risk premium is above 1,000 bps, increased significantly in 2022, reflecting the escalation of global risks on emerging countries.




These countries no longer have access to external financing because of the soaring cost of borrowing in dollars. They also face large external debt repayment maturities. As an illustration, Egypt must repay $4 billion in November and $3 billion in February 2023. Nevertheless, Egypt can count on the financial support of the Gulf countries (deposits with the Central Bank) to honor its commitments.

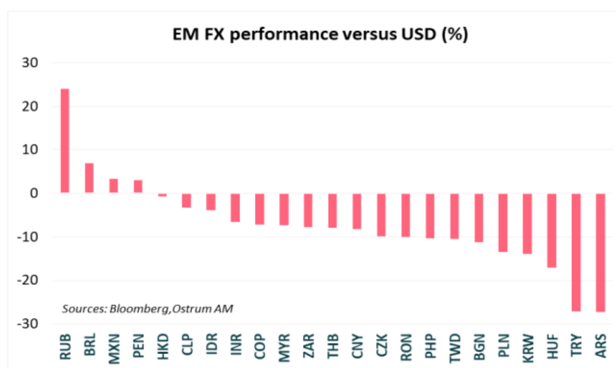
It can be noted that the number of countries in "distress" has decreased over the recent period, stabilizing at 18 countries.

This reflects the financial intervention of the International Monetary Fund (IMF) and China. Over the past two weeks, the IMF has concluded loan agreements or approached some of the most vulnerable countries. This is the case for Pakistan, Sri Lanka, Zambia, Egypt, and Chile, after months of negotiations. China has also overcome its reluctance to provide debt relief, saying it will cancel the (23) loans from 17 African countries and redirect its US$10 billion in IMF reserves to aid the continent. China accounts for 40% of the bilateral debt and private creditors that the world's poorest countries must repay this year, according to the World Bank. Bilateral support helps to allay concerns about default risk for the countries concerned. The IMF appears to be becoming increasingly responsive to the challenges faced by the most fragile countries.

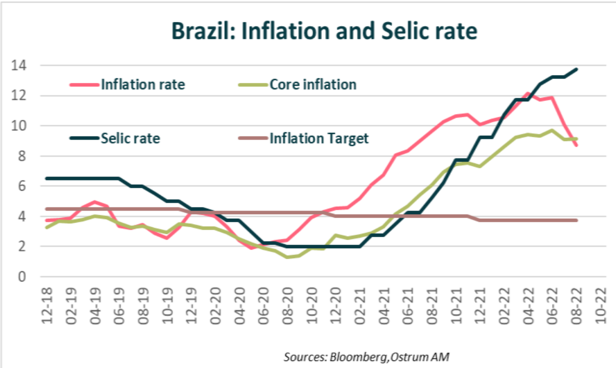
# Markets Strategy

## EM currencies have had different behaviour towards the strong dollar

The strength of the dollar penalized emerging markets currencies this year. However, we see that they behaved differently. Currencies that have benefited from positive real rates, and whose countries have a diversified commodity export base, have weathered the strength of the dollar best. This is the case for Latin American currencies. Since the beginning of the year, the emerging market currency that recorded the best performances against the greenback (excluding the ruble) is the Brazilian real, at nearly 7%!




The Brazilian currency enjoyed a positive real interest rate of 5.02% (key interest rate less the inflation rate), which allowed it to better withstand the strength of the dollar. It is the only currency among the top five Latin American countries that has a positive real interest rate. The inflation's outlook should continue to improve. Brazilian inflation peaked at 12.13% in April, then slowed down rapidly to 8.73% in August, as shown in the chart below.



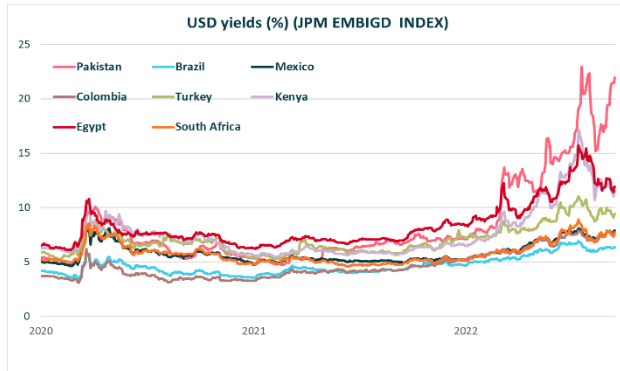

The Brazilian Central Bank is nearing the end of its cycle of monetary tightening, which should raise the country's real rates, thus strengthening the attractiveness of the Brazilian currency. The presidential election that will take place on October 2 could bring some volatility on the real, but investors seem to have well integrated the outcome of the election. At this stage, we think it is wise to play with the fall in local Brazilian rates, considering the currency which benefits from a very attractive real interest rate.

Another example is the Mexican peso, whose real interest rate is close to 0% at - 0.2%. Banxico is determined to combat the acceleration of inflation, with the implicit objective of reducing the interest rate differential with the United States. The prospect of continued monetary tightening and a slowdown in inflation in Mexico should benefit the peso.

In Asia, the Indonesian Rupiah was also the strongest currency. Since the beginning of the year, the Rupiah has only depreciated by 4% against the dollar. Indonesia has historically enjoyed the highest real interest rates in the region. In the absence of inflationary pressures, the Indonesian Central Bank had not raised its policy rate, which it had just raised for the first time in July from +25bps to 3.75% (inflation was 4.7% in August). Indonesia has a varied raw material export base. The country is a major producer and exporter of coal to China (it is its main supplier, following the embargo on Australian imports). This should support Indonesia's current account and Rupiah.

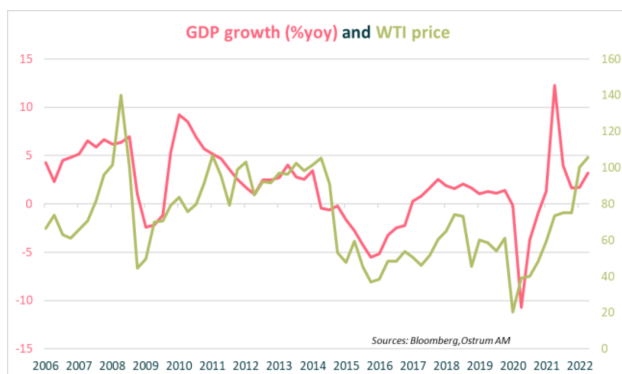
## External sovereign debt: IMF and China's bilateral support is a game-changer for the asset class

Borrowing costs in dollars have increased for emerging countries, especially for heavily indebted countries like Pakistan. Its dollar cost of borrowing has increased fourfold since 2020, as shown in the chart below.

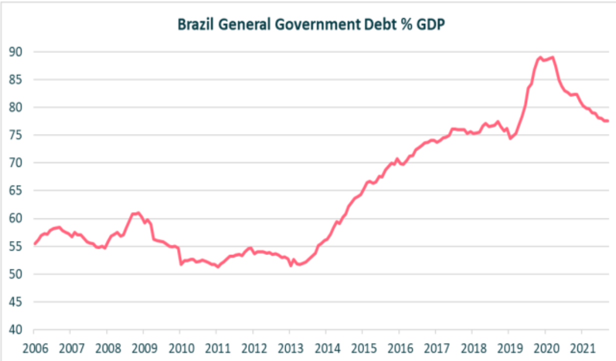



Overall, tensions have eased in these countries, except for Pakistan, which has recently been hit by devastating floods, significantly worsening its economic prospects. However, these countries still do not have the possibility to go into external debt, because of the borrowing costs in dollars that remain high. Bilateral support from the IMF and China to the most vulnerable countries reduces the risk of default. This is a real positive catalyst for the asset class.

The other key point to note is that there is no contagion to other emerging countries. So, there is no systemic risk. Investors seem to be discriminating. Net exporters of raw materials (diversified export base) are expected to be the best placed in this environment of strengthening the dollar. This is the case for Brazil, whose GDP growth prospects are expected to improve in the wake of rising crude oil prices, as shown in the chart below.




Over the period 2014-2019, the fall in crude oil prices had penalized Brazilian growth, explaining the sluggish growth over the period. The trend is reversing for Brazil's growth momentum, which is rapidly improving its fiscal outlook, as shown in the chart below. The debt-to-GDP ratio fell rapidly from almost 90% of GDP in 2020 – reflecting pandemic spending – to 77% of GDP in July 2022. Brazil is the first of the top five countries in Latin America to withdraw significant fiscal support (8% of GDP) from the pandemic.




# Conclusion

While the effective exchange rate of the dollar has remained stable against emerging markets currencies, in the current context of high food and energy prices, the strong dollar is an additional risk for highly indebted emerging markets. These countries must choose between feeding themselves or paying off their debts. Tensions related to their sovereign risk premiums have generally eased, thanks to bilateral financial support from the IMF and China. However, these countries still do not have the opportunity to incur external debt because of the high borrowing costs in dollars. Restructuring their debt seems inevitable in the medium to long term. However, fears of default have eased, eliminating systemic risk in other emerging markets. Discrimination by country plays its full role. The countries producing raw materials and whose export base is varied seem to be the best off in this environment.

**Zouhoure Bousbih**

## Market review

# The infernal cycle

### US Inflation is torture for markets as it hints at further Fed Funds hikes and valuation adjustments

All it took was a slight upside surprise in US consumer prices to wipe out the sharp rebound in equities seen after the ECB's 75bp rate hike. Inflation at 8.3% gave rise to expectations of a 100 bp hike in Fed funds at the FOMC scheduled for September 21. The hawkish turn of central banks is gaining renewed traction. The correction in equities was brutal. The S&P tumbled 4% following the August CPI release before losing another 1% on mixed economic data. Thus, uncertainty about the cyclical high on policy rates keeps pressure on risk premia – both valuation multiples and credit spreads. The T-note is trading above 3.40% as the 2-year yield is approaching 4%. In the euro zone, the Bund is following the upward movement, but without prejudice to sovereign spreads. The 4% threshold on the Italian debt holds despite the upcoming elections. Corporate credit remains subject to rising interest rates, especially as the primary market activity picks up. The volatility of the iTraxx CDS indices highlights the nervousness of the market participants. On the foreign exchange market, the yen and the yuan continued to fall. The BoJ meeting, a day after the FOMC, will be an opportunity to communicate on the historic weakness of the Japanese currency partly caused by ongoing QE purchases.

US inflation obviously remains well above the levels targeted by the Fed. The CPI was up 8.3% over one year. Core inflation, excluding energy and food, rebounded to 6.3%. While the decline in gasoline prices was expected, it did not mask the inertia of inflation across most categories. Trimmed consumer price indices (taking out the largest rises and falls in prices) give a better idea of the general trend in inflation than core inflation. The trimmed index thus stood at 7.2% in August and shows no slowdown. Likewise, the most inert prices continue to accelerate at 6.1% according to the calculation of the Atlanta Fed. A further rise of 75 or even 100 bp is looming this week, but the challenge now is to know the level of rates required to slow down employment, wages and, ultimately, bring down inflation. The rate cuts projected by the market in 2023 are fading in favor of a high plateau on Fed funds around 4.25%.

The rates market continues to adjust after the odd rally of the summer. The rise in yields is detrimental to risky assets and the selling pressure is logically stronger on the shorter maturities. The T-note (3.47%) hover about its 2022 peaks and the 2-year is eyeing 4%. The inversion of the US yield curve has become more pronounced. In Europe, the Bund (1.80%) is projected at 2% at the end of the year. The shortage of collateral continues to push up swap spreads, but the ECB has further means to intervene. We expect a gradual tightening of swap spreads. This will be beneficial to covered bonds and agencies as well as to the sovereign sphere, which has held up despite the sharp drop in equities. Sovereign spreads appear to ignore Italian risk, thanks to potential TPI support and ECB arbitrages (using PEPP proceeds). The upgrade of Portugal's rating to BBB+ is also a support factor. Inflation breakevens are stabilizing after their overreaction to the fall in oil prices and the willingness displayed by the EU to quickly put an end to the upward spiral in electricity prices. Inflation inertia and the acceleration of labor costs in the euro zone (+4% in 2Q 2022) however continue to argue for a constructive position on indexed bonds in the euro area.

Credit remains volatile with, however, homogeneous returns across the various market segments last week. Competition from higher sovereign yields is limiting the attractiveness of credit, but there is light at the end of the tunnel as regards flows into credit funds. The upcoming roll of CDS indices will nevertheless encourage the purchase of credit protections. IG euro spreads are hovering around 200bp against Bund. Primary market activity is sustained. Issuance is met by good demand, but the generous issue premiums shift the bond spreads on the secondary market. On the other hand, high yield spreads are wide enough to enable some tightening despite ongoing high yield fund outflows. The Crossover index trades around 550 bps.

The drawdown on equities came from the United States. The S&P fell 4% after the CPI as the rate expectations drifted higher. Growth stocks are the most sensitive to higher yields, but the decline is widespread across sectors. The energy outperformed modestly. Europe is caught up in the equity correction, especially as US hedge funds accumulate short positions on European stocks. Paradoxically, profits are holding up.

**Axel Botte**

Global strategist

## Main market indicators

| G4 Government Bonds | 19-Sep-22 | -1wk (bp) | -1m (bp) | YTD (bp) |
|---|---|---|---|---|
| EUR Bunds 2y | 1.61 % | +29 | +78 | +223 |
| EUR Bunds 10y | 1.80% | +15 | +57 | +198 |
| EUR Bunds 2s10s | 19 bp | -14 | -21 | -25 |
| USD Treasuries 2y | 3.96 % | +39 | +73 | +323 |
| USD Treasuries 10y | 3.49 % | +13 | +52 | +198 |
| USD Treasuries 2s10s | -47 bp | -26 | -21 | -125 |
| GBP Gilt 10y | 3.14 % | +4 | +101 | +217 |
| JPY JGB 10y | 0.26 % | +1 | +6 | +19 |
| **€ Sovereign Spreads (10y)** | 19-Sep-22 | -1wk (bp) | -1m (bp) | YTD (bp) |
| France | 55 bp | -2 | -3 | +17 |
| Italy | 232 bp | +1 | +5 | +97 |
| Spain | 115 bp | 0 | -1 | +40 |
| **Inflation Break-evens (10y)** | 19-Sep-22 | -1wk (bp) | -1m (bp) | YTD (bp) |
| EUR OATi (9y) | 164 bp | +5 | +13 | - |
| USD TIPS | 237 bp | -5 | -19 | -23 |
| GBP Gilt Index-Linked | 410 bp | -6 | +8 | +16 |
| **EUR Credit Indices** | 19-Sep-22 | -1wk (bp) | -1m (bp) | YTD (bp) |
| EUR Corporate Credit OAS | 201 bp | +4 | +22 | +106 |
| EUR Agencies OAS | 85 bp | +1 | +6 | +36 |
| EUR Securitized - Covered OAS | 102 bp | +2 | +7 | +57 |
| EUR Pan-European High Yield OAS | 561 bp | +7 | +32 | +243 |
| **EUR/USD CDS Indices 5y** | 19-Sep-22 | -1wk (bp) | -1m (bp) | YTD (bp) |
| iTraxx IG | 112 bp | +7 | +10 | +64 |
| iTraxx Crossover | 553 bp | +39 | +33 | +311 |
| CDX IG | 89 bp | +10 | +9 | +40 |
| CDX High Yield | 531 bp | +68 | +65 | +238 |
| **Emerging Markets** | 19-Sep-22 | -1wk (bp) | -1m (bp) | YTD (bp) |
| JPM EMBI Global Div. Spread | 505 bp | +14 | +19 | +137 |
| **Currencies** | 19-Sep-22 | -1wk (%) | -1m (%) | YTD (%) |
| EUR/USD | $0.999 | -1.49 | -0.44 | -12.11 |
| GBP/USD | $1.140 | -2.67 | -3.66 | -15.78 |
| USD/JPY | ¥143.45 | -0.86 | -4.52 | -19.78 |
| **Commodity Futures** | 19-Sep-22 | -1wk ($) | -1m ($) | YTD ($) |
| Crude Brent | $90.7 | -$3.3 | -$5.4 | $16.9 |
| Gold | $1 666.7 | -$65.2 | -$80.4 | -$162.5 |
| **Equity Market Indices** | 19-Sep-22 | -1wk (%) | -1m (%) | YTD (%) |
| S&P 500 | 3 863 | -6.02 | -8.64 | -18.95 |
| EuroStoxx 50 | 3 495 | -4.16 | -6.32 | -18.70 |
| CAC 40 | 6 051 | -4.46 | -6.84 | -15.40 |
| Nikkei 225 | 27 568 | -2.29 | -4.71 | -4.25 |
| Shanghai Composite | 3 116 | -4.49 | -4.37 | -14.40 |
| VIX - Implied Volatility Index | 26.85 | 12.48 | 30.34 | 55.92 |

Source: Bloomberg, Ostrum Asset Management

## Additional notes

**Ostrum Asset Management**

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