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Monthly Insight

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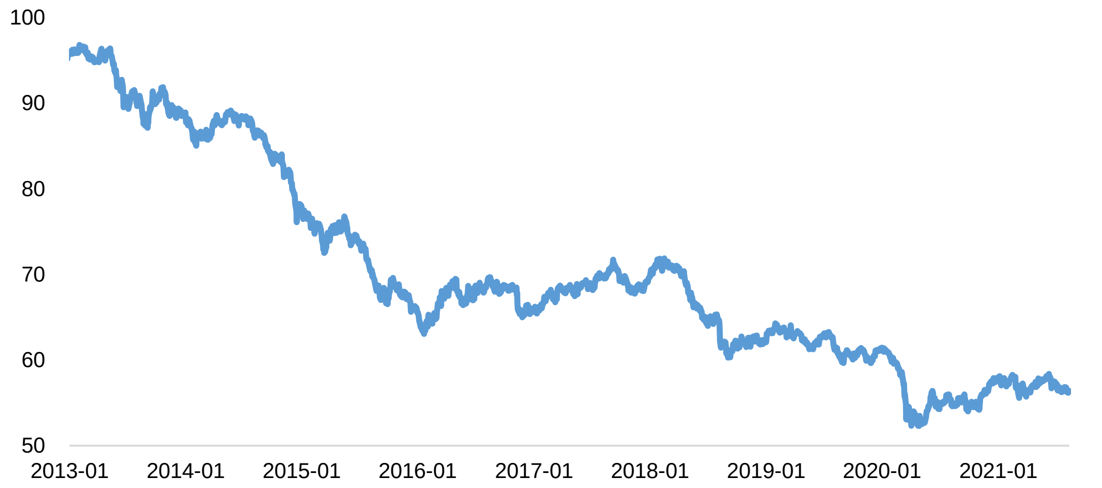
Fire and Ice

- **The EM selloff triggered by 2013 taper tantrum is broad-based, with its value losing an eye-watering of 7% in a year. If history rhymes, EM currencies are due for a meaningful drop.**
- **"Over-categorization", according to American psychologist Gordon Allport, "is perhaps the commonest trick of the human mind."**
- **In 2013, EM countries running a current account surplus have not been sheltered from the sell-off, this is far from a contagion.**
- **Taper has been a wet blanket, but not necessarily a deal-breaker.**

Theme Article

Every bull market has its signature sector, and emerging markets (EM) are typically the place to be. Buoyed by ease credits and contained virus outbreak, the EM currency as a whole is currently sporting a 7.8% gain from its low recorded last May (Exhibit 1).

Exhibit 1: JPM EM Currency Index



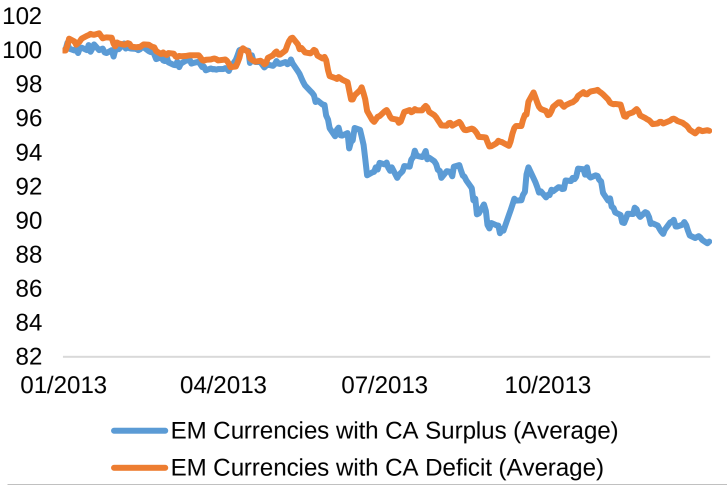
Source: Bloomberg, JPM

Leader of a single lap, however, doesn't always win the race. Denied its past self, the Fed suddenly feels the inflation goal has been met. Taper, once like an old furniture that was warehoused, moves back into the spotlight. Make no mistake: QE withdrawal is not a threat of negligible order. Evoking a sense of déjà vu, the EM selloff triggered by 2013 taper tantrum is broad-based, with its value losing an eye-watering of 7% in a year. If history rhymes, EM currencies are due for a meaningful drop.

Intuitively, investors shall not touch EM assets with a 10-foot pole. This makes sense, but up to a point. We would hasten to add that, "over-categorization", according to American psychologist Gordon Allport, "is perhaps the commonest trick of the human mind." This mental shortcut clarifies everything, making us feel ease, energizing us to act. But it blurs out important details.

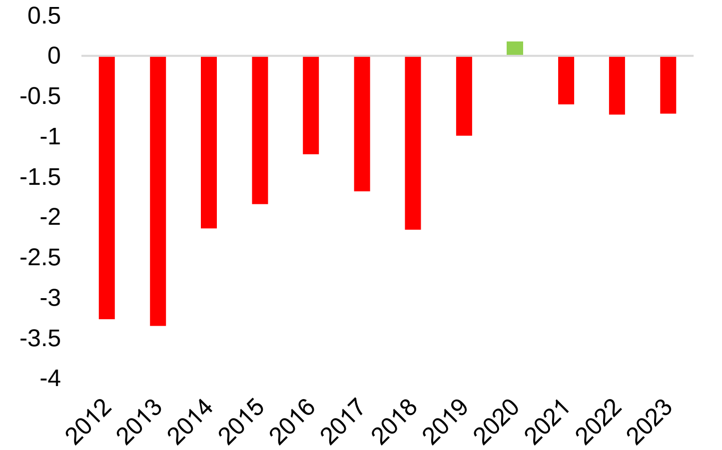
Just eyeballing Exhibit 2, one can immediately tell that, while EM countries running a current account surplus have not been sheltered from the sell-off, this is far from a contagion. Said differently, taper has been a wet blanket, but not necessarily a deal-breaker.

Exhibit 2: EM FX Performance (Jan 2013 = 100)



Source: Wind, Shanghai Commercial Bank

Exhibit 3 (: CA Balance of EM Deficit Group (% of GDP)



Source: IMF, Shanghai Commercial Bank

Why would EM currencies with current account surplus fared relatively well against its deficit-laden peers? To avoid taxing reader's patience, let us pull the rabbit out of hat now. The answer lies in its foreign reserves.

Much of the surplus-blessed central bank's balance sheet consists of foreign assets, instead of domestic assets. When the foreign reserves reach levels that generate substantial returns, the currency is indirectly backed by the foreign reserves, and not a purely 'fiat' currency that derives its value solely from the policymaker's credibility in question. This is not the sole force in play: any depreciation in local currency would mechanically boost the value of its foreign holdings. This negative correlation helps compress volatility and thus offer a better risk-reward ratio to number-crunching trader.

Investors need a compass with which to navigate the uncertainty, and understandably, many grabbed the one most readily available. Still, we shouldn't lump EM with current account surplus together with the rest of EM. Even for deficit-laden countries, its current account balance is on track of improvement over years (Exhibit 2). Perhaps the gloomy thoughts about a looming apocalypse are merely a sign that perma bear needs a summer holiday.

UK

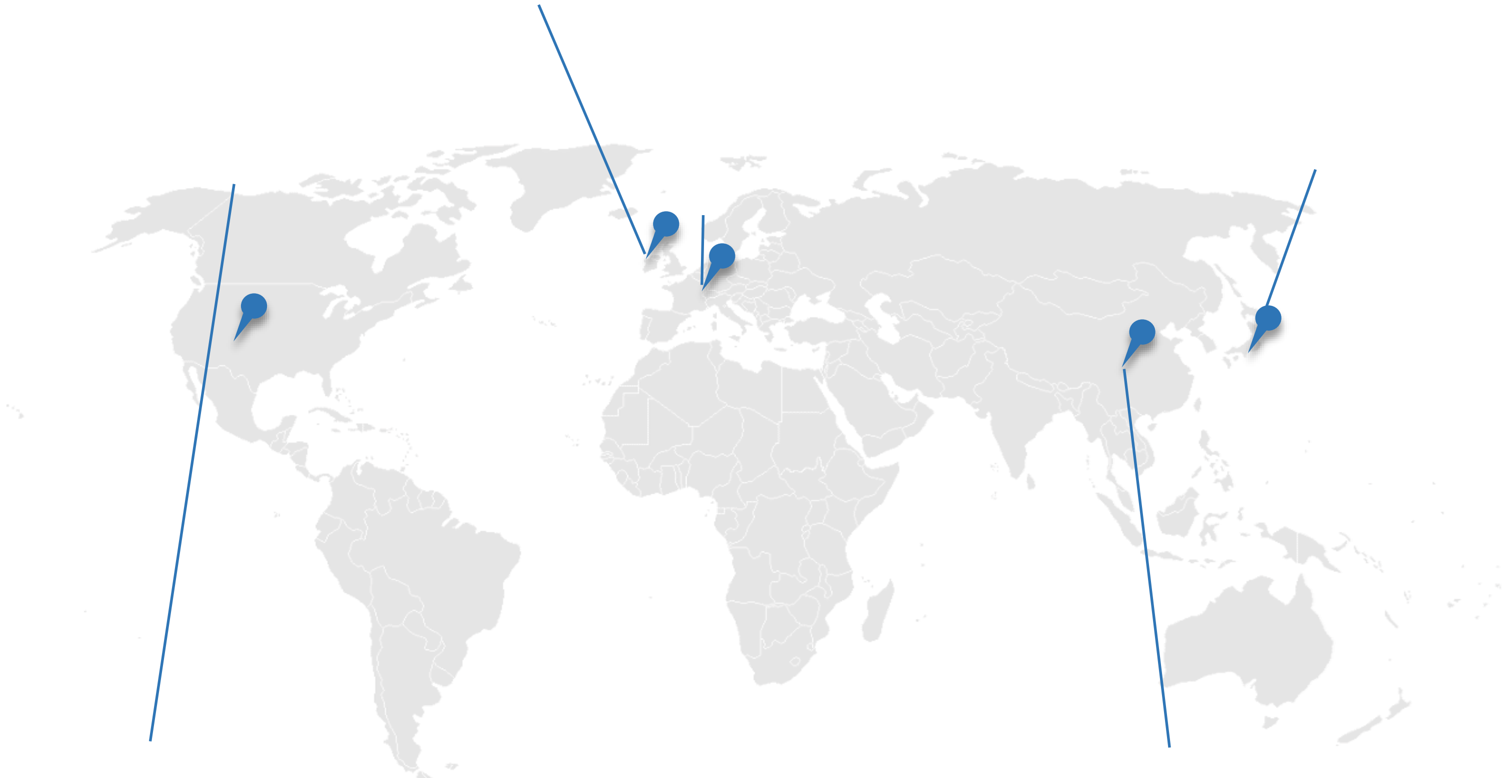
GDP growth accelerated in June as hospitality reopened further. The elevated inflation will likely continue to give the market reasons to expect the BoE to hike early.

EU

The decline in infections among most of the EU hotspots looks quite heartening. The journey back to social normality could be gradual, though.

Japan

Mobility in Japan started to decline in the wake of the fifth infection wave that struck the country in late July. The economy will returns to normal in tandem with rapid rollout in vaccinations.



US

July's employment report checked all the boxes: solid jobs gain, a marked decline in the unemployment rate, a spike in average hourly earnings. Following the passage of the bipartisan infrastructure deal, market focus shifts to the resolution of debt ceiling.

Mainland China

The rapidly COVID outbreak clouds Chinese outlook. In couple with regulatory headwinds, the consumption recovery sets to be lackluster in the short run.

Foreign Exchange Outlook

USD	Overweight / Neutral / Underweight	The Fed is deliberately leading markets towards the inevitable announcement on tapering. With the newfound hawkish tilt, the greenback should remain bid on dips, though the introduction of standing repo facility and the resulting liquidity will cap the upside of dollar rally.
EUR	Overweight / Neutral / Underweight	Volumes still seem to be rather mild during the holiday season. Traders are on guard, a break below key resistances 1.17 could very well attract short-sellers, especially the longer term bulls might have to reassess positions.
GBP	Overweight / Neutral / Underweight	COVID cases in the highly-vaccinated UK are slowly moving lower, providing reassurance that renewed lockdown may not in sight. Despite that, GBP longs are generally looking to sell into any bounce and wait for the dust to settle.
RMB	Overweight / Neutral / Underweight	The RMB's yield advantage is narrowing as the monetary policies in China and US diverge. Besides, policymakers have, in various circumstances, floated the idea of enhanced FX flexibility. Downside risks remain prevail for the yuan.
JPY	Overweight / Neutral / Underweight	Focus will likely remain on the USD side of the equation. The USD gains can be most pronounced vs low-yielders like the JPY. The yen's best chance of a rebound is probably on the back of a stock shakeout.
AUD	Overweight / Neutral / Underweight	The market by and large traded Aussie with an offer tone. Cutting resistance like a knife through butter, new stops got triggered at different levels. As weak short positioning has been washed out, we expect the Aussie to grind lower.
NZD	Overweight / Neutral / Underweigh	This re-pricing in rate expectations has allowed NZD to be the only major currency to resist dollar appreciation. The pricing for hikes has nevertheless gone up too far. A sweeping risk-off sentiment and the further unwinding of reflation trades will act as force for profit taking, if any.

Table 1: GDP Growth and Rates Forecasts								
	GDP growth (% YoY)				Key policy rate (% yearend)			
	2018	2019	2020F	2021F	2018	2019	2020	2021F
US	2.9	2.2	-3.5	5.3	2.25-2.50	1.75-2.00	0.00-0.25	0.00-0.25
Eurozone	1.8	1.2	-6.8	4.0	-0.40	-0.50	-0.50	-0.50
UK	1.4	1.4	-9.0	4.5	0.75	0.75	0.10	0.10
Japan	0.8	0.7	-5.0	3.0	-0.10	-0.10	-0.20	-0.20
China*	6.6	6.1	2.3	7.5	4.35	4.35	4.35	4.35
Hong Kong^	3.5	-1.2	-6.1	5.7	5.125	5.125	5.125	5.125

*1-year lending rate, ^Prime rate

Source: Bloomberg, Shanghai Commercial Bank

Table 2: Foreign Exchange Outlook			
	Yearend target		
	Current	2020	2021F
EUR/USD	1.17	1.22	1.15
GBP/USD	1.38	1.37	1.36
USD/JPY	110	103	110
USD/CNH	6.48	6.50	6.60
AUD/USD	0.73	0.77	0.70
NZD/USD	0.70	0.72	0.68

Source: Bloomberg, Shanghai Commercial Bank

Recent Publications

The Valley of Silence	Aug 5, 2021
Dipping Toe in the Water	Jul 29, 2021
Bad Term Brings Out True Colors	Jul 21, 2021
Deja Vu	Jul 12, 2021
Why Friends Don’t Let Friends Become Habitual Contrarian	Jul 2, 2021
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Trading Momentum Like Soros	Jun 10, 2021
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Gold in Negative Rate	May 27, 2021
How to Flourish When Inflation Roars Back	May 24, 2021
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Following the Script	Mar 5, 2021
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Every Silver Cloud Has a Dark Lining	Feb 26, 2021
The Amazing Rate	Feb 22, 2021
Shorts on the Rocks?	Feb 16, 2021
Money Never Sleep	Feb 5, 2021
David and Goliath	Jan 29, 2021
No Time for Talk	Jan 28, 2021
Party Like It's 1999	Jan 22, 2021

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