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Thoughts from a Renaissance man
FX views from the Volga to the Volta

This year we like local currency bonds in Argentina, Turkey and Ghana.

Key conclusions

We sadly can't explain all market moves with our wonderful real effective exchange rate (REER) model. While we can understand the market having little confidence in the ARS or GHS (although at today's FX levels, we like unhedged local bonds in both), we find it harder to explain both weakness in the ZAR (pre-election, worsening trade balance) and, at the same time, the TRY (high rates, rapidly improving C/A). Below we give headlines that are justified in more detail within.

We've never been able to forecast the dollar, but our REER model shows it is 13% overvalued against its own history, which could help explain consensus views looking for dollar weakness. One interesting theory we heard recently is that President Donald Trump's trade team have a core goal of dollar weakness against the euro (3% cheap) and the JPY (20% cheap).

That is more interesting still if the US trade war with China ends as it did against Japan, with a halving of the dollar (to CNY3.5/$). Yes, that is clickbait.

We do see EM FX in general doing well from either generalised dollar depreciation, or CNY appreciation.

Argentina, Turkey and **Egypt** are our local debt top picks for 2019, even if the dollar and CNY go nowhere, due to interest rates, cheap currencies and supportive trade (Argentina), current account (Turkey) or overall balance of payments (Egypt) trends. We think Egypt's pound will end 2019 in an EGP16.5-18.5/$ range, dependent on the size of interest rates this year.

It looks like we were wrong on **Bangladesh**. Despite a big minimum wage hike, and a 32% overvalued currency that makes the country much less competitive vs Pakistan or Sri Lanka, the authorities have not used this post-election period to restore FX competitiveness. We cut our nominal depreciation forecast from 10% to 5% in 2019.

We think depreciation risk in **Pakistan** is limited to 0-10% weaker in 2019.

South Africa's minimum wage looks too high to greatly reduce the 27% unemployment rate. A currency rate of around ZAR21/$ would put wages on a par with Vietnam or lower-paid provinces in China. In the short term (2019-2020), an African National Congress (ANC) victory and a US/China trade deal leading to a global reflation trade (as Chinese exports orders would presumably boom), could see the overtraded ZAR strengthen by 10-20%.

Nigeria and **Angola** both have currencies that are around 20% overvalued. We assume modest nominal depreciation in the Nafex rate to NGN395/$, which would maintain that overvaluation to end-2019.

Kenya's currency is supported by rising external debt. We suspect only a global trade shock would threaten this.

Emerging European and most CIS currencies look well supported at these levels. We currently see no reason for the RUB to move dramatically.

The cheapest African currencies are those of Tunisia and Ghana. We prefer Ghana. Meanwhile, the CFA peg remains secure in 2019.

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Developed markets

We were curious about how developed market (DM) currencies looked using our REER model.

For newcomers, this model looks at the REER index today compared with a country's own REER average rate since 1995. This average means the starting point for the REER rate is not relevant. That period includes a full boom-and-bust cycle for commodities; oil has averaged $63/bl over this period in 2017 US dollars. We convert the average REER rate into today's money (the second data column) and, in the fifth data column, we compare the spot rate today to that average and rank countries by how overvalued or undervalued they are relative to their own history. We include a reference to the weakest point over that period (data columns three and four) because most years we need to put headlines about "record weakness" into a real context (very rarely are they really record weak levels). We cross-check our model against current account forecasts from the IMF and, lastly, we include one-year interest rates, which often help to explain currency levels.

Figure 1: USD overvalued, EUR fairly valued, GBP and JPY weak

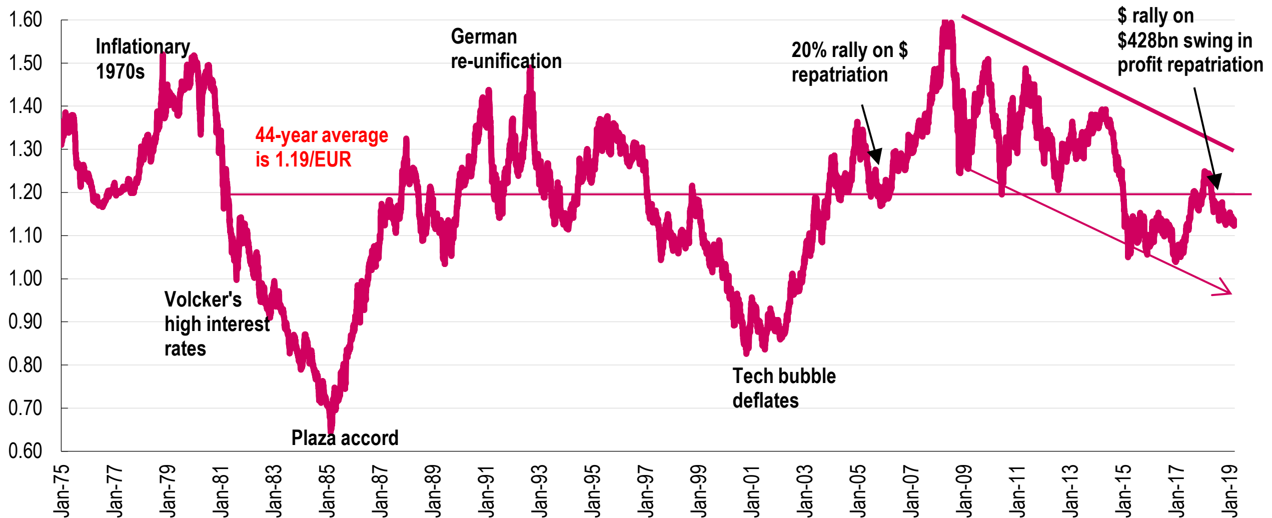
	Current spot rate*	FX rate implied by LT average REER	FX rate if REER falls to previous lows	Date of REER low	LT average divided by current rate	IMF 2018E C/A (% GDP)	IMF 2019E C/A (% GDP)	Standard deviations away from historical average	1-year local currency yields, %
New Zealand	0.69	0.61	0.43	Oct-00	1.13	-3.6	-3.8	1	1.7
US*	1.14	1.28	1.51	Jul-11	1.13	-2.5	-3.0	1	2.5
Singapore	1.35	1.49	1.74	Sep-05	1.10	18.5	18.3	1	2.0
Israel	3.60	3.91	4.71	Feb-06	1.09	2.3	2.3	1	0.3
Australia	0.71	0.67	0.49	Mar-01	1.06	-2.8	-3.1	0	1.6
Switzerland	1.00	1.06	1.21	Oct-07	1.06	10.2	9.8	0	-0.7
Hong Kong	7.85	8.25	10.3	Apr-08	1.05	3.4	3.1	0	1.5
Belgium	1.14	1.10	0.98	Oct-00	1.03	0.1	-0.1	0	-0.6
Austria	1.14	1.11	1.03	Oct-00	1.02	2.2	1.8	0	-0.5
Spain	1.14	1.12	0.97	Oct-00	1.02	1.2	1.2	0	-0.3
Netherlands	1.14	1.13	1.00	Oct-00	1.00	9.9	9.7	0	-0.6
Portugal	1.14	1.14	1.03	Oct-00	0.99	0.0	-0.3	0	-0.3
Denmark	6.57	6.51	7.21	Oct-00	0.99	7.7	7.5	0	-0.6
Italy	1.14	1.15	0.96	Apr-95	0.98	2.0	1.6	0	0.0
Finland	1.14	1.17	1.08	Oct-00	0.97	0.9	0.9	0	-0.4
Euro area	1.14	1.18	0.96	Oct-00	0.97	3.0	2.9	0	-0.4
Canada	1.33	1.28	1.55	Dec-98	0.96	-3.0	-2.5	0	1.7
Germany	1.14	1.19	1.08	Oct-00	0.96	8.1	7.9	0	-0.5
Ireland	1.14	1.19	0.99	Oct-00	0.95	7.4	6.7	0	-0.5
France	1.14	1.19	1.09	Oct-00	0.95	-0.9	-0.7	-1	-0.5
Norway	8.51	7.95	9.05	Dec-15	0.93	7.8	7.8	-1	1.1
UK	1.33	1.46	1.20	Jan-09	0.91	-3.5	-3.2	0	0.8
Sweden	9.21	7.56	8.99	Aug-18	0.82	2.6	2.8	-2	-0.5
Japan	112	88.0	121	Jun-15	0.79	3.6	3.8	-1	-0.2

Note: Government bond/bill yields except: euro area (swap rate). *Currencies quoted as per market convention

Source: Bruegel, Bloomberg, IMF, Renaissance Capital

The most striking aspect was the US currency being 13% overvalued relative to its long-term average. This would not be significant enough to warrant much of a comment from us in emerging or frontier markets, but might explain why consensus expects US dollar weakness over the medium-term. Previously we only showed the chart below, which shows the US dollar as only insignificantly stronger than its 44-year average against a synthetic euro (more understandable to most people than using DXY).

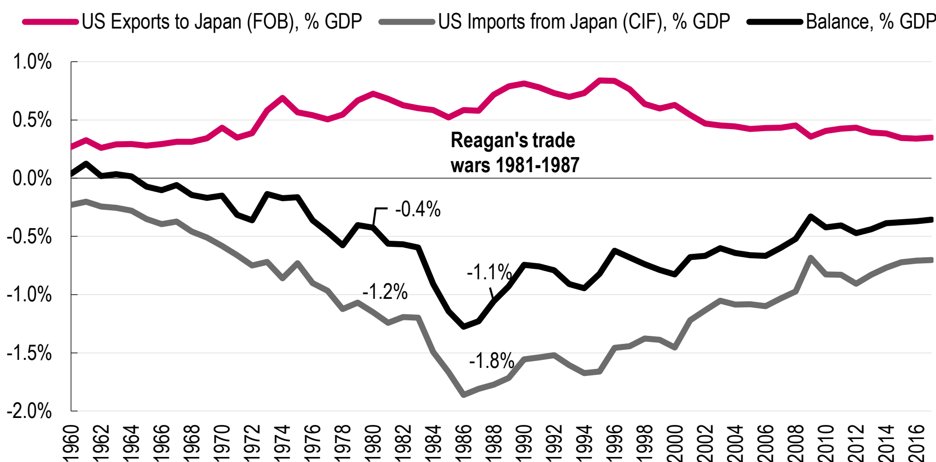
Figure 2: Without any inflation adjustment, the dollar is not far off its nominal average since 1995



Source: Bloomberg

The DM table is also interesting in the context of the US trade wars. If the Trump administration really wants to reduce US trade deficits, then aside from raising taxes to close the budget deficit, the most successful policy would be to provoke dollar weakness. This was the only policy that worked with Japan in the 1980s. The US might want to see its currency move 15% weaker, with the JPY appreciating by 20% and the EUR by roughly 5%.

Figure 3: The US trade deficit with Japan increased despite tariffs and quotas until post-Plaza accord



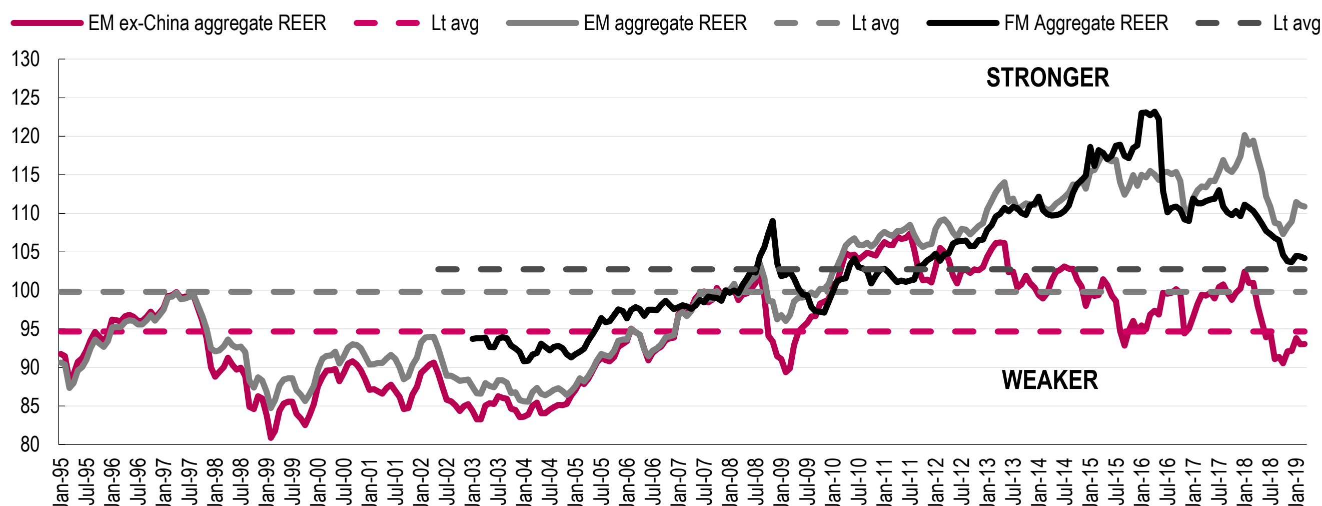
Source: Bloomberg

As an aside, eurozone data surprised us. Given high unemployment in southern Europe and very low unemployment in Germany, we thought the REER figures would show wide dispersion. In fact, the spread is very close, ranging from just 5% undervaluation in France (the country has become more competitive over time) and 3% overvaluation in Belgium.

The eurozone is a more optimal currency area than we assumed.

With the exception of 2017, EM (ex-China) currencies, weighted by 2017 GDP and in real terms, have been in a bear trend for seven years. EM FX is slightly undervalued relative to its history since 1995. Frontier currencies are slightly overvalued (we blame Kuwait).

Figure 4: EM currencies are slightly undervalued, FM slightly overvalued relative to their long-term average (GDP weighted)



Note: We have removed Saudi Arabia from the FM index.

Source: Bruegel, Bloomberg, Renaissance Capital

Among the countries we want to talk about, China is particularly topical. As regular readers know, we discount overvaluation relative to the 1995-2018 period, if an economy has changed as fundamentally as China's or the Czech Republic's has since 1995. Both were in many ways communist basket-cases back then, which have dramatically moved up the value-added curve. Their healthy current account positions support our view that REER red flags do not apply to these currencies.

Figure 5: REER model, based on 1995-2018 average rates

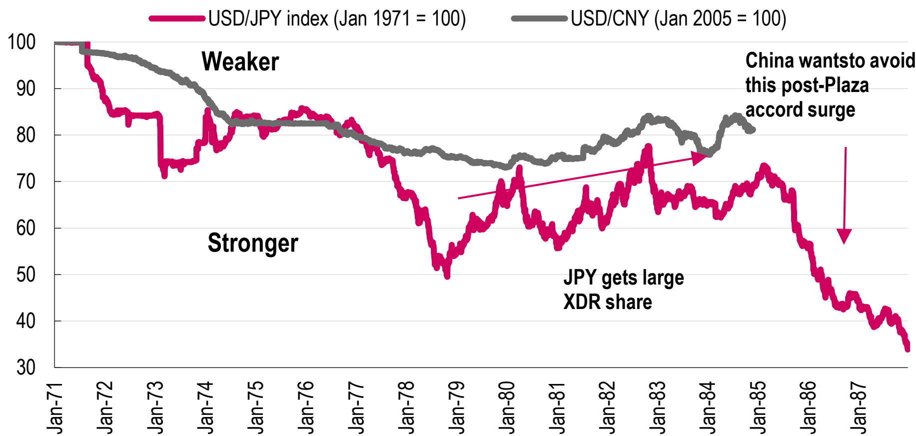
	Current FX rate vs $	FX rate implied by LT average REER	FX rate if REER falls to previous lows	Date of REER low	LT average divided by current rate	IMF 2018E C/A (% GDP)	IMF 2019E C/A (% GDP)	Standard deviations away from historical average	Yvonne's avg REER estimate*	RenCap 19YE forecast	1-year local currency yields, %
China	6.71	8.26	11.3	Apr-95	1.23	0.7	0.7	1			2.4
India	68.5	81.9	99.9	Nov-96	1.20	-3.0	-2.5	1			6.5
Czech Republic	22.6	26.7	41.0	Jan-95	1.18	-0.4	-0.9	0			1.8
Thailand	31.7	36.6	53.2	Jan-98	1.16	9.1	8.1	1			1.8
Philippines	52.7	60.2	83.8	Feb-04	1.14	-1.5	-1.5	0			6.3
Qatar	3.65	4.15	5.26	Dec-03	1.14	4.8	6.6	1			3.4
UAE	3.67	4.12	4.70	Nov-07	1.12	7.2	7.5	1			3.3
Peru	3.30	3.68	4.16	Jul-07	1.12	-1.8	-2.2	1			2.8
Chile	667	712	885	Jun-03	1.07	-2.5	-2.7	0			3.5
Indonesia	14,239	15,165	39,418	Jun-98	1.07	-2.4	-2.4	0			6.3
Russia	64.2	68.2	133	Jan-99	1.06	6.2	5.2	0		68	7.3
Korea	1,132	1,194	1,850	Jan-98	1.05	5.0	4.7	0			1.8
Hungary	277	289	388	Apr-95	1.04	2.3	2.1	0			0.3
Poland	3.79	3.76	4.54	Nov-97	0.99	-0.8	-1.3	0			1.5
Egypt	17.3	17.1	26.2	Dec-03	0.99	-2.6	-2.4	0	15.2	16.5	17.0
Colombia	3,119	3,026	4,192	Mar-03	0.97	-2.4	-2.4	0			4.7
Pakistan	140	135	156	Sep-01	0.97	-5.9	-5.3	0			11.1
Brazil	3.81	3.68	7.11	Oct-02	0.96	-1.3	-1.6	0			6.4
Greece	1.14	1.18	1.03	Sep-00	0.96	-0.8	-0.4	0			0.8
Taiwan	30.8	29.4	34.5	Nov-09	0.95	13.8	13.6	0			1.1
Malaysia	4.08	3.84	5.81	Dec-98	0.94	2.9	2.3	0			3.4
South Africa	14.4	12.9	19.4	Dec-01	0.90	-3.2	-3.5	0	11.3		7.9
Mexico	19.2	16.0	25.9	Mar-95	0.83	-1.3	-1.3	-1			8.2
Turkey	5.46	4.27	6.37	Sep-18	0.78	-5.7	-1.4	-1			20.0
Argentina**	40.0	30.8	68.4	Jun-02	0.77	-3.7	-3.2	0			53.1

Note: Govt bonds/bills except: Argentina (deposit rate), Qatar, Taiwan, UAE (Interbank rates).
*Yvonne Mhango, Renaissance Capital SSA economist; REER model based on 2004-2018 data.
**Argentina's inflation data were unreliable for 2007-2015 – we have constructed an REER series using 'shadow' inflation data.

Source: Bruegel, Bloomberg, IMF, Renaissance Capital

Indeed, the most interesting risk case for us is that China's currency gets twice as strong relative to the US dollar. We think the Japan 1971+ and China 2005+ comparison we have been tracking for a decade or so remains useful.

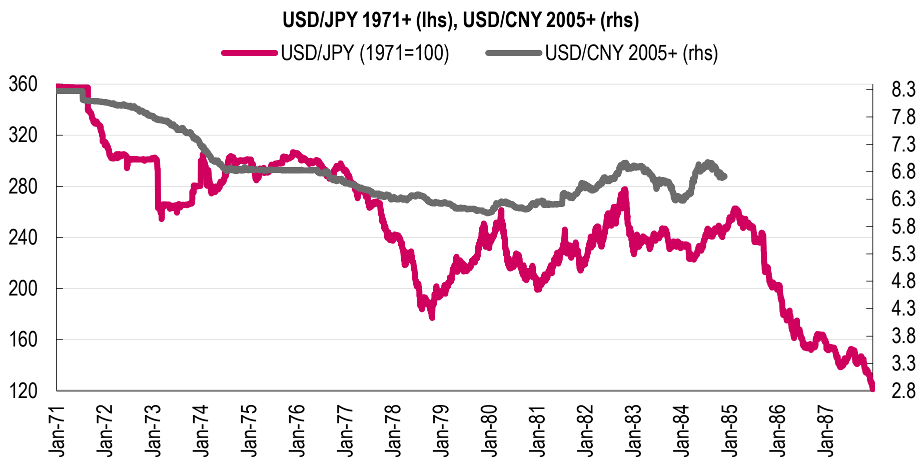
Figure 6: Since the end of fixed pegs in 1971 and 2005, Japan and China have seen similar moves



Source: Bloomberg

At this point on the comparison, Japan was engulfed in the Reagan trade wars and eventually acquiesced to dramatic JPY strengthening, from JPY240/$ to JPY120/$ in just over two years.

Figure 7: If the US dolllar were as overvalued as in 1985, we might expect dramatic CNY appreciation from here



Source: Bloomberg

While we would see the CNY heading to CNY3-4/$ as bullish for EM in general, there are two reasons why such an extreme move will not happen. First the US dollar is nowhere near as overvalued today as it was then (the dollar is half the value today it was in 1985 against the euro). Second, the Chinese authorities are terrified of the Japan comparison. They see the Plaza accord as the turning point in the US economic war with Japan, although US victory did not become obvious until the 1990s. It led to low interest rates in Japan, a property bubble and an eventual crash. We pencil in a little China crash for 2023. China has fought back against the trade war, initially let its currency weaken. Yet this has still ended badly, with falling exports, plunging new export orders and weakening GDP. Reluctantly, China has come back to the negotiating table, and allowed its currency to strengthen modestly.

So far then, we see two risk cases that are both EM FX bullish – that the US dollar gets less overvalued in REER terms (relative to other DM currencies and its own history) and that China's currency strengthens, which should be supportive of other EM currencies too.

EM – ex China

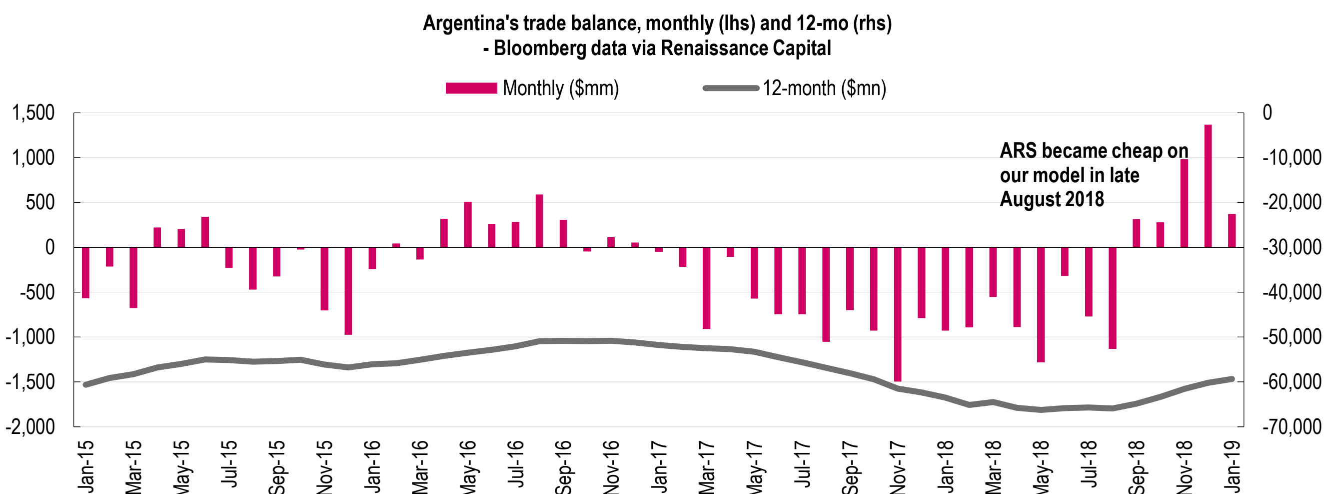
We have little to say about **Russia** or **Brazil** – which are both within 5-6% of their long-term fair value estimates, with similar interest rates. Oleg Kouzmin's call on the RUB is that in 2019 it will end the year at the same RUB68/$ level as our long-term REER model implies is fair value.

Egypt is interesting. The competitiveness gained in the big devaluation in 2016 has now disappeared and two-way risk has begun to emerge. We still think reward outweighs the risk, due to the interest rate premium over most of EM. Our tentative forecast is that 100 bpts more of rate cuts this year will take the EGP to EGP~16.5/$ by year-end and 10% overvaluation, while our risk case of 200 bpts of additional cuts or more could see the EGP weaken to EGP18.5/$[1].

Turkey we also like, with 22% undervaluation, a dramatic improvement in the current account and 20% one-year rates. We expect deep interest rate cuts from mid-2019[2].

Argentina also makes our top three. The loss of local confidence in the currency is more acute than in Turkey, partly because few called the valuation of the currency right in 2018. It was not until August 2018 that it reached fair value on our REER model. We do not think it is a coincidence that Argentina started recording trade surplus a month later.

Figure 8: Argentina's currency only weakened to fair value in August 2018; since then the country has had a trade surplus



Source: Bloomberg

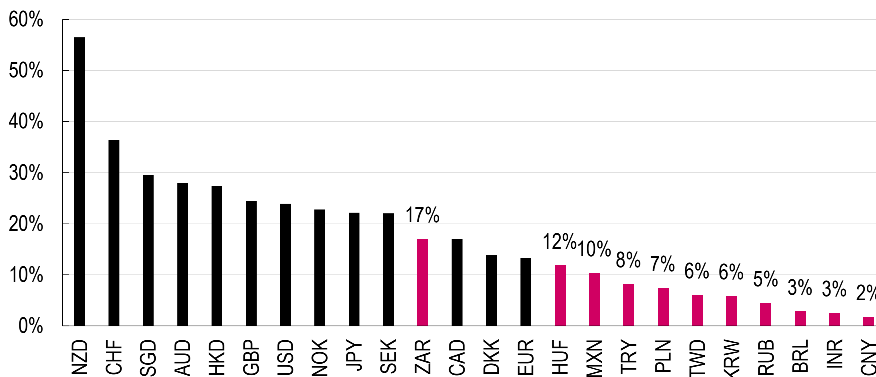
Politics and the economy could get much worse if the president is beaten by his predecessor in the presidential elections. However, 20-25% undervaluation and 53% one-year interest rates are an attractive combination – even if 50% inflation removes that undervaluation in six months. Nominal depreciation is very likely, but insufficient (we think) to wipe out the profits from having been in the ARS since late 2018.

[1] See *Thoughts from a Renaissance Man: Egypt: Still the best reform story in EEMEA*, 8 March 2019
[2] See *Thoughts from a Renaissance Man: Turkey: 2020+ uncertain, 2019 looks good*, 7 February 2019

South Africa and global minimum wages

The South African rand is the most overtraded EM currency, based on the last BIS survey from 2016. It trades more like DM currencies, based on capital account rather than current account trends, and so fundamentals matter less. The ZAR is used as a London/eurozone time-zone hedging currency for EM exposure, as the MXN is in the New York time-zone.

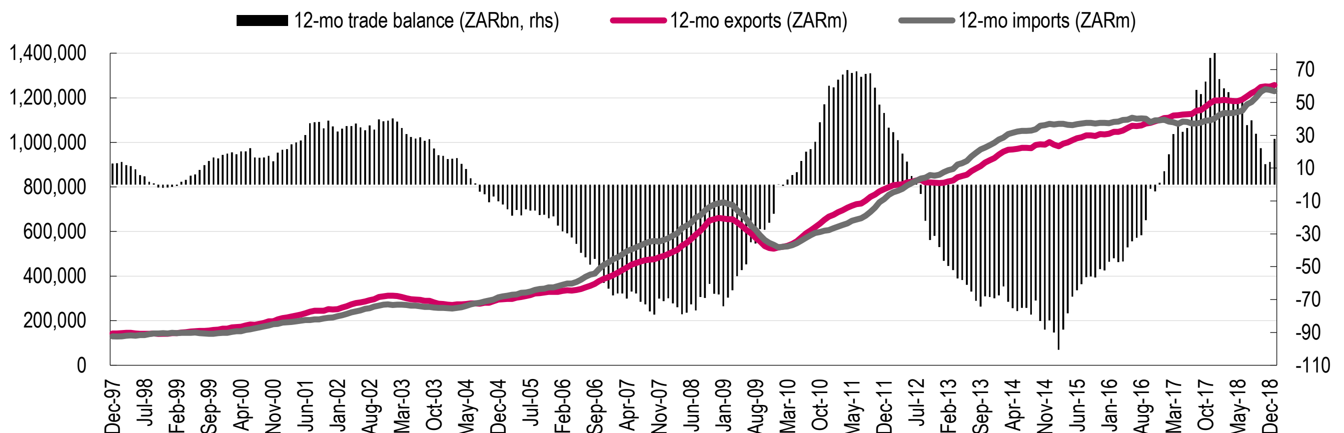
Figure 9: Overtraded currencies are where the capital account far outweighs the current account



Source: BIS, IMF, Renaissance Capital

In terms of fundamentals, the currency is cheap and South Africa's deteriorating trade balance is one cause ofr this. If we get a global reflation trade out of a US/China trade deal, trade trends could improve again via higher previous metal prices and the ZAR could easily bounce 10-20% stronger due to trade and more bullish global sentiment which would benefit an EM proxy like the ZAR. Markets would also like to see the more reform-minded president winning a mandate for change in the May 2019 elections.

Figure 10: South Africa's currency no longer has big trade surplus support

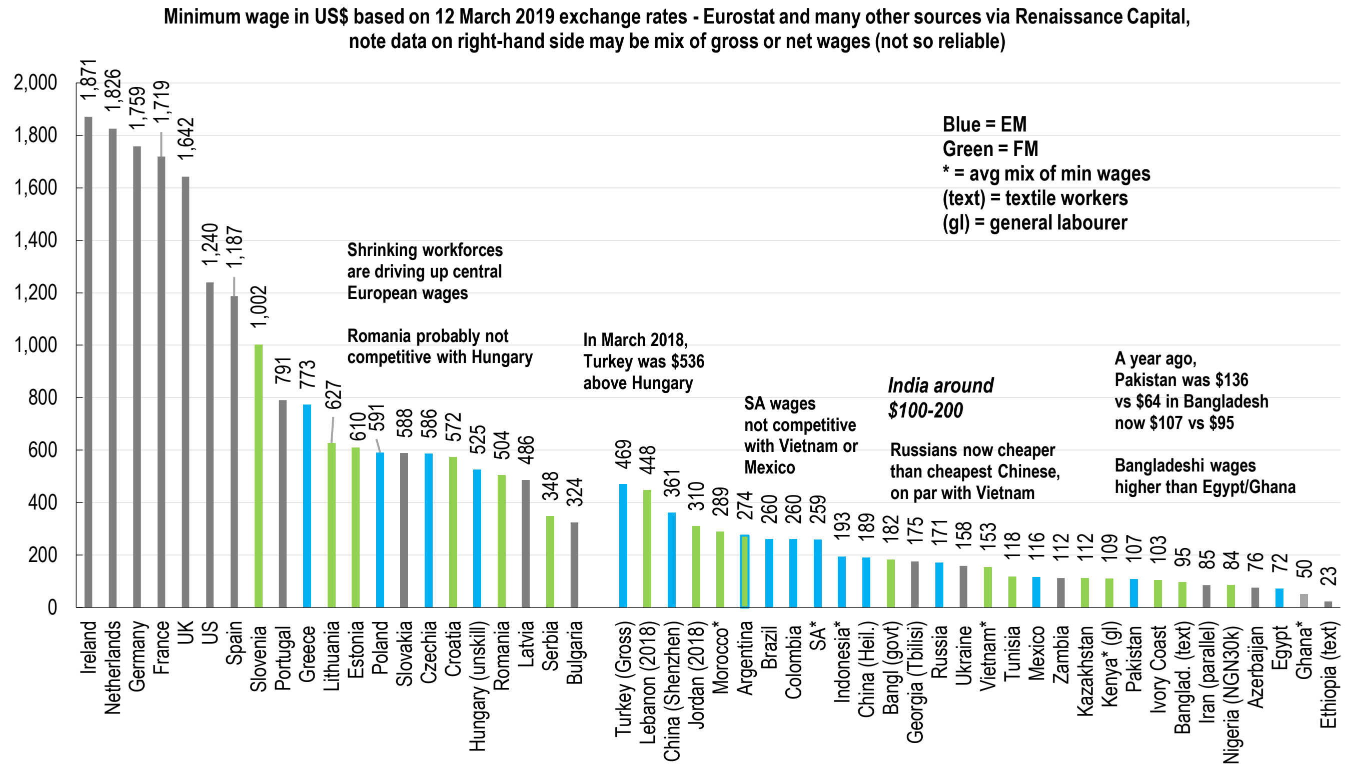


Source: Bloomberg

But beyond 2019, we are more interested in what South Africa needs to do to become globally competitive and provide jobs for the 27% unemployed. Our best guess (at present) is that a very significant proportion of those 27% are unemployed because of insufficient education stemming from under-funding in the 1980s and 1990s. We suspect

educational levels may not be better than SSA peers, for example of Zambia or Zimbabwe. This becomes a problem when the minimum wage rate in South Africa is so much higher than in these peers. Why employ a (relatively) expensive South African when cheaper labour is available in a near-neighbouring country? It's not as if electricity supply is so much better in SA that you can be sure your factory will work without interruption.

Figure 11: From $34 to $1,871 - minimum wages around the world



Note: These data are not all strictly comparable, as they mix up gross and net wages, may be country or sectoral averages, or single sector, or single area.

Source: Eurostat, local media, Bloomberg, Renaissance Capital

Moreover, if you are going to set up a factory, there is clearly a good chance that it will not be put in South Africa, but will go to Vietnam, where wages are lower, education levels are good, worker relations are less problematic for employers, and infrastructure investment is developing fast. For South Africa, an exchange rate of ZAR21/$ would be sufficient to bring the average minimum wage (for 40-45 hours a week) to $176, just below the $180 level in Hanoi or Saigon (the $153 in our chart is an average for the country) and below that of China's poorest province. That would be easier to justify than having a minimum wage similar to China's average, when China's per-capita GDP is 50% higher than South Africa's.

Of course, changing the minimum wage can happen in South African rand without any shift in the exchange rate, but that is politically difficult, especially when it has only recently been introduced.

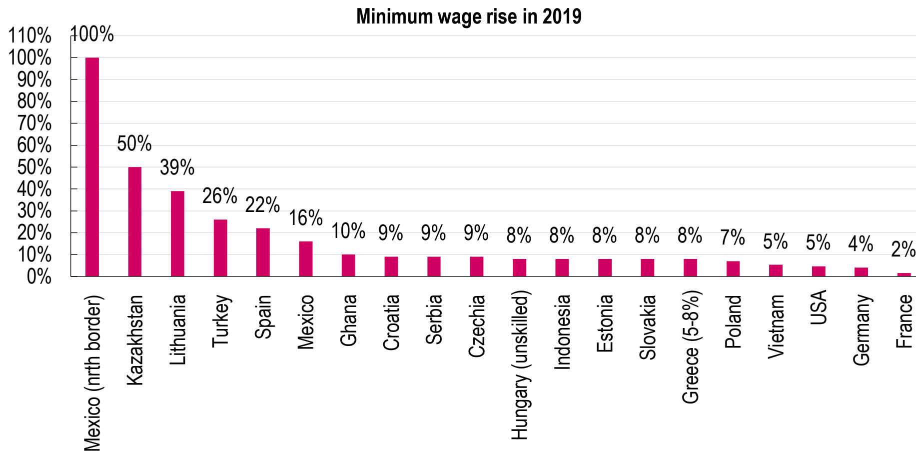
Other key conclusions to the minimum wage data:

- Russia and other CIS countries look cheap, suggesting their industrial base is now globally competitive.
- Hungary, Poland, the Czech Republic, Romania and others are seeing wages rise due to demographic shifts from the 1990s, and this will continue to drive up their costs.
- North Africa, especially Egypt, looks globally competitive now.

- India has too many minimum wages to make a good estimate for, but Pakistan is much more competitive with Bangladesh than it was.

- Argentina remains expensive relative to Brazil, and both are very expensive compared with Mexico, where big rises are coming through.

Figure 12: Up, up, up and away – minimum wage increases in January 2019, % change YoY

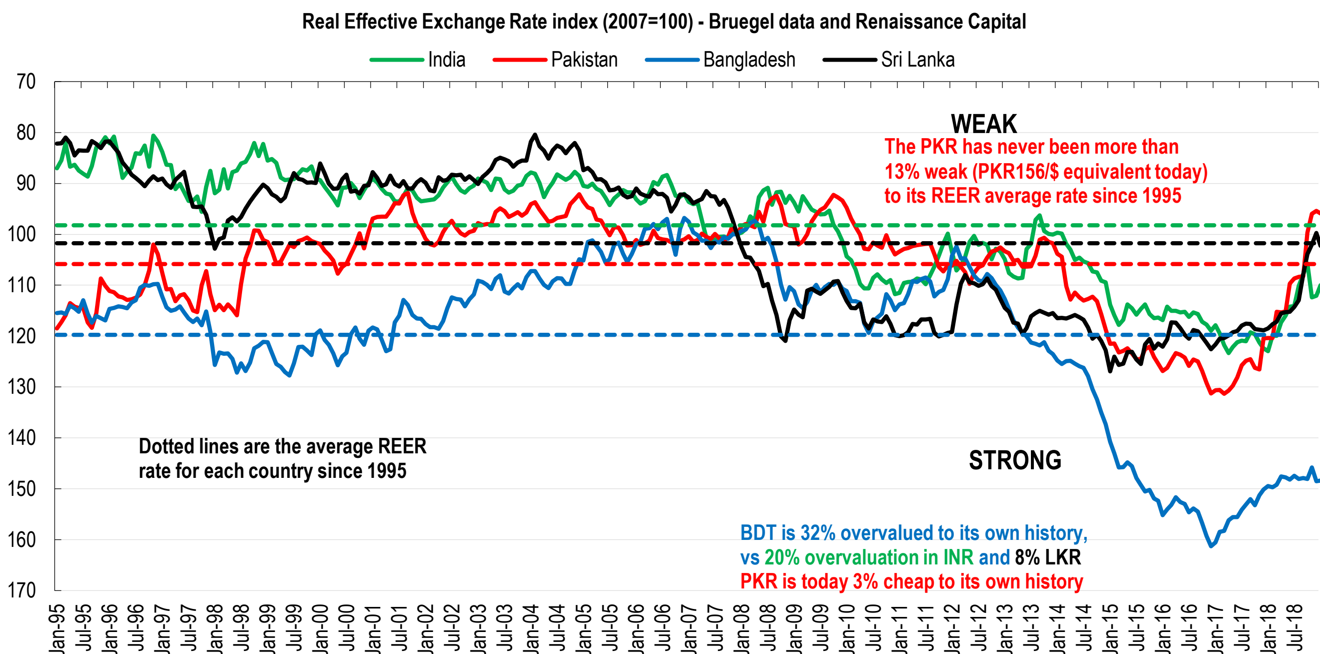


Source: Eurostat, local media

South Asian currencies

We have been flagging the overvaluation of South Asian currencies for some time. Sri Lanka and then Pakistan have fallen to much more competitive levels. India has wobbled but remains roughly 20% overvalued. Bangladesh remains very expensive.

Figure 13: South Asian REER levels vs their own history



Source: Bruegel, Renaissance Capital

Given the overweight position of investors in India, we think it will require an equity-negative event (reforms stall, growth slumps, etc.) for an outflow of funds sufficient to

bring the INR down 20% or so to fair value, or a bigger fall into weak territory. The 2019 elections could provide that trigger, but our base case is bullish for India due to fundamentals (literacy, electricity, investment), so even a change of government may not derail the country. The currency may remain “too strong” for years to come, but the risk is to the weak side.

We wrote last year[3] that we expected **Bangladesh** to keep the BDT stable ahead of the December 2018 elections, but then allow 10% annual depreciation in 2019. But YtD the annualised move is more like 2-3%. Why were we wrong?

1) Exports are still growing well, so there is no obvious need for a weaker currency.

2) FDI flows reached a record $3bn in 2018, according to UNCTAD.

3) The current account deficit is not big, and possibly the IMF view, that a 1% of GDP deficit in Bangladesh is as worrying as a considerably bigger deficit elsewhere, is no longer valid.

However, we do think Bangladesh should be concerned by the near-closing of what was a big gap in the minimum wage with Pakistan. The December pre-election hike took wages up by nearly 50% to $95, while Pakistan’s wages have plunged from $136 to $107. Pakistan was more than twice as expensive as Bangladesh about a year ago, so for the same amount of money you would get 24 months of work out a Bangladeshi vs 12 months in Pakistan – while now you only get an additional 6 weeks more labour in Bangladesh vs that year of labour in Pakistan.

Sri Lanka is also a rising challenge, because its currency has got cheaper, human capital is more developed and infrastructure is better. Sri Lanka attracted $2bn of FDI in 2018, also (we think) a record for that country, and with a population 8 times smaller. Bangladesh would need to get $16bn to be similar on a per-capita basis.

Clearly Pakistan has security and geopolitical reasons why FDI might be deterred for now, but Saudi investment is already promised that should be PKR-supportive. A $10bn refinery is planned with Saudi support, again outweighing what we see in Bangladesh.

The longer the gap persists between relative exchange rates across South Asia, the more likely that Bangladesh loses attractiveness to its peers. We admit there is no evidence that this is a 2019 story though. We tentatively assume just 5% depreciation this year, instead of the 10% we were calling for (a much bigger adjustment is likely, eventually).

For **Pakistan**, our last expressed view was that the PKR devaluations would be complete for the medium term when the currency reached PKR140-160/$. We maintain that view. The devaluations could be finished – imports are falling by double-digit amounts – but if we had to guess, we’d see another shift a little weaker. In any case, we think downside is limited to about 10% from here.

[3] See *Thoughts from a Renaissance Man: How vulnerable is the Bangladeshi taka?*, 21 June 2018

Below we show the MSCI Frontier and beyond Frontier currencies, and further down the Africa currency table.

Figure 14: MSCI Frontier and beyond frontier currencies

	Current FX rate vs $	FX rate implied by LT average REER	FX rate if REER falls to previous lows	Date of REER low	LT average divided by current rate	IMF 2018E C/A (% GDP)	IMF 2019E C/A (% GDP)	Standard deviations away from historical average	Yvonne's avg REER estimate*	RenCap 19YE forecast	1-year local currency yields, %
Bangladesh	84.3	111	138	Dec-06	1.319	-3.2	-2.7	2			4.2
Vietnam	23,205	29,685	38,116	Jan-04	1.28	2.2	2.0	1			3.1
Jordan	0.71	0.88	1.10	Sep-95	1.24	-9.6	-8.6	2			7.7
Kenya	101	124	254	Jul-95	1.23	-5.6	-5.3	1	122	105	9.4
Nigeria	359	437	995	Apr-95	1.22	2.0	1.0	0	346	395	14.3
Kuwait	0.30	0.36	0.45	Jun-95	1.20	11.3	11.0	1			3.3
Lebanon	1,512	1,804	2,250	Apr-08	1.19	-25.6	-25.5	1			10.8
Estonia	0.88	1.05	1.76	Jan-95	1.19	2.2	1.1	1			na
Lithuania	0.88	1.03	2.01	Apr-95	1.17	0.3	0.0	1			0.0
Mauritius	34.6	39.8	46.5	Dec-06	1.15	-8.2	-10.4	2			3.5
Oman	0.38	0.43	0.49	Nov-07	1.11	-3.3	-0.5	1			3.4
Sri Lanka	178	192	244	Feb-04	1.08	-2.9	-2.7	0			10.7
Romania	4.19	4.47	9.48	Feb-97	1.07	-3.5	-3.4	0			3.1
Bahrain	0.38	0.39	0.48	Jun-11	1.04	-2.5	-2.3	0			4.6
Ivory Coast	579	596	693	Aug-97	1.03	-4.6	-4.2	0	546		5.8
Croatia	6.53	6.61	7.41	May-00	1.01	2.7	2.3	0			0.1
Slovenia	0.88	0.88	0.96	Aug-97	1.00	6.3	5.5	0			-0.6
Morocco	9.59	9.58	10.2	Aug-12	1.00	-4.3	-4.5	0			2.4
Serbia	104	101	171	Feb-01	0.97	-5.7	-5.6	0			na
Senegal	579	543	598	Nov-00	0.94	-7.7	-7.1	-1	546		5.5
Kazakhstan	376	316	409	Jan-16	0.84	-0.2	0.2	-1		370	9.0
Argentina*	40.0	30.8	68.4	Jun-02	0.77	-3.7	-3.2	0			53.1
Tunisia	3.00	2.13	3.00	Dec-18	0.71	-9.6	-8.5	-2			8.2
Moldova	17.2	23.0	37.2	Jun-99	1.34	-7.4	-6.3	1			6.7
Armenia	487	570	899	Mar-95	1.17	-3.8	-3.8	0			6.6
Saudi Arabia	3.75	4.19	5.09	Mar-08	1.12	8.4	8.8	1			3.0
Georgia	2.68	2.73	4.62	Apr-95	1.02	-10.5	-10.2	0		2.8	6.9
Azerbaijan	1.70	1.60	2.18	Feb-04	0.94	6.6	8.1	0			7.1
Ukraine	27.1	24.3	46.6	Feb-15	0.90	-3.1	-3.9	0			17.6
Belarus	2.11	1.49	2.56	Oct-11	0.71	-2.5	-4.2	-1			3.7
Iran (UNO rate)	86,461	37,395	84,850	Jun-95	0.43	1.3	0.3	-1			na

Note: Kenya's REER dates from 2010 only.
Govt bonds/bills except: Morocco, Kenya, Senegal, Tunisia, Mauritius, Ivory Coast, Georgia, Azerbaijan, Belarus, Moldova, Saudi Arabia (auction yields); Oman, Bahrain, Jordan (interbank rates); Argentina (deposit rate); Kazakhstan (12M NDF implied yield).
*Yvonne Mhango, Renaissance Capital SSA economist; REER model based on 2004-2018 data.

Source: Bruegel, IMF, Bloomberg, Renaissance Capital

Kenya

In Frontier, the most common question is about Kenya and why the KES remains so strong.

A few years ago, we had a variety of explanations, ranging from Somalian pirates and South Sudanese oil barons parking their loot in Nairobi real estate, to the bid for that same real estate from Western expats who wanted their headquarters in Nairobi because the international schools were good and the temperatures acceptable. Basically, we suggested capital inflows were not being accurately recorded and were offsetting the current account deficit. We also made a special exemption for the KES in our model, which dates from end-2009, not early 1995, due to a change in Kenay's inflation calculation methodology in 2009.

In recent years, the correlation of the current account deficit to the rise in external debt has become increasingly obvious. **We showed this in detail in Figure 2 of *Thoughts from a Renaissance Man: Kenya: Avoiding Argentina, emulating Mauritius* (28 September 2018)**. As the growth in external debt has matched the current account deficit, the exchange rate could remain steady, and FX reserves too.

If the ratio of external debt to GDP was staying roughly constant – because external borrowing was being used to creating export manufacturing growth – this story could be classed as benign and sustainable over the long term. But that is not happening. The external debt ratio is rising and could become a significant problem. If borrowing from abroad gets difficult, and the currency plunges as a result, the external debt ratio would spike higher, credit ratings would get downgraded and a negative spiral could ensue. An alternative scenario is that without external borrowing, the current account deficit would shrink, so limiting the eventual KES depreciation.

There is no reason to assume dollar borrowing is under short-term threat. The Fed is on pause. The European Central Bank (ECB) is easing. Our debt strategist Greg Smith points out that the Kenya 2024 eurobond yield has fallen from 8.3% to 6.4% from January to early March. Kenyan borrowing has got cheaper, not more expensive. Indeed, this might explain why the KES got stronger in early 2019. Our base case is the KES weakens to KES105/$ in 2019.

Nigeria

This is the biggest market we cover with multiple exchange rates, ranging from the NGN306/$ cited on the Central Bank of Nigeria (CBN) website, the market traded Nafex rate, now at NGN359/$, and the Bureau de Change rate at NGN362/$ (on 14 March). Our long-term average rate since 1995 is NGN437/$, meaning the currency is about 20% overvalued. We think the Nafex rate is strong because of tight CBN policies, and because domestic demand is weak so the current account is roughly balanced.

We think NGN depreciation would support Nigeria's import substitution goals, by deterring foreign imports. It should also improve the budget deficit, if Eurobond proceeds and oil revenues were converted at NGN437/$, instead of NGN306/$ (although at the expense of CBN profits). Lastly it would reduce corruption risk that is inherent in multiple exchange rate countries.

However, our base case is for NGN depreciation only to NGN395/$ by end-2019, which would still leave it 20% overvalued, on the assumption that Nigerian inflation of roughly 10% takes the currency's fair value to about NGN470/$ by end-2019. Our main risk case (a 1/3 chance) is that the currency remains stable, leaving it 30% overvalued by December. The currency outlook will depend partly on the CBN governor, whose term begins on 2 June, but our base case should be that the naira will not trade on the weak side of fair value under President Muhammadu Buhari.

Vietnam

We think Vietnam, like China or the Czech Republic, has a currency that will appreciate in real terms due to dramatic changes in the structure of its economy relative to the past. We think the current account surplus shows that our REER analysis showing the VND to be overvalued is not a good indicator of currency risk. We think there is only significant depreciation risk for the VND if: 1) the US targets Vietnam in trade wars because it has the fifth-biggest trade surplus with the US (the top four have all faced pressure from the US); 2) if China depreciates its currency significantly; or 3) if growth slumps and the current account moves into significant deficit. The 12-month trade surplus has shrunk from $9bn in June 2018 to $1bn in February due to export growth slowing to 7%, which we attribute to slowing global demand, while imports are still up by 9% due to good growth. A modest deficit is plausible in 2019, but not enough on its own to justify significant currency weakness.

MENA – Lebanon, Jordan, Bahrain, Oman, Saudi, UAE, Kuwait and Qatar

We have not been very concerned by Gulf currency overvaluation, since we published *Thoughts from a Renaissance Man: A wave of reform by oil exporters* (28 April 2016) – and showed how they reacted in the 1980s to the oil price slump of that decade. The devaluations then were very modest (roughly 3-10%) by EM standards. Qatar, the UAE, Saudi Arabia and Oman are all roughly 10-15% overvalued. We assume Saudi support will be sufficient to maintain currency pegs.

The one country where we cannot have confidence is Lebanon. High twin deficits and external debt ratios may be common in countries with large financial sectors, but the ratios are looking particularly extreme here. We are not attempting to make a call on this 20% overvalued currency or the country's debt assets.

CIS currencies – Kazakhstan, Moldova, Armenia, Azerbaijan, Belarus – and Ukraine

The main theme we think is interesting in the CIS region (plus Ukraine), is that wage levels are very competitive. Currencies are cheap in Kazakhstan, Azerbaijan, Ukraine and Belarus. We think most are influenced by the RUB, which would be stronger were it not for sanctions and the Russian policy response to this. We expect the macro impact of undervalued currencies to show up via good industrial output and export data.

CFA peg – Senegal and Ivory Coast

These currencies remain close to fair value and current account deficits are not (yet) big enough to give us serious concern. We do not believe that plans for a common West African currency to include Ghana's cedi, and due to take effect at the end of 2019, are credible[4]. We also expect in the short-to-medium term that, the CFA region will retain the peg guaranteed by the Central Bank of France. The advantages in terms of low inflation and low interest rates are too obvious to the authorities.

Tunisia

The TND has now been the cheapest African currency in our model for well over a year (last week, GHS took this label briefly)[5]. The IMF does not think the TND is as undervalued as our model says it is. The fact that the current account worsened in 2018, despite the country having such a "cheap" currency, suggests that the IMF has a point. Weakness in key export markets (France and Italy) combined with a fairly wide fiscal deficit, and relatively low interest rate support (compared with other cheap currencies from Ghana to Argentina) are drivers of TND weakness. Elections at the end of 2019 are important, EU demand is also important, but most important of all is an improvement in the current account. The latest 12-month trade data to February 2019 still show export growth of 14% (in TND) lagging 19% import growth, and in January, the 12-month deficit reached a record nominal high of TND20.4bn (nearly one-fifth of GDP). The IMF is assuming the current account deficit shrinks in 2019, but from around 10% of GDP to around 9% of GDP, and without high interest rate support, we see still see this as a

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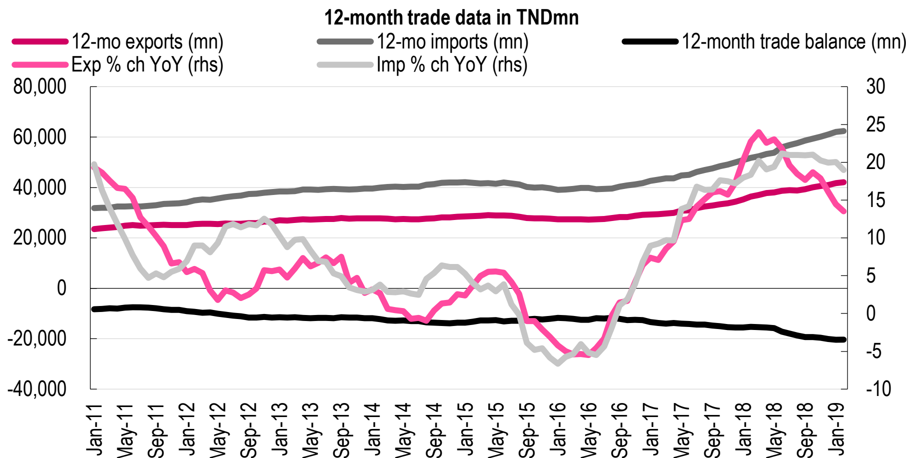
[4] See *Thoughts from a Renaissance Man: ECOWAS single currency in 2020? Not credible*, published 22 March 2018
[5] See *Thoughts from a Renaissance Man: Tunisia: Outperforming in the 2020s*, 25 January 2018

currency to watch, not one to necessarily own. Note the TND/EUR rate has stabilised in February and March, and February trade data did show exports beating imports and a modest YoY improvement in the trade deficit.

Figure 15: Tunisia's trade deficit (lhs) just keeps widening, as imports rise faster than exports (rhs)



Source: Statistiques Tunisie, Renaissance Capital

Emerging Europe – Estonia, Lithuania, Romania, Slovenia, Croatia and Serbia

We think the Baltic states have changed more dramatically since 1995, when our REER index began, than almost any other country, which is why Estonia and Lithuania can have apparently “overvalued” currencies while their current accounts in surplus. But we are interested by the significant minimum wage hike in Lithuania, and demographic shortages do suggest wages will rise until the real competitiveness of these economies disappears. We may be close to that point, but it will require close analysis of FDI, export and other data to judge it correctly. Most investors don’t care enough to warrant the time.

Romania, Croatia, Slovenia and Serbia have currencies that are so close enough to fair value that we have nothing urgent to say on these currencies. Depreciation risk would stem from domestic overheating related to upward wage pressure and demographic shortages, which could trigger current account deterioration.

Africa

Within Africa, the peg in Central Africa to the CFA looks less sustainable than the West African CFA franc, because inflation has been higher in Central Africa. We focus on just a few currencies that matter more to most investors.

Figure 16: African currencies – from 88% overvalued to 29% undervalued

	Current FX rate vs $	FX rate implied by LT average REER	FX rate if REER falls to previous lows	Date of REER low	LT average divided by current rate	IMF 2018E C/A (% GDP)	IMF 2019E C/A (% GDP)	Standard deviations away from historical average	Yvonne's avg REER 2018 estimate*	RenCap 19YE forecast	1-year local currency yields, %
C.A. Republic	584	1,097	1,561	Dec-99	1.88	-8.9	-8.4	2			na
Ethiopia	28.4	37.4	52.0	Jan-04	1.32	-6.2	-6.2	1	30.6		na
Kenya	101	124	254	Jul-95	1.23	-5.6	-5.3	1	122	105	9.4
Nigeria	359	437	995	Apr-95	1.22	2.0	1.0	0	346	395	14.3
Eq. Guinea	584	705	1,112	Oct-00	1.21	-3.1	-3.6	0			8.0
Angola	316	374	1,319	Oct-99	1.18	-2.1	-1.9	0	271		17.9
Mauritius	34.6	39.8	46.5	Dec-06	1.15	-8.2	-10.4	2			3.5
Congo (Rep)	584	649	847	Feb-95	1.11	9.1	12.4	1			na
Botswana	10.7	11.7	13.8	Sep-98	1.10	8.7	7.7	1			na
Zambia	12.0	12.6	23.1	Jul-95	1.06	-4.0	-3.4	0	9.2	12.6	23.6
Cameroon	584	607	697	Oct-00	1.04	-3.2	-3.0	0			3.8
Gabon	584	605	671	Sep-00	1.04	-1.6	-0.5	0			na
Ivory Coast	579	596	693	Aug-97	1.03	-4.6	-4.2	0	546		5.8
Chad	584	592	748	May-00	1.01	-4.2	-5.5	0			6.0
Tanzania	2,344	2,346	2,938	Dec-93	1.00	-4.3	-5.5	0	2,201	2,488	8.8
Morocco	9.59	9.58	10.2	Aug-12	1.00	-4.3	-4.5	0			2.4
Egypt	17.3	17.1	26.2	Dec-03	0.99	-2.6	-2.4	0	15.2	16.5	17.0
Namibia	14.4	14.0	18.9	Dec-01	0.97	-6.0	-7.6	0			8.4
Algeria	119	113	132	Apr-08	0.95	-9.0	-7.9	0			na
Senegal	579	543	598	Nov-00	0.94	-7.7	-7.1	-1	546		5.5
Uganda	3,707	3,360	4,279	Aug-11	0.91	-6.9	-8.9	0	3,228		11.0
Mozambique	62.9	56.8	83.9	Sep-16	0.90	-18.2	-44.8	0	39		13.0
South Africa	14.4	12.9	19.4	Dec-01	0.90	-3.2	-3.5	0	11.3		7.9
Rwanda	902	804	1,071	Dec-03	0.89	-8.9	-9.4	0	842	926	8.5
Ghana	5.46	4.03	7.41	Aug-14	0.74	-4.1	-4.0	-1	3.7	5.35	15.5
Tunisia	3.00	2.13	3.00	Dec-18	0.71	-9.6	-8.5	-2			8.2

Note: Auction yields except: Egypt, Nigeria, Uganda, South Africa.
*Yvonne Mhango, Renaissance Capital SSA economist; REER model based on 2004-2018 data.

Source: Bruegel, Bloomberg, IMF, Renaissance Capital

Angola

There has been a steady and sensible shift on the AOA from the authorities that has reduced the very high overvaluation we were worried about over a year ago[6]. It is now just 18% overvalued, the current account deficit is small and local currency yields might attract investor interest, but to us Nigeria looks a little more attractive, and Turkey still more so.

Zambia

The currency has slipped but remains a little overvalued based on our 1995-2018 REER model. It is arguably compensated for by high one-year rates.

Rwanda vs Ethiopia

These two economies are both pushing a high-investment growth model, creating pretty large high current account deficits, and in recent years both have on occasion run very low on the FX reserves to support this model. We think Rwanda has reacted better to the FX shortages that emerged as it was completing its conference centre and hotel complex. Its (*de facto*) crawling peg monthly devaluation means the currency is now around 10% undervalued relative to its long-term rate, which we think should encourage FDI and

[6] See *Thoughts from a Renaissance Man: Weaker dollar improves EM/Frontier FX fair values*, 4 January 2018

support exports and import substitution over time. One-year government borrowing costs were 8.5% on 1 March.

Ethiopia by contrast, maintains a heavily managed economy, and still has the second most overvalued currency in Africa and the third most overvalued currency in the world. The unofficial parallel market rate did reportedly converge with the official rate in the wake of Ethiopia's change of prime minister. Privatisation-related dollar inflows could help provide some financing for the investment-led growth model for some time to come. However, our model still tells us that fair value is around ETB37/$, over 30% weaker than the spot rate of ETB28/$. The authorities have said Ethiopia will continue to have FX shortages for years to come, which tells us that they will not be shifting from their heavily managed model towards the more competitive model of Rwanda. Therefore we do not expect the ETB to depreciate significantly (e.g. by 20%) in the near term, and we instead assume that FX shortages will continue to be an issue. This may well reduce the price the government can get for the minority stakes it hopes to privatise, because foreign investors should be concerned that profit repatriation will be difficult. Deep-pocketed, very long-term investors might not mind too much. They may be happy just to re-invest profits, and wait a decade or two until the situation improves before they can take profits on their operations.

Ghana

The collapse of the GHS in February and the first half of March was we think, due to a combination of investor concerns related to the unexpected January interest rate cut, the expiry of the IMF deal in April and a lack of confidence in the fiscal outlook heading into the 2020 election year. We were surprised by the weakness, although the fragile state of Ghanaian confidence in the GHS among local market participants has been obvious in our discussions in Accra.

We remain bullish on the fundamentals in the country. Literacy and electricity data tell us Ghana will be the most successful economy in West Africa over the next decade (and probably two). New oil finds could double daily output to 400k b/d by the mid-2020s. The current account deficit is covered by FDI and double-digit interest rates should be attractive.

However, the last month has made it quite clear that Ghana has to pay a price for the fiscal profligacy of 2008-2016. To maintain currency stability, that price will need to be paid via tighter fiscal and monetary policy than in countries with a better historical record. This means less scope for either the government (via higher spending) or the local banking sector (via higher lending) to fund the higher investment that Ghana needs to maximise growth. The good news is that the energy sector is delivering high growth anyway, and a couple more years of tight policy could boost investor confidence, cut debt ratios, and then allow still faster GDP growth via higher investment. The risk-case scenario is that Ghana again front-loads the benefits of future higher oil revenue, spends too much in 2020, and sends the GHSJ sharply weaker. We are cautiously on the optimistic side of this debate. We expect the GHS to strengthen to GHS5.35/$ by year-end.

Tanzania

We need also to mention the TZS, which is fairly valued according to our long-dated REER model and is cheap based on our 2004-2018 REER model. Neither help us explain a somewhat heavy-handed approach to those questioning the currency rate. We are paying a little more attention to the currency as a result and can only reiterate that TZS weakness does not seem justified by the REER.

Conclusion

We see little value in trying to emulate the guesses of DM FX strategists on the major currencies, when BIS data highlight just how driven by the capital account (and emotion) those currencies are. Our REER table on DM markets does help to explain why the consensus assumes US dollar weakness.

We don't worry about REER "overvaluation" in countries such as China, the Czech Republic, Vietnam or Estonia, where we think economies have changed much more substantially over nearly 25 years than other countries around the world. We don't worry much about Gulf currencies either.

We are interested by the potential for significant CNY appreciation, in an echo of the post-Plaza accord move in the JPY. We assume this would drag other Asian currencies stronger, and lift China's purchasing power with regard to EM commodities.

We think India, the Philippines, Bangladesh and Ethiopia are countries where significant 20%+ depreciation is likely in the medium-to-long term.

Currencies that we think offer interest rate-adjusted value for money include Argentina, Turkey and Egypt as our top three picks. Ghana, Nigeria, Zambia and Angola may offer value too.

We think CIS currencies are generally cheap and suggest their industrial bases can do well.

We see minimum wage data as a useful additional way of looking at currencies, and suggest the ZAR may need to weaken in the long term, to reduce unemployment.

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