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Thoughts from a Renaissance man
Equity Research

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Thoughts from a Renaissance man
FX update for EM – cheapest in 15 years

Our updated REER model does not look quite so compelling as the old model did last week, but LatAm and South Africa still stand out as attractive.

Within EEMEA, the rand is the most attractive currency despite many macro issues

The new updates to our REER model, via the Bruegel think-tank, show the impact of high inflation in Argentina and Lebanon as well as Nigeria, but continue to demonstrate that Latin America currencies and those of Turkey and South Africa (SA) are the cheapest in emerging markets (EM). We reiterate our view expressed last Thursday (2 April) that the rand may be the most attractive among these. While there is much to be concerned about with the SA economy, we think ZAR16-17/$ would be a more appropriate level for the currency. Even in a worst-case 2020 scenario, we do not think the currency should weaken past the ZAR20.9/$ record weak point seen in December 2001, when HIV was ravaging the economy; many feared the country would imminently become another Zimbabwe and the South African Reserve Bank (SARB) had negative FX reserves (once forward book obligations were taken into account).

The rouble again comes out as cheap, but would presumably need to see a strong oil price rally to become stronger than the implied 'fair value' of RUB71/$. Fair value here refers to the average exchange rate since 1995 in today's money. The Turkish lira is 25% cheap, but we suspect the authorities are happy to see it stay 20% undervalued, so we see less appreciation gains to be had from the lira.

The KZT and AOA look as cheap on this model as oil implies they should, the NGN does not

More controversial is the new 'fair value' for Nigeria's naira, which thanks to inflation is now at NGN492/$ on our London-based 1995-2020 REER model. This incorporates a period when nominal oil has been $55/bl or about $64 in 2018 prices. It should arguably be much weaker than this given where oil is. Angola on this model is 20% cheap to its long-term average rate and Kazakhstan's tenge is 25% cheap to its long-term average rate. Our base case is that the naira ends 2020 at 420/$.

Bangladesh and Kenya remain expensive in Frontier, but the drop in oil prices helps them both. Kenya loses out from the hit to tourism though, unlike Bangladesh. Both lose out from remittances. We expect only limited nominal depreciation in both this year to BDT86/$and KES106/$, respectively.

We dismiss the REER model's claim of Vietnam dong (VND) overvaluation as we think Vietnam, like China and Czechia, have seen considerable productivity improvements far in excess of the rest of the world, that justify real appreciation of their currencies.

EM FX cheapest since 2005, but not as cheap as during the Asian meltdown of 1998/99

An important point to note is that EM FX moves in recent months have been much more significant in nominal terms than in real terms. As a result, the updated model now shows that EM FX (ex China) is only the cheapest it has been in 15 years, but is actually 10% stronger in real terms than the lows seen in 1998/1999. Before the updated Bruegel data, EM FX had looked as cheap as it was in 1998/1999. After a seven- to eight-year bear trend, we still think this is a good medium-term entry point into EM assets, but is not such a compelling buy as it appeared last week.

Overview

Bruegel has updated its REER database, which because it incorporates the past few months of inflation data, revises the long-term average rates of currencies in today's money (which we sometimes refer to as 'fair value'). In two-weeks' time we should be able to update the IMF views on the current account (C/A) balance outlook as well.

Within major EEMEA markets, the rouble average rate – since 1995 when oil prices have averaged about $60-65/bl – is now around 71/$ and the currency is 6% cheap to this. Turkey is 25% cheap and South Africa is 23% cheap. LatAm currencies range from 13% (Chile) to 29% cheap (Mexico). Thanks to inflation, Argentina's currency has rocketed back up the table from bottom to the fifth cheapest. We think the Brazilian real, Mexican peso and rand are particularly interesting to investors and the rouble if the oil price ramps up later this year.

Elsewhere, we would only draw attention to the Egyptian pound, which is the third most expensive currency in EM. Despite positive real interest rates, we think this is less attractive than the options noted above. We expect portfolio investors to take profits and the fall in Egypt's March FX reserves by $5bn suggests many have done so. We expect them to re-allocate to cheaper currencies offering yield in LatAm and SA.

Figure 1: EM FX using our REER model

	Current FX rate vs US$	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 2019E C/A (% GDP)	IMF 2020E C/A (% GDP)	Standard deviations away from historical average	Yvonne's* avg. REER 9/19 estimate	RenCap YE20 forecast	1Y local currency yields
China	7.07	8.56	11.8	Apr-95	1.21	1.0	0.9	1			1.2
Philippines	50.6	61.1	85.8	Feb-04	1.21	-2.0	-2.3	1			3.6
Egypt	15.8	18.5	28.4	Dec-03	1.17	-3.1	-2.8	0		17	13.0
India	76.3	88.0	108	Nov-96	1.15	-2.0	-2.3	1			4.8
Czech Republic	25.0	28.4	44.0	Jan-95	1.13	-0.1	-0.2	0			1.1
Peru	3.37	3.80	4.32	Jul-07	1.13	-1.9	-2.0	1			1.2
Thailand	32.8	37.0	54.1	Jan-98	1.13	6.0	5.4	1			0.7
Qatar	3.67	4.03	5.14	Dec-03	1.10	6.0	4.1	0			1.5
Saudi Arabia	3.76	4.06	4.94	Mar-08	1.08	4.4	1.5	0			1.2
UAE	3.67	3.86	4.43	Nov-07	1.05	9.0	7.1	0		3.67	1.4
Indonesia	16,250	16,177	42,206	Jun-98	1.00	-2.9	-2.7	0			6.1
Korea	1,221	1,211	1,877	Jan-98	0.99	3.2	2.9	0			0.8
Taiwan	30.1	29.7	34.8	Nov-09	0.99	11.4	10.8	0			0.8
Poland	4.17	4.03	4.86	Nov-97	0.97	-0.9	-1.1	0			0.9
Russia	75.7	71.3	140	Jan-99	0.94	5.7	3.9	0		79.2	5.7
Hungary	330	307	412	Apr-95	0.93	-0.9	-0.6	0			1.1
Greece	1.09	1.18	1.02	Sep-00	0.92	-3.0	-3.3	-1			0.3
Pakistan	168	155	179	Sep-01	0.92	-4.6	-2.6	0		165	9.9
Malaysia	4.35	3.92	5.91	Dec-98	0.90	3.1	1.9	0			2.5
Chile	854	745	925	Jun-03	0.87	-3.5	-2.9	-1			0.6
Colombia	3,908	3,202	4,418	Mar-03	0.82	-4.2	-4.0	-1			3.8
Argentina**	65.1	51.2	114	Jun-02	0.79	-1.2	0.3	0			53.5
South Africa	18.2	14.0	20.9	Dec-01	0.77	-3.1	-3.6	-1	12.7	16.5	5.8
Brazil	5.22	3.96	7.64	Oct-02	0.76	-1.2	-1.0	-1			3.3
Turkey	6.78	5.08	7.54	Sep-18	0.75	-0.6	-0.9	-1		6.5	11.6
Mexico	24.4	17.4	28.0	Mar-95	0.71	-1.2	-1.6	-2			5.8

Note: Govt bonds/bills except: Argentina (implied forward), Qatar, Taiwan, UAE (Interbank rates). * Yvonne Mhango, Renaissance Capital's Sub-Saharan Africa economist
**Argentina's inflation data was unreliable for 2007-15 - we have constructed an REER series using 'shadow' inflation data

Source: Bruegel, IMF, Renaissance Capital estimates

In the Frontier space, we expect the Nigeria figure will get the most attention. There is considerable depreciation risk from current levels. Yvonne Mhango's 2004-2020 REER model has a considerably stronger 410/$ figure for 'fair value'. The reality might be in the middle, closer to where Kazakhstan's tenge is trading (at KZT436/$). The tenge has been cheap for years on this model, but is now cheaper than Tunisia, which reflects oil prices and the currency's implicit link to the rouble.

Notable is the Moroccan dirham, which rarely moves far from its long-term average. It has become 7% cheap thanks to the strong US dollar.

Lebanon also jumps out. Since inflation reached 10%, its overvaluation has become worse.

We do not worry about Vietnam's apparent overvaluation as we think that the economy has seen considerable productivity improvements over the past 25 years, well in excess of global norms.

We continue to think the Bangladeshi taka and Kenyan shilling should be weaker, but with low oil prices helping the balance of payments, it is not that obvious what will trigger faster depreciation.

Figure 2: Frontier FX using our REER model

	Current FX rate vs US$	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 2019E C/A (%GDP)	IMF 2020E C/A (%GDP)	Standard deviations away from historical average	Yvonne's avg. REER 9/19 estimate	RenCap YE20 forecast	1Y local currency yields
Bangladesh	84.9	116	146	Dec-06	1.36	-2.0	-2.1	2		86	7.4
Vietnam	23,527	31,004	40,333	Jan-04	1.32	2.2	1.9	1			2.1
Nigeria	386	492	1,134	Apr-95	1.28	-0.2	-0.1	1	410	420	3.5
Lebanon	1,514	1,918	2,437	Apr-08	1.27	-26.4	-26.3	2			251.8
Jordan	0.71	0.86	1.09	Sep-95	1.21	-7.0	-6.2	1			6.2
Kenya	107	128	270	Jul-95	1.20	-4.7	-4.6	0	133	106	9.0
Kuwait	0.31	0.36	0.45	Jun-95	1.16	8.2	6.8	1		0.31	2.8
Estonia	1.09	0.94	0.56	Jan-95	1.16	0.7	0.3	1		1.1	na
Lithuania	1.09	0.95	0.48	Apr-95	1.15	1.1	1.1	0		1.1	0.0
Oman	0.38	0.42	0.49	Nov-07	1.09	-7.2	-8.0	1			3.4
Romania	4.45	4.72	10.0	Feb-97	1.06	-5.5	-5.2	0			3.0
Bahrain	0.38	0.40	0.49	Jun-11	1.05	-4.3	-4.4	0			2.3
Mauritius	39.3	40.5	47.4	Dec-06	1.03	-7.2	-6.5	0			0.7
Sri Lanka	195	193	245	Feb-04	0.99	-2.6	-2.8	0			7.5
Slovenia	1.09	1.10	1.01	Aug-97	0.99	4.2	4.1	0		1.1	-0.2
Ivory Coast	604	589	685	Aug-97	0.97	-3.8	-3.8	0	563		4.8
Serbia	108	105	177	Feb-01	0.97	-5.8	-5.1	0			na
Croatia	7.02	6.76	7.58	May-00	0.96	1.7	1.0	0			-0.7
Senegal	604	563	620	Nov-00	0.93	-8.5	-11.1	-1	563		5.5
Morocco	10.3	9.55	10.1	Aug-12	0.93	-4.5	-3.8	-2			2.3
Tunisia	2.90	2.28	3.29	Feb-19	0.79	-10.4	-9.4	-1		3	8.2
Kazakhstan	436	325	417	Jan-16	0.75	-1.2	-1.5	-1		440	15.4
Beyond Frontier											
Moldova	18.4	24.5	40.3	Jun-99	1.34	-9.1	-8.9	1			5.3
Cambodia	4,064	5,106	6,456	Dec-04	1.26	-12.5	-12.3	1			6.2
Armenia	493	554	881	Mar-95	1.13	-7.4	-7.4	0			5.9
Ukraine	27.3	26.1	49.9	Feb-15	0.96	-2.8	-3.5	0			18.1
Azerbaijan	1.70	1.58	2.15	Feb-04	0.93	9.7	10.0	0			7.5
Georgia	3.18	2.82	4.78	Apr-95	0.89	-5.9	-5.8	0		3.3	8.9
Belarus	2.55	1.54	2.62	Oct-11	0.60	-0.9	-3.4	-1			7.4
Iran (UNO rate)	140,500	50,493	116,142	Jun-95	0.36	-2.7	-3.4	-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)

Source: Bruegel, IMF, Renaissance Capital estimates

In Africa, the most notable shift is that SA has again become the cheapest on the continent. This is often a buy signal, in our view.

Also interesting is that Angola looks 20% cheap on this model, while Nigeria looks 28% expensive.

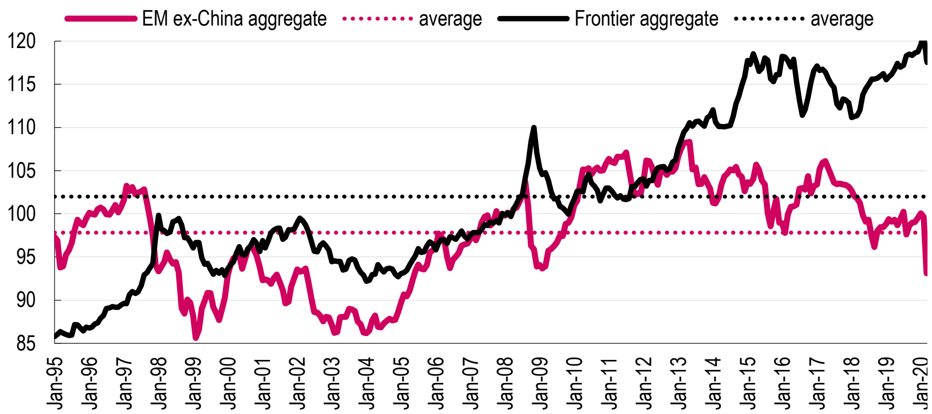
Figure 3: Africa FX using our REER model

	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 2019E C/A (% GDP)	IMF 2020E C/A (% GDP)	Standard deviations away from historical average	Yvonne's avg. REER 9/19 estimate	RenCap YE20 forecast	1Y local currency yields
C.A. Republic	604	1,099	1,620	Dec-99	1.82	-4.1	-4.9	2			na
Ethiopia	32.6	43.6	61.8	Jan-04	1.34	-6.0	-5.3	1	38		na
Nigeria	386	492	1,134	Apr-95	1.28	-0.2	-0.1	1	410	420	3.5
Congo (Rep)	604	733	1,019	Feb-95	1.21	6.8	5.3	1			na
Kenya	107	128	270	Jul-95	1.20	-4.7	-4.6	0	133	106	9.0
Eq. Guinea	604	716	1,138	Oct-00	1.19	-5.9	-6.2	0			8.0
Egypt	15.8	18.5	28.4	Dec-03	1.17	-3.1	-2.8	0	16.7	17	13.0
Chad	604	651	825	May-00	1.08	-6.4	-6.1	0			6.0
Gabon	604	632	704	Sep-00	1.05	0.1	1.0	1			na
DR Congo	1,707	1,777	2,414	Jan-10	1.04	-3.4	-4.2	0	1,781		na
Cameroon	604	626	720	Oct-00	1.04	-3.7	-3.5	0			3.4
Mauritius	39.3	40.5	47.4	Dec-06	1.03	-7.2	-6.5	0			0.7
Tanzania	2,314	2,352	2,947	Dec-93	1.02	-4.1	-3.6	0	2,403	2,406	4.9
Botswana	12.1	12.1	14.3	Sep-98	1.00	-3.0	-1.0	0			na
Ivory Coast	604	589	685	Aug-97	0.97	-3.8	-3.8	0	563		4.8
Rwanda	953	912	1,212	Dec-03	0.96	-9.2	-8.7	0	880.0	967.0	7.2
Senegal	604	563	620	Nov-00	0.93	-8.5	-11.1	-1	563		5.5
Morocco	10.3	9.55	10.1	Aug-12	0.93	-4.5	-3.8	-2			2.3
Uganda	3,818	3,488	4,427	Aug-11	0.91	-11.5	-10.5	0	3,522		13.6
Mozambique	66.8	60.4	89.3	Sep-16	0.90	-58.0	-66.7	0			11.0
Algeria	127	114	134	Apr-08	0.90	-12.6	-11.9	-1			na
Namibia	18.2	14.8	19.9	Dec-01	0.81	-4.1	-2.3	-2			6.6
Angola	555	445	1,571	Oct-99	0.80	0.9	-0.7	0	374	490	15.0
Zambia	18.9	15.0	27.4	Jul-95	0.79	-3.6	-3.4	0	11		22.6
Ghana	5.84	4.60	8.38	Aug-14	0.79	-3.6	-3.8	-1	4	6	17.9
Tunisia	2.90	2.28	3.29	Feb-19	0.79	-10.4	-9.4	-1		3.0	8.2
South Africa	18.2	14.0	20.9	Dec-01	0.77	-3.1	-3.6	-1	13	17	5.8

Source: Bruegel, IMF, Renaissance Capital estimates

The most important change at a broader level is that EM FX – which last week on the non-updated model – looked like the cheapest it had been since 1998/1999 – is now not as exciting as we thought. EM FX (excluding China) is the cheapest it has been in 15 years – but is not so cheap as 1998/1999. Currencies in general would still need to lose another 10% on the REER (ie, more in nominal terms, given inflation) to get as cheap as 1998. The nominal plunge in currencies has been partly offset by inflation in recent months. Also, plenty of Asian currencies remain much stronger than the 1990s low shown in the table above.

Figure 4: EM (ex-China) and Frontier currencies – weighted by GDP – since 1995



Source: Bruegel, IMF, Renaissance Capital

This does not change the story much for the currencies that we think look most attractive. The rand on Monday (6 April) morning at 19.1/$ was within 9% of its record weak point of

ZAR20.9 (in today's money) in December 2001. Though hard to imagine now, there was a president who did not take a virus seriously (HIV) and it was wreaking havoc. In addition, markets feared SA would become Zimbabwe and the SARB had negative FX reserves thanks to obligations on its forward book. SA has plenty of issues, it is true, but 2020 is not 2001.

We have been arguing for some time that SA might be best served by a cheap currency at ZAR20/$ to make its minimum wage more globally competitive. This remains our long-term view, but electricity problems are an impediment to attracting foreign direct investments (FDI) and a global recession means little will come anyway in 2020.

The Mexican peso is also not that far above its record lows of MXN28/$ seen during the Tequila crisis of 1995, and the lira is not that much stronger than the TRY7.5/$ equivalent lows seen in September 2018.

Frontier markets – so often dollar pegged, or heavily managed – remain expensive. In our view, deflation will be required to make currencies cheaper.

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