CEEMEA: Less important EUR effect

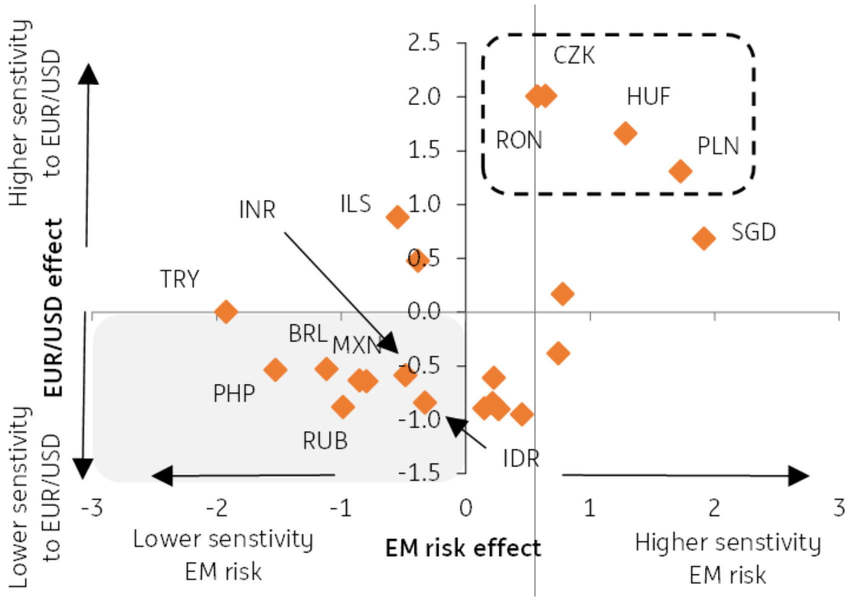
For USD investors, CEE looks a better proposition in 2H19 than 1H19 due to our V-shape EUR/USD profile. But don't look for a repeat of the 2017 CEE FX rally (when EUR/USD spiked) as, this time, higher EUR/USD will be more about a weaker dollar than a stronger euro. In contrast to 2017, CEE economies will no longer be booming

Source: Shutterstock

The CEE does not look to be an attractive proposition for USD-denominated investors in 1H19. Except for RON, the regional currencies offer a low risk-adjusted carry (vs USD) and are levered to EUR/USD, which we expect to struggle in the early part of next year. When measured against USD, the CEE currency segment has a high correlation exposure to EM risk (gauged by MSCI EM equity index) which, like the EUR/USD, we expect to struggle in 1H19 as the trade war rhetoric continues (i.e., US raising tariffs on Chinese goods to 25% on 1 January 2019).

The figure below shows the results from our Principal Component Analysis (PCA) of key drivers of EM crosses. EM risk and EUR/USD are the two most important factors, explaining more than 50% of the variation in EM FX returns. Given our outlook for the first half of 2019 (fragile risk sentiment, lower EUR/USD), CEE FX finds itself in the undesirable top right quadrant – undesirably levered to EUR/USD downside and precarious risk appetite.

CEE FX in the 'wrong' quadrant for 1H19



Source: ING

The modestly fading importance of the higher EUR/USD

While the expected rebound in EUR/USD in 2H18 should be welcome news for regional currencies, our view that this will be primarily driven by the negative dollar story in the maturing stage of the global business cycle rather than a positive EUR story suggests that the positive spillover into CEE FX should not be exaggerated.

Hence don't look for a repeat of 2017, when the euro-generated strength of EUR/USD (via expectations of the ECB QE tapering) helped to push CEE FX meaningfully higher against the euro itself. Bar the EUR/USD upside no longer being driven by EUR strength, in contrast to 2017, we expect 2019 (and mainly the second half) to see slowing CEE growth which is in clear contrast to the booming CEE economies back in 2017 which, hand in hand with the ECB-induced EUR rally, led to meaningful CEE FX gains vs EUR.

Hence, the CEE FX highs vs EUR reached in early-2018 or late-2017 are unlikely to be re-tested next year. But 2H19 should be a better period for CEE FX vs USD, but as is the case for the EUR outlook itself, don't look for fireworks.

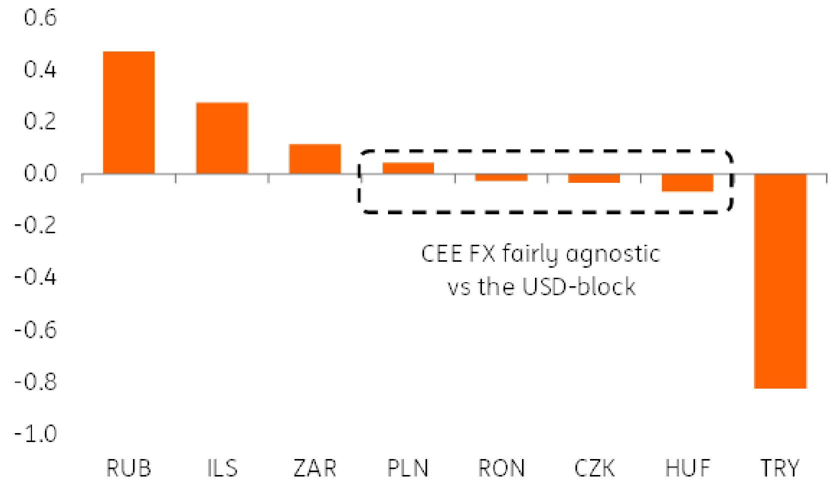
Oil price: Agnostic CEE FX vs. highly sensitive RUB and TRY (but in different directions)

In terms of spillovers from the recent sharp moves in oil prices, CEE FX is fairly agnostic, but there are significant variations present in the USD-bloc CEEMEA space. RUB, ILS (both oil exporting currencies) and ZAR (commodity FX) are the most exposed to falling oil prices, while the oil importing TRY benefits the most from lower oil prices.

This is depicted in the figure below, which shows relative sensitivities of CEEMEA FX to oil prices (which we identify as the third principal component). The individual sensitivities (or PC3 loadings) come from our PCA analysis done on the CEEMEA FX sample only, rather than an entire cross-regional EM segment. As is the case for the wider EM FX sample, oil price is the third most important driver of the CEEMEA crosses (after EM risk and EUR/USD).

Oil matters much more for CEEMEA dollar block

PC3 (the third principal component) loadings to individual CEEMEA currencies vs USD. We identify PC3 as oil price.



Source: ING

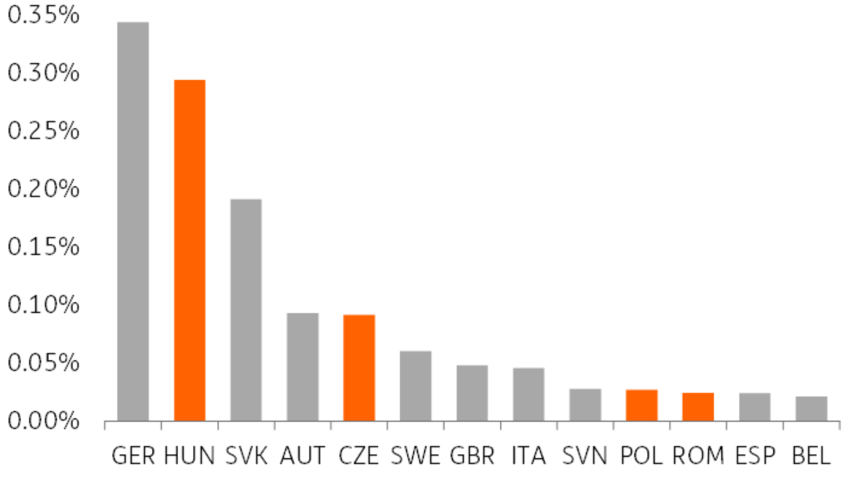
HUF and CZK most at risk to the potential imposition of auto tariffs

Given the non-negligible risk of the US imposing auto tariffs on the EU at some point next year (given ongoing threats from President Trump), this may place CEE currencies in a vulnerable position given their reliance on auto exports. In the figure below we show the share in selected EU countries' GDP to US demand for European cars. Among CEE countries, Hungary and the Czech Republic are exposed the most, more so than Poland and Romania.

We thus see CZK and HUF as vulnerable to the potential imposition of tariffs and view a short position in an equally-weighted basket of HUF and CZK vs a long position in managed and carry friendly RON as an effective relative value regional hedge to auto tariff risk. Note that the very saturated positioning in CZK and the potential concerns about execution risk during the start of the Bubor normalisation process may exaggerate the downside moves in both CZK and HUF in a potential non-friendly CEE FX environment.

Hungary and Czech most exposed to auto-tariffs

% share in GDP due to US demand for European cars among EU countries



Source: Macrobond

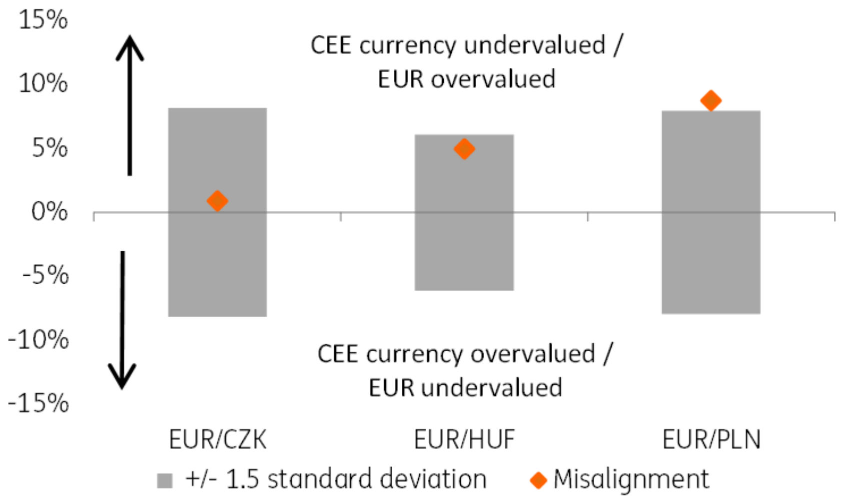
HUF: The light at the end of the tunnel

Omitting the risk of auto-tariffs mentioned above, we are no longer bearish on HUF and see it as unlikely that the cross moves above the 330 level next year. During the first part of 2018, NBH missteps led the market to question its credibility and weakened the forint, which then saw the central bank embarking on a more cautious approach in 2H18 (communicating its intention to exit its ultra-loose monetary stance gradually; lowering upside volatility in Bubor).

This is good news for HUF.

PLN is the cheapest CE3 currency, followed by HUF

%, CEE real exchange rates misalignments vs their BEER fair value



Source: ING, Macrobond

Given uncertainty related to how the NBH manages Bubor normalisation (the 'execution' risk), we expect EUR/HUF to remain flat (within the 320-325 range) in 1H19. However, we expect EUR/HUF to approach 310 by the end of 2019 for the following reasons: (1) very stretched short positioning; (2) delivery of a well behaved Bubor normalisation; (3) an ongoing current account surplus; and (4) non-negligible undervaluation vs EUR - you can see this in the above figure.

The currently stretched positioning is one key difference to the period before the 2Q18 forint drop. In the absence of NBH missteps, the one-way positioning will make it virtually impossible for EUR/HUF to sustainably break above 330. Also, HUF benefits from the highest current account surplus in the CEE region. The flow picture is still positive even though the external position has been deteriorating meaningfully (and is currently not as large a supportive factor as in previous years). We thus expect EUR/HUF moving towards 310 by end-2019.

310 EUR/HUF

End-2019

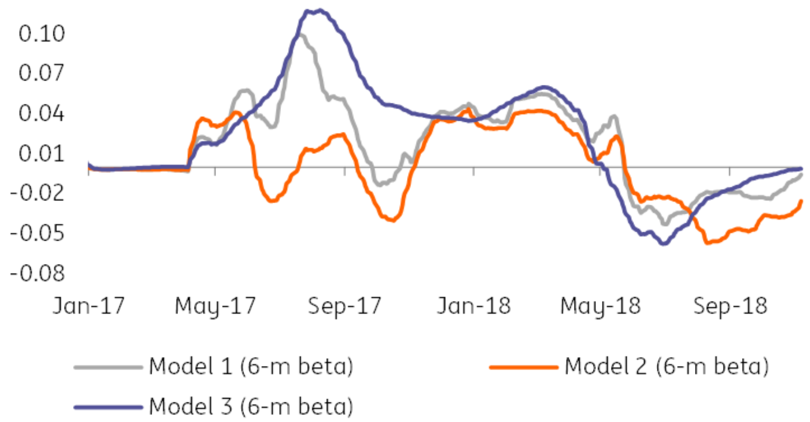
CZK: The CNB holding it all together

CZK has turned into the pain trade of 2018. Despite the ultra-hawkish CNB, the exchange rate did not perform. We look for a modest decline in EUR/CZK in 2019, but our conviction is not overly high. In our view, potential CZK gains are heavily dependent on further tightening from the CNB.

And as observed this year, CNB hikes alone are not a sufficient condition for CZK strength. This is because the still saturated positioning in large part tames the transmission mechanism from higher interest into CZK, as evident in the figure below. Indeed, despite the five CNB hikes this year, CZK is down vs EUR year-to-date. Interestingly, the CZK outperformance vis-à-vis what is the perceived higher beta PLN and HUF has been only marginal this year despite that fact that: (1) both PLN and HUF should underperform CZK in an EM risk challenging environment anyway; (2) both suffered from idiosyncratic negative stories (HUF in particular); and (3) their respective central banks did not deliver hikes. This clearly suggests that the CZK non-performance is not only about the weak EUR/USD or soft EM risk. Under normal, non-overbought circumstances CZK should have been much higher given the scale of CNB tightening.

CZK sensitivity to rate spreads is muted

6-month rolling betas of 2-y interest rate differential to EUR/CZK. Model 1 and 2 are the short term financial fair value models using either four or three variables (ie, rate spread, shape of the curve, risk, relative equity). Model 3 is a pure one variable (rates spread) model



Source: ING, Macrobond

In our view, the ultra-hawkish CNB has been the main factor holding CZK together as, in the absence of aggressive hikes, the koruna would have been much weaker. As a result, the market perception of the CNB outlook is the key driving factor and, at the same time, the key risk to CZK. To the extent to which the global investment community may ascertain that: (1) the Eurozone, CEE and Czech economic cycles are maturing; (2) the room for pronounced and prolonged tightening is closing; and (3) causing the market to tame expectations for a pronounced CNB tightening cycle from here (which is already evident in the aggressive flattening of the CZK curve), then the koruna's fortunes will look heavily at risk.

And the downside risk will be further compounded by the still heavy positioning. That's why we expect the CNB to continue hiking next year and see it as more likely that the CNB delivers four hikes next year rather than none (currently 40bp priced in by the market) just to hold the CZK together (note that our base case is three hikes by August 2019).

As per the argument that EUR/CZK may restart a meaningful depreciation trend once the global risk environment stabilises and EUR/USD rises, we note two things. First, we expect a better risk environment and higher EUR/USD to occur only in 2H19. Second, recall the situation in 3Q17 when EUR/CZK was particularly flat and struggled to break below 26.00 despite the fact that both DM and EM equities were rising and the EUR/USD rallied. EUR/CZK only broke meaningfully below 26.00 once the CNB turned on very hawkish rhetoric.

Hence, and in terms of the CZK upside potential, it is largely about the CNB. The hawkish CNB gives, the dovish CNB takes. We still look for the former and expect a modest CZK appreciation, but believe it will struggle to move meaningfully below EUR/CZK 25.50.

PLN: Helped by unique inflation profile in 1H19

The zloty is the most undervalued currency in the CE3 space.

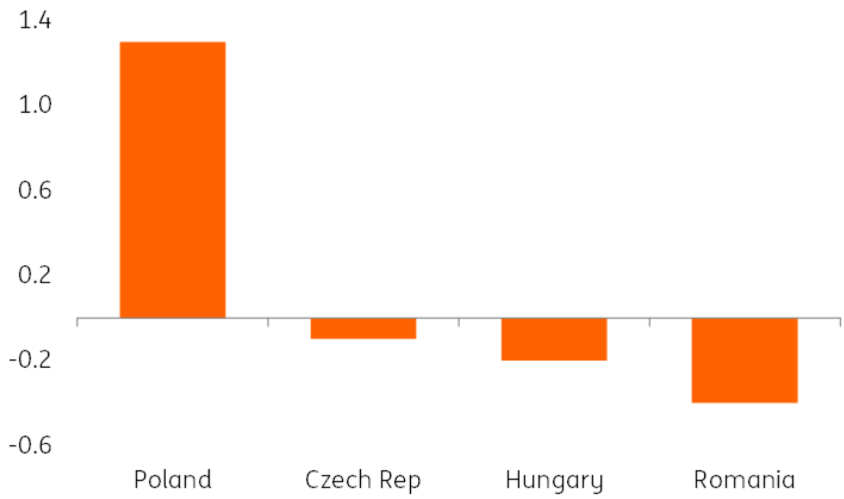
Also, the Polish inflation profile is rather unique in the CEE space. We believe that CPI inflation has reached its peak in both Hungary and Romania and is set to decelerate from here. Although Czech inflation should reach modestly higher levels in 1Q19 in what has been a sustained above-target slog higher, it will decline in 2Q19. In contrast, the Polish CPI profile is set to experience a rather sharp acceleration, from 1.5% this November to above 3% by June 2019, which is above the 2.5% inflation target. As the figure below shows, this will constitute a large divergence vs its CEE peers. While we have a high conviction that the NBP is set to remain on hold throughout this cycle, such a sharp acceleration in price dynamics should lead to (albeit ex-post unjustified) market hawkish re-pricing of the NBP and support the zloty during the first half of the year.

The zloty is the most undervalued currency in the CE3 space

Less positive for the zloty is the substantial deceleration in Polish GDP in the second half of the year that our economists are pencilling in as well as the parliamentary elections in autumn 2019. The potentially negative headline news ahead of the election may reduce investor appetite for PLN. Mainly for domestic reasons, we see more upside to the zloty vs EUR in 1H19 vs 2H19. But as is the case for all CEE FX, gains should be fairly limited, and EUR/PLN should not move below 4.20.

PLN to benefit from unique CPI profile in the region

Forecasted change in CEE CPI inflation between 4Q18 and 2Q19 (based on ING forecast)



Source: ING

RON: Futile effort to try to short RON

We don't see it as likely that the NBR would allow a meaningful RON depreciation such that long EUR/RON positions would outperform the forwards, which reflect a 4% carry – the highest in the CEE space. With Romania having the highest FX pass-through in the region (around 0.4) and CPI still hovering above the upper-tolerance band, it is difficult to imagine the inflation targeting NBR allowing an aggressive RON depreciation.

While we agree with the view that Romanian fundamentals are rather poor, RON is not the most effective vehicle with which to play that. Given the high FX pass-through, RON is an inflation play, not a fiscal play.

4.72 EUR/RON

End-2019

TRY: When cheap valuation is not enough

Following its decline this year, TRY is the cheapest EM currency by a considerable margin, being 45% undervalued vs USD based on our BEER model. Despite such a meaningful medium-term undervaluation, TRY may not rally further. This is partly because due to the high inflation (current and expected in coming months) the currency has been and will be meaningfully appreciating in real terms. This has been in part closing the extreme valuation gap and we believe will continue to do so.

After its decline this year, TRY is the cheapest EM currency by a considerable margin

For example, the inflation differential alone led to the 10% TRY appreciation vs USD via the price channel in the third quarter this year. As Turkish inflation remains elevated, the lira will continue appreciating in real terms, thus eating into what is currently a stretched valuation gap.

6.30 USD/TRY

End-2019

While we acknowledge that TRY nominal and risk-adjusted carry remain attractive, the real yield remains sub-zero and is one of the lowest among the EM FX sample. Moreover, with the lack of concrete steps following the introduction of the medium-term plan and the uncertainty ahead of the local elections in March 2019, all this suggests that the lira's outlook for the early part of next year may be tricky. Coupled with the last push in USD higher in the ending dollar bull cycle, USD/TRY is likely to head higher during the first part of next year.

Given the lira's idiosyncratic factors, we look for a weaker currency, with USD/TRY rising above 6.00. We expect USD/TRY to rise modestly more than the already stretched forwards throughout 2019.

RUB: Hoping to carry on

We expect RUB to strengthen into end-2018, benefitting from the seasonal strength in the current account, the on-hold MinFin FX interventions and our view that no punitive sanctions will be announced this year.

The main theme for RUB in 1H19 is the potential for US sanctions. Not only whether the US imposes sanctions, but what form the sanctions will take (punitive or rather low key). This is the main risk that could derail USD/RUB from our carry friendly/flattish profile (broadly around USD/RUB 65.00 throughout 2019). Importantly, our economists do not see the potential re-start of FX purchases next year as a material RUB negative as this should be done in response to easing capital outflows.

The main theme for RUB in 1H19 is the potential for US sanctions

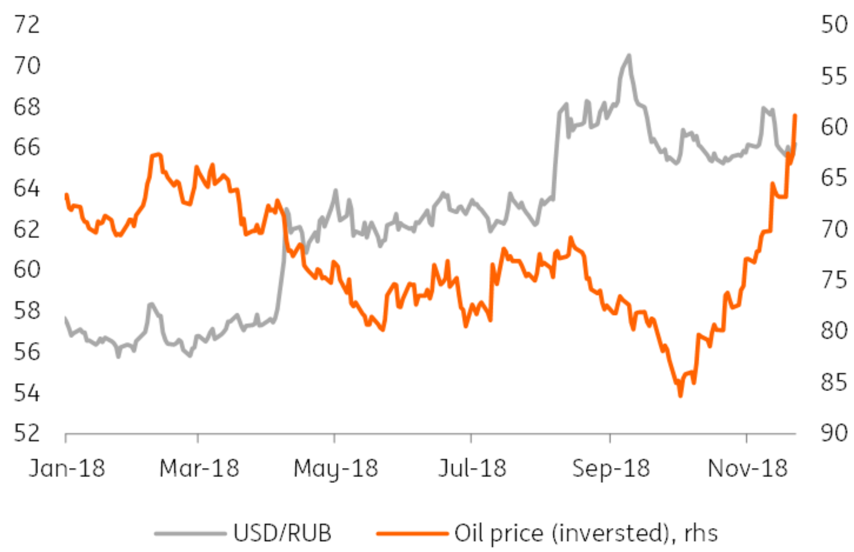
Hence, as a balancing/ stabilisation factor to Russia's current account surplus, the FX purchases will be restarted only if capital outflows ease, but are unlikely to be introduced on the top of them as an additional RUB negative. This means that the net effect of flows on RUB should not change versus the current state of affairs and the eventual restart of FX purchases should not be seen as net RUB negative.

65.0 USD/RUB

End-2019

While the recent collapse in the oil price is not good news for RUB (which in relative terms is one of the most sensitive CEEMEA currencies to oil prices) its absolute sensitivity remains muted, in line with the trend of past quarters. This is depicted in the figure below.

RUB has been relatively resilient to falling oil price



Source: ING, Macrobond

This report is part of our 2019 FX outlook published in November 2018 and was written in conjunction with the EMEA Economics team

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