

Is the EM sell-off running out of steam?

EM currencies have stabilized over the last couple of weeks, and local currency bond yields have retreated from their highs. Has this sell-off ended, or is it merely marking time?



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Tariff announcements no longer moving the needle

When the US President announced the latest round of tariffs on Chinese imports this week, markets didn't do an awful lot. At least in part, this may be because markets had already taken a very dim view of how this trade war would actually develop. And in the end, this latest \$200bn of tariffs is perhaps being phased in a little slower than many had believed. Of course, there are more Tariffs in the pipeline, but like many episodic market drivers, there comes a point when incremental changes cease to have much economic impact. Think of the North Korean missile tests last year... In the end, the market seems to just lose interest unless the story fundamentally changes.

Moreover, the EM sell-off wasn't driven solely by the Trade war. The strength of the US dollar from the end of April, though connected with President Trump's tariffs, could also be viewed as the main catalyst that drew attention to current account deficit countries within the EM universe, pouring fuel on the already flickering flames - these flames started by interference with the independence of some EM central banks, high external debt, fiscal deficits, and high inflation. Over the last month, however, the USD has traded in a fairly tight range, with even some tendency for EURUSD to test that range's upside.

Within the Asia region, markets are also looking calmer. Exchange rates for Indonesia, India and

the Philippines have all retreated from their recent highs, and local government bond yields are also lower.

A steady China is helping

Helping to provide a semblance of calm in the region, and perhaps globally, the stability shown by the Chinese yuan since mid-August after it pared back moves towards USD/CNY7.0, is certainly a helpful addition to recent stability.

Chinese Premier Li Keqiang is reported as saying that China will not stimulate exports by devaluing the yuan. And although this could be viewed more as a backward-looking description of reality than any pledge about the future, it does confirm that for the moment at least, the gravity exerted on other Asian currencies by the yuan is not pulling them weaker.

What could change this?

With rising twin deficits in the US weighing on the USD and the ECB finally moving away from its ultra-loose policy stance, there looks to be a good case for this period of currency stability, even perhaps some retracement of the move since April, to continue.

About the only thing we think might alter this outlook could be a change in views about the Fed, driven perhaps by stronger than expected inflation or wages data, and capitulation by the market, which remains in partial denial of the Fed dot diagram - that diagram is finally beginning to look at if it might not be that far off the mark after all. I'm not sure that more bad news from EM countries would shift the balance much.

Stronger than expected NZ GDP figures lift the NZD

The NZD has been on a downward march since April, dropping from USD/NZD 0.74 to as low as 0.6501 only a few weeks ago. Expectations for any tightening from the RBNZ are very low, with hints by the RBNZ at the August meeting that rate cuts should not be ruled out. These hints have been reinforced by weak business confidence readings and low expectations about future activity.

Market chatter was that even an upside shock like this would have little impact on these downbeat RBNZ expectations. But the upside miss, 1.0%QoQ, against a 0.8% expectation, is quite a big one. And we wonder if business confidence might pick up a bit if the economy is shown to be growing faster than most observers had imagined. It is not always clear what is driving what with such surveys. Are they really forward-looking? Or do they also respond reactively to backward-looking data releases like GDP?

In line with downbeat business surveys, gross fixed capital formation in 2Q18 did grow only 0.1%QoQ, and most of this comes from residential construction, suggesting very soft business investment in plant and machinery. Exports rose by 2.4% from the first quarter, improving from the flat outcome in 1Q18, whilst imports only nudged up to 1.5%QoQ from 1.1%.

We aren't going to alter our RBNZ forecasts, which keep rates unchanged through the rest of this year and 2019. But we are being a bit more open-minded about the future for the RBNZ, and perhaps a little less inclined to blindly accept the RBNZ's rate guidance.

Abe on course for third term at head of LDP

Not that there was really any doubt, but Japan's PM Abe will almost certainly win the leadership of the Liberal Democratic Party today, allowing him to continue serving as Prime Minister for another three years.

Abe may be being helped by the good performance of the Japanese economy, and amongst other policy initiatives, leaves the consumption tax hike on track for an increase next October. and move forward with efforts to amend Japan's pacifist constitution.

We don't see Abe's election today having any significant market impact.

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