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## There could be hurdles to this emerging market currency rally

◆ MSCI EM currency index is nearly flat for the year, down only 1.8% year-to-date and up 5.7% since its recent low on 23 March.

◆ The Chinese yuan has been pacing the gains, up 2.2% year-to-date and 5.8% since its 27 May recent low.

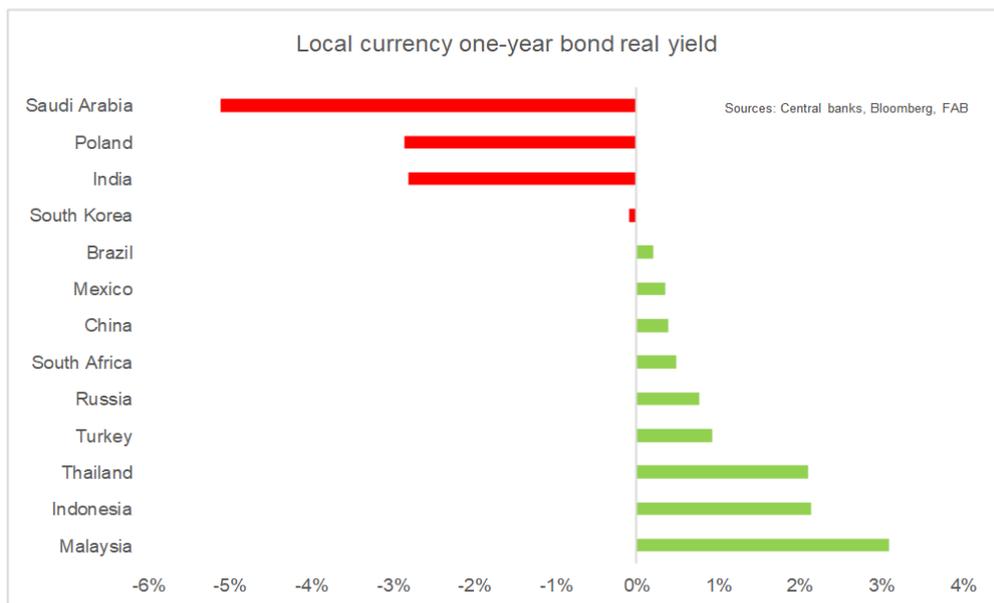
◆ Despite the gains, many of the challenges of the most liquid currencies remain in place or have worsened this year.

◆ Local currency real yields (discounting inflation) of many developing nations are now at, or near, record lows.

◆ The FAB AAC favours hard currency emerging market bonds and remains slightly overweight gold.

Like other risk assets, local emerging market currencies have recovered nicely after an initial jolt due to economic concerns following the Covid-19-related lockdowns in March. The MSCI Emerging Market Currencies index has rallied 5.7% since its low on 23 March and is now only 1.8% away from turning positive for the year. While that pales in comparison to the 61% rally of the NASDAQ 100 since 23 March, it is not bad for an index that has only gained 11.4% in the past five years.

These local currencies normally would benefit from the global hunt for yield as US\$15.4 trillion of bonds worldwide offer negative nominal returns. That has been seen, with money flowing to emerging market government bonds in the past couple of months after historically high withdrawals earlier in the year. However, these are far from normal times.



Usually, the central banks in these countries would have been increasing interest rates to control rising inflation and accelerated currency depreciation in many of them. Instead, the opposite is happening. Many of the biggest economies have leaned on their central banks to buy government bonds and finance soaring spending targeted at reversing the global slowdown.

This has resulted in some of the lowest yields on record for many of the local currency government bonds in developing markets, and in many cases these returns are negative when adjusted for the local inflation. On top of that, high volatility over the past year has increased the cost of hedging against currency fluctuations.

As a result, in very few instances in recent history it was less profitable to invest in local currency government bonds of most large emerging markets. Then again, when compared to negative rates even low returns look attractive.

### Real yields in the biggest developed nations are near the lowest in their history

There is something to be said, too, about potential appreciation ahead, regardless of such historically low yields. EM currencies have a high correlation to the Chinese yuan, and that has been on a tear. Today it crossed the CNY6.8/US\$ barrier for the first time since May, 2019. The move came in the wake of positive year-on-year retail sales numbers for China and strong data on construction spending.

Despite Chinese tailwinds, the frailties of some of the developing nations have not been strengthened by weaker currencies. The current account balances of Turkey, Brazil, Mexico, India, Indonesia and South Africa (to name a few) remain negative or nearly so, while reserves are dwindling. With this kind of risk, investors may have expected better rewards.

# Investment Strategy Update

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