

Emerging Insight

Hard landing: EM FX is likely to perform better than in previous episodes

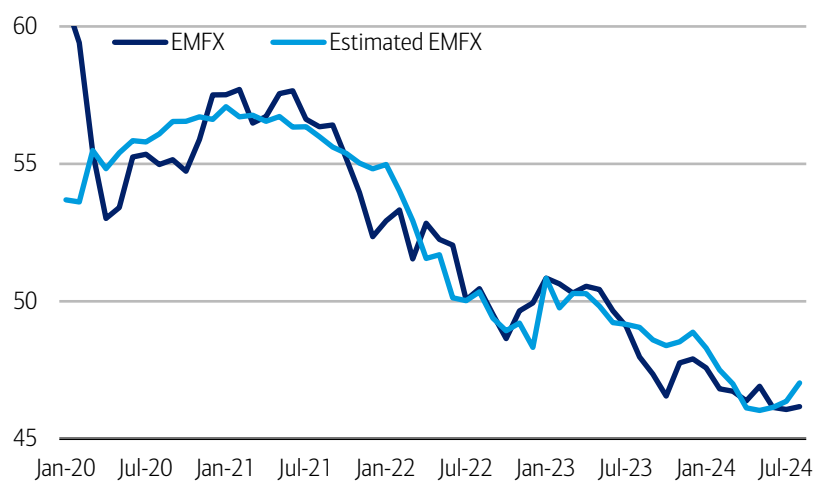
Key takeaways

- US ToT + US 2y + China's hp drive EM FX after COVID. US ToT = oil now. In hard landing, oil + US 2y fall, supporting EM FX.
- EM FX drivers may change in a hard landing with a major credit event (lower likelihood) - EM FX weakens as much as before.
- Our weekly + monthly EM FX PCA is in line with the conclusions above - global growth is less important for EM FX now.

By Mikhail Liluashvili

Chart of the day: Fed easing and worsening US ToT to support EM FX in a hard landing

US ToT, US 2y and China's house prices drive EM FX after COVID in our regression analysis



Source: Bloomberg, EViews, BofA Global Research

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Lower oil + Fed easing to support EM FX in a hard landing

Since COVID, higher oil has been associated with weaker EM FX, while the opposite was true before the shock. The importance of US monetary policy has also increased post COVID, while global growth has become less important. Lower oil prices (and hence worse terms-of-trade in the US) and falling 2y US swap in a hard-landing scenario should provide some support to EM FX, making its performance better than in previous similar episodes. If a hard landing involves a major credit event, EM FX might weaken as much as in previous episodes as drivers change.

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GEM Fixed Income Strategy & Economics
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Abbreviations

DOLS is Dynamic Ordinary Least Squares

PCA is principal component analysis

PC is principal component

ToT is terms of trade

hp is house prices

DXY is dollar index

China's hp, US ToT and 2y swap drive EM FX after COVID

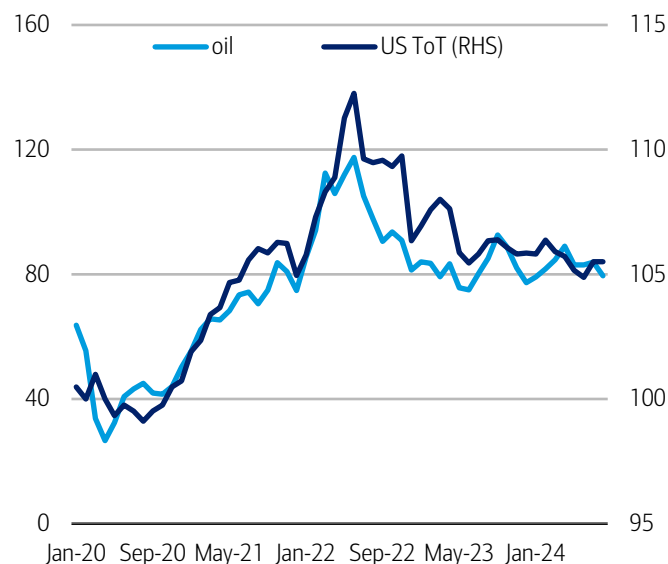
Since COVID, China's house prices coupled with US ToT and US 2y swap have explained EM FX performance (see Appendix and Exhibit 5-Exhibit 6). This implies that EM currencies are driven by the strength of China's economy, US terms of trade and US monetary policy. This is a big change from pre-COVID times. In our previous piece, we showed that global real growth (proxied by EM export volumes) and commodity prices drove EM currencies in the period between the Global Financial Crisis and COVID (see [Emerging Insight: Hard landing might be less bad than usual for EM FX 05 December 2023](#)).

US ToT have been very correlated with oil prices since COVID

After COVID, US ToT became positively and strongly correlated with oil prices. The correlation coefficient between the two variables is circa 0.94 for January 2020 to July 2024. This strong relationship is driven by the fact that the US has become a major oil exporter, in our view. This is a big change from pre-COVID times when the correlation was negative at circa -0.87.

Exhibit 1: Higher oil = better US terms of trade after COVID

The correlation is circa 0.94

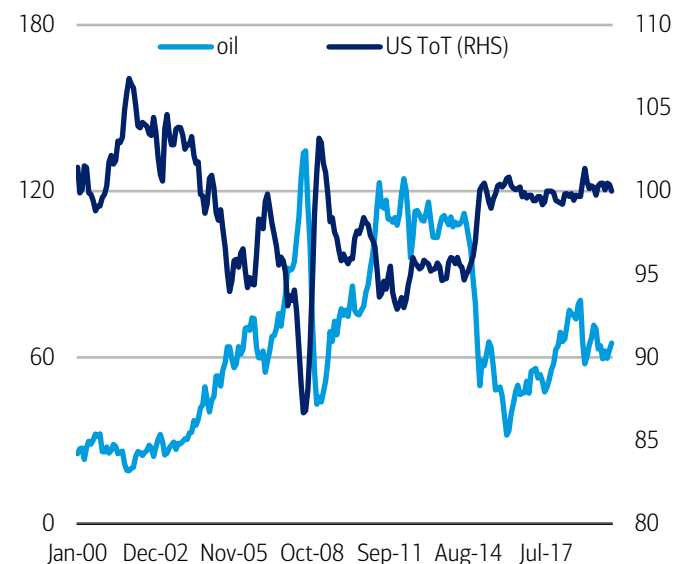


Source: Bloomberg, BofA Global Research

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Exhibit 2: Higher oil = worse US terms of trade before COVID

The correlation is circa -0.87



Source: Bloomberg, BofA Global Research

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Oil prices + US 2y swap should drop in a hard landing, supporting EM FX

In a hard-landing scenario, a fall in oil prices and, hence, deterioration in US ToT coupled with a fall in US 2y swap (as the Fed cuts more than priced) should provide support for EM FX. However, this analysis assumes that the drivers of EM FX do not change.

In the case of a major credit event, EM FX might weaken as much as before

Drivers of EM FX tend to change over time and major events (such as the Global Financial Crisis, oil price shocks, COVID) are usually the triggers for that. As a result, if there is a major credit event, EM FX would probably weaken significantly as risk-off would most likely overshadow any potential support from US ToT and monetary policy, in our view.

PCA analysis: hard landing might not as bad as before

Our analysis confirms that global growth has become less important for EM FX since COVID, while the importance of US rates and China has increased. We update monthly and weekly PCA for EM FX, including all major EM currency pairs against the USD. We use the period from January 2020 to now for the monthly frequency and past 42 weeks for the weekly PCA. For reference, our PCA analysis for January 2010 to December 2019



was done in this piece: [Emerging Insight: EM FX has become more idiosyncratic since COVID 17 January 2024](#).

Monthly PCA: global growth less important than before because...

Global growth, which we proxy using EM exports, does not seem to matter much for the first three principal components. This supports our view of better EM FX performance in a hard landing compared with previous episodes. This a change from the pre-COVID period when EM export volume was strongly correlated with the first principal component and EM export prices were correlated with the second ([Emerging Insight: EM FX has become more idiosyncratic since COVID 17 January 2024](#)).

... US rates, DXY + VIX are the main drivers of the first and second PCs now

The first principal component is driven by US rates and DXY, while US ToT, US BAA 10y spread and VIX have the strongest correlation with the second after COVID. The first principal is cointegrated only with DXY and the US 10y real rate, while the second principal component is cointegrated only with VIX. Exhibit 3 shows the results of monthly PCA of EM FX for the period January 2020 to now.

Exhibit 3: US rates and DXY drive PC1; VIX drives PC2

Monthly PCA on all major EM FX currencies (monthly average data from Jan 2020-Aug 2024)

	factor1	factor2	factor3
Brent crude oil	0.45	-0.13	0.63
Industrial metals	0.05	-0.19	0.82
US BAA 10y spread	-0.33	0.64	-0.46
US Terms of Trade	-0.44	0.62	-0.15
US 1y1y forward rate	0.90	-0.20	0.22
US 5y breakeven	0.06	-0.24	0.82
US money market conditions	0.75	-0.45	-0.01
US 5y5y real rate	0.47	-0.42	0.64
Dollar index	0.93	0.18	0.07
US Economic Surprises	-0.50	-0.28	-0.02
US Swap 2s5s	-0.88	0.13	0.08
VIX Index	-0.36	0.62	-0.27
EU Swap 2s5s	-0.85	0.25	0.01
USDCNY	0.83	-0.01	-0.51
Atlanta Fed GDP	-0.14	-0.33	0.22
EUR Swap rate 5y	0.92	-0.25	0.17
China Economic surprises	-0.01	-0.22	0.15
US 2 year swap	0.93	-0.24	0.14
US 10 year swap	0.89	-0.31	0.22
US 10y breakeven	0.19	-0.30	0.80
US 10y real rate	0.94	-0.27	-0.04
US 5 year swap	0.91	-0.27	0.20
UST Implied Index	0.76	0.01	0.28
China House Prices	-0.50	0.16	0.65
EM export volume	0.52	-0.36	0.66
EM export price	0.37	-0.06	0.80
EM exports	0.46	-0.17	0.78

Source: Bloomberg, Haver, MATLAB, BofA Global Research

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Weekly PCA: EM FX is mainly about China and US inflation, not global growth

US ToT, USDCNY, China's house prices and DXY are most correlated with the first principal component (Exhibit 4). Only China house prices and USDCNY are cointegrated with the first principal component. The second principal component is most correlated with US breakevens and US economic surprises, while global growth variables matter a lot less for EM FX than before COVID. Only US 5y and 10y breakeven inflation variables are cointegrated with the second principal component.

Exhibit 4: China's hp are cointegrated with the first PC, US breakevens with the second PC

PCA analysis is fully consistent with our view on EM FX performance in a hard landing

	Factor 1	Factor 2	Factor 3
Brent crude oil	0.55	0.53	-0.26
Industrial metals	0.54	0.10	-0.27
US BAA 10y spread	-0.27	-0.58	0.15
US Terms of Trade	-0.81	-0.04	0.30
US 1y1y forward rate	0.42	0.62	-0.04
US 5y breakeven	0.04	0.91	-0.29
US money market conditions	0.72	-0.23	-0.26
US 5y5y real rate	0.04	0.73	0.09
Dollar index	0.79	0.48	0.19
US Economic Surprises	-0.22	0.88	-0.13
US Swap 2s5s	0.26	-0.48	-0.19
VIX Index	0.34	-0.26	-0.15
EU Swap 2s5s	0.67	-0.41	-0.32
USDCNY	0.86	0.31	-0.05
Atlanta Fed GDP	0.39	0.28	0.01
EUR Swap rate 5y	0.35	0.40	0.21
China Economic surprises	-0.09	0.79	-0.02
US 2 year swap	0.28	0.67	0.03
US 10 year swap	0.35	0.62	0.04
US 10y breakeven	0.17	0.82	-0.20
US 10y real rate	0.49	0.35	0.14
US 5 year swap	0.37	0.65	0.00
UST Implied Index	-0.54	-0.12	0.43
China House Prices	-0.92	-0.06	0.22
EM export volume	0.40	0.04	-0.15
EM export price	0.18	0.57	-0.45
EM exports	0.55	0.53	-0.26

Source: Bloomberg, Haver, MATLAB, BofA Global Research

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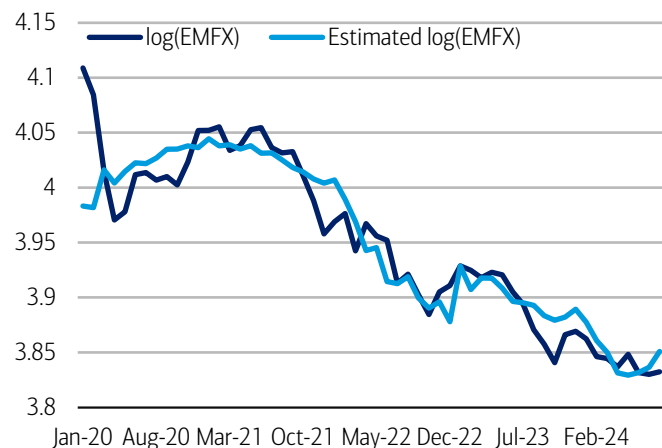
Appendix: EM FX DOLS models after COVID

US ToT, US 2y swap + China's house prices are EM FX drivers

We construct a DOLS model of EM FX as a dependent variable and seasonally adjust China's house prices, US ToT and US 2y swap as independent variables. We use logarithm transformations for all variables except for US 2y swap. We also use monthly average frequency for January 2020 to August 2024. The variables are cointegrated on a 10% significance level (with EM FX being a dependent variable in the cointegration test). We use both Engle-Granger and Phillips-Ouliaris tests to confirm cointegration. All variables under consideration have 1 unit root, as confirmed by both Dickey-Fuller and Kwiatkowski-Phillips-Schmidt-Shin tests.

Exhibit 5: EMFX and estimated values

EM FX looks undervalued now



Source: Bloomberg, EViews, BofA Global Research

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Exhibit 6: Global growth is no longer that important for EM FX

It is a big change from pre-COVID times

Dependent Variable: LOGEMFX

Method: Dynamic Least Squares (DOLS)

Date: 08/16/24 Time: 17:32

Sample: 2020M01 2024M08

Included observations: 56

Cointegrating equation deterministics: C

Fixed leads and lags specification (lead=0, lag=0)

HAC standard errors & covariance (Bartlett kernel, Newey-West fixed bandwidth = 4.0000)

No d.f. adjustment for standard errors & covariance

Variable	Coefficient	Std. Error	t-Statistic	Prob.
_2YEAR_SWAP_US	-0.019633	0.004047	-4.850684	0
LOGHP_CHINA	0.863796	0.183301	4.712438	0
LOG(US_TOT3)	-0.659002	0.327709	-2.010937	0.0499
C	3.075386	1.34051	2.29419	0.0261
R-squared	0.857241			
Adjusted R-squared	0.83976			
S.E. of regression	0.030724			
Mean dependent var				3.951273
S.D. dependent var				0.076752
Sum squared resid				0.046254

Source: Bloomberg, EViews, BofA Global Research

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New and Views

Mexico: Retail sales fell -0.5% mom sa in June

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Retail sales in June surprised to the downside at -0.5% mom sa in real terms (E. 0.2%, BofA 0.7%), down from 0.0% in May (revised to the downside from +0.1%). So far in 2024, retail sales have fallen, in monthly terms, in 4 out of 6 months. Employment in retail was flat (same as in May), while real wages increased by 0.7% mom sa (vs 0.7% in May). Furthermore, wholesale sales fell -1.7% mom sa (vs +2.9% in May). In annual terms, retail sales fell -3.9% yoy nsa, while year-to-date they have fallen -0.3% sa.

- **To follow:** The Mexican economy looks weak at the start of the second half and this print confirms the downside risks to our (below consensus) 1.1% GDP growth expectation for this year. Banxico is likely to continue cutting on weak growth despite headline inflation way above its target.

Mexico: CPI weights will be updated on Thursday, August 22

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CPI weights will be updated on Thursday, August 22, at the same time when the biweekly inflation figures for the 1H Aug are published (6 AM local time, 8 AM ET). The updated weights will be primarily based on the results from the Encuesta Nacional de Ingresos y Gastos de los Hogares (ENIGH) carried out in 2022, which is a survey that tracks consumption expenditure patterns in Mexico. Among the notable changes observed in the survey, food and beverage significantly increased its share in quarterly household expenditure, while education's share fell sharply.

- **To follow:** In our view, food and beverage will likely get more weight. Since those are tradable goods, this would increase the sensitivity of the CPI to MXN movements. Services will likely get less weight, in part driven by less weight to private education (as households likely switched to public education in the pandemic). However, the overall impact on inflation remains unclear, although in the past changes of this nature have been of second order.



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