EMERGING MARKETS & CHINA STRATEGY

September 24, 2024

Central Bank Decisions: The Fed, Brazil, And South Africa

In This Report

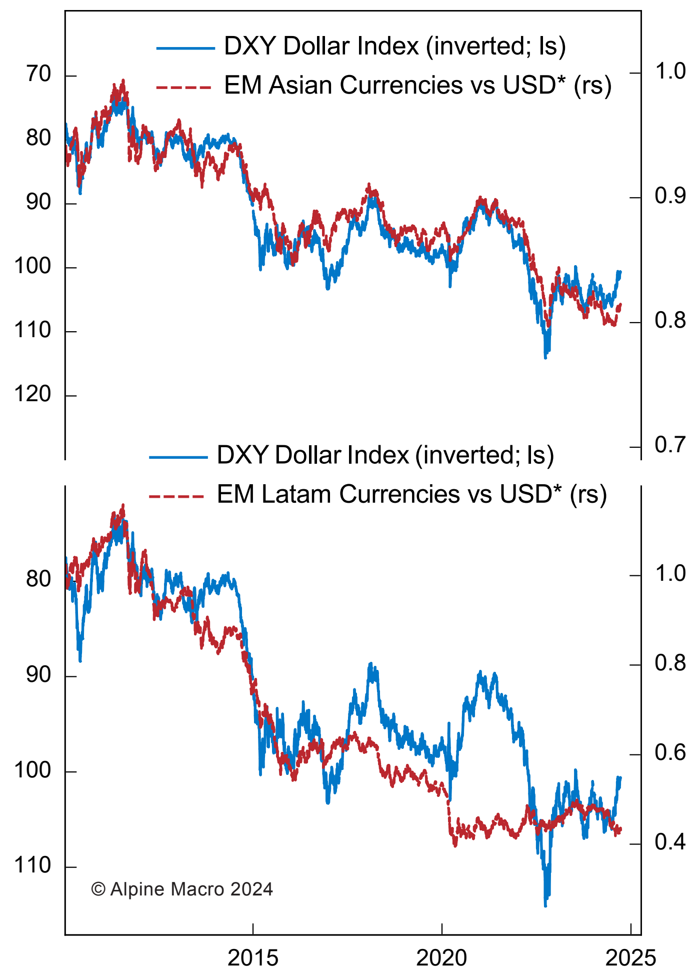
The Federal Reserve's 50 basis-point rate cut last week marked the beginning of an easing cycle. This reduces the risk of a U.S. economic hard landing and allows EM central banks to follow suit with rate cuts, providing a catalyst for EM assets to rally. The only EM central bank that is bucking the easing trend is Brazil, which raised rates last week and hinted at more to come. This is bad news for stocks but should be good news for its currency. Meanwhile, the South African economy is showing budding signs of improvement, and the rand has also begun to strengthen from a deeply depressed starting point. This week, we are going long on the Brazilian *real* versus the Mexican peso, and long on the South African rand versus the U.S. dollar.

EM Assets: Where Does The Fed Easing Fit In?

At Alpine Macro, we have consistently argued against the possibility of a U.S. recession,[1] and the Fed's decision to "front-load" rate cuts further reduces recession risk. Even though more policy easing remains necessary, it is important to note that the U.S. economy has been fairly resilient to the Fed's previous aggressive rate hikes, with no signs of major cracks in the labor market or economic growth. Moreover, U.S. households and the banking sector are in very good shape. This argues against a major consumer retrenchment and a financial crisis, both of which are necessary conditions for a U.S. recession.

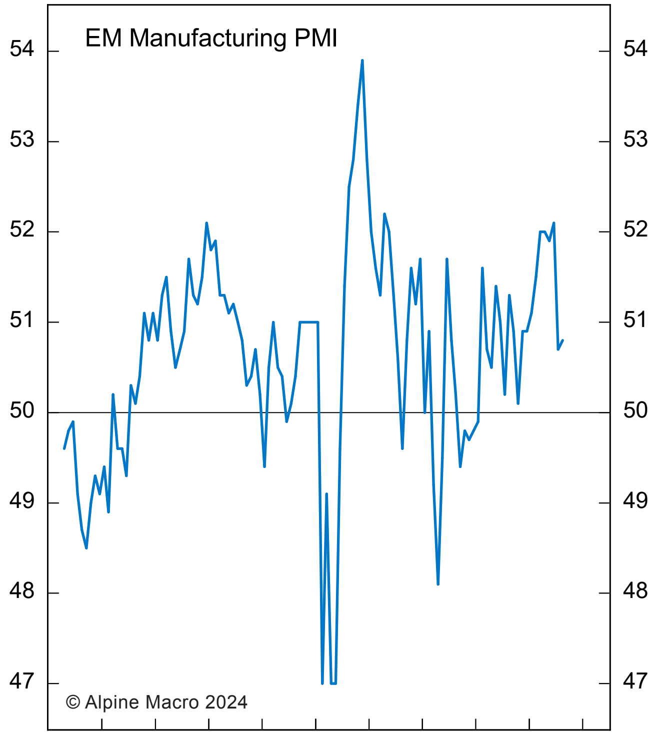
1 Alpine Macro *Global Strategy Special Report* "Why Are We Still Bullish?" (August 5, 2024).

Chart 1 EM Currencies Likely To Strengthen



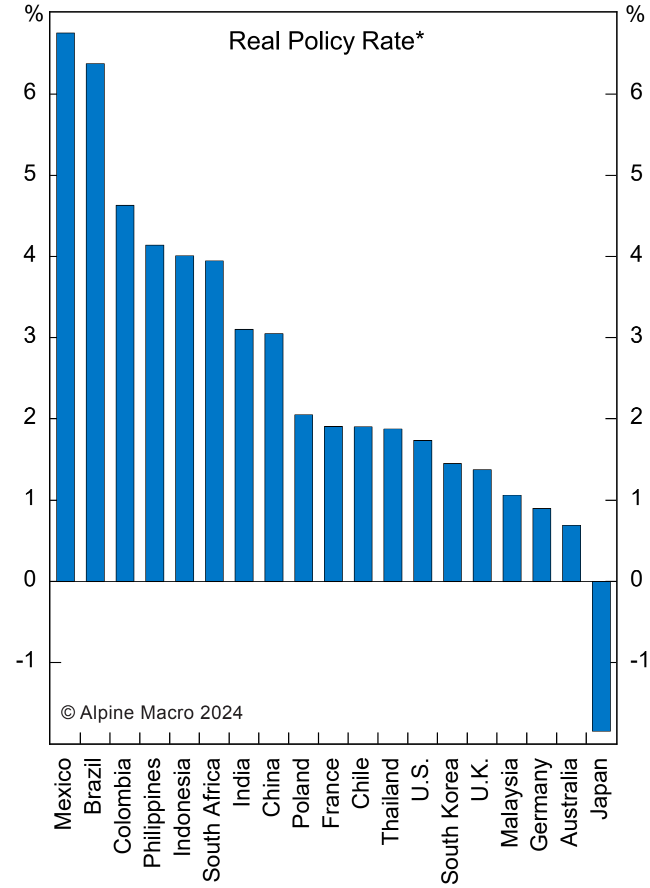
*Calculated as EM stock prices in US$ terms divided by those in local currency terms; source: MSCI

Chart 2 EM Growth Has Been Resilient



Note: Series truncated at 47; source: S&P Global

Chart 3 EM Monetary Policies Are Much Tighter Than DM



*Deflated by core CPI inflation

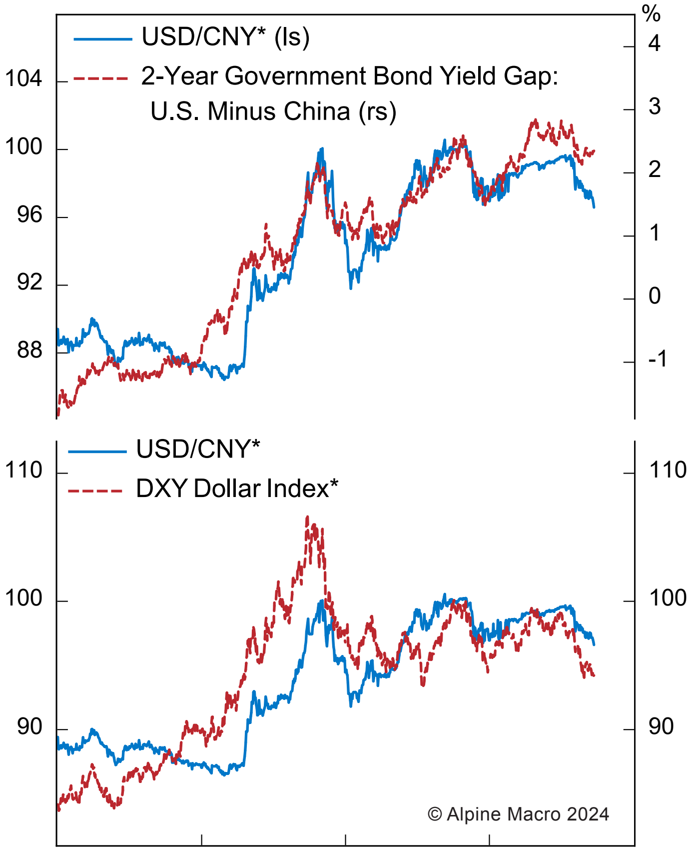
This is a crucial judgment for EM investors, as EM assets have never performed well during U.S. recessions. On the contrary, a soft-landing scenario would be positive for EM, as slower growth in the U.S. and Fed easing would narrow the growth and interest rate gaps between the U.S. and the rest of the world, which in turn reduces downward pressure on EM currencies and allows EM central banks to ease (Chart 1). Already, this month alone, early movers such as the Chilean and Peruvian central banks have cut rates again, while Bank Indonesia and the Reserve Bank of South Africa have also joined the chorus, embarking on the easing cycle.

Meanwhile, most EM economies have been reasonably buoyant despite aggressive Fed rate hikes, domestic policy tightening, and the growth slowdown in China.[2] On aggregate, the EM manufacturing PMI has consistently stayed above the expansionary threshold (Chart 2), and some EM countries appear to be on the verge of a reacceleration.[3] Chart 3 shows that real policy rates in many EM countries are at the high end of their respective ranges, and are far higher than in major DM countries, leaving more room for policy easing.

2 Alpine Macro *EM & China Strategy* "Is China In A Slow-Motion Implosion?" (August 27, 2024).

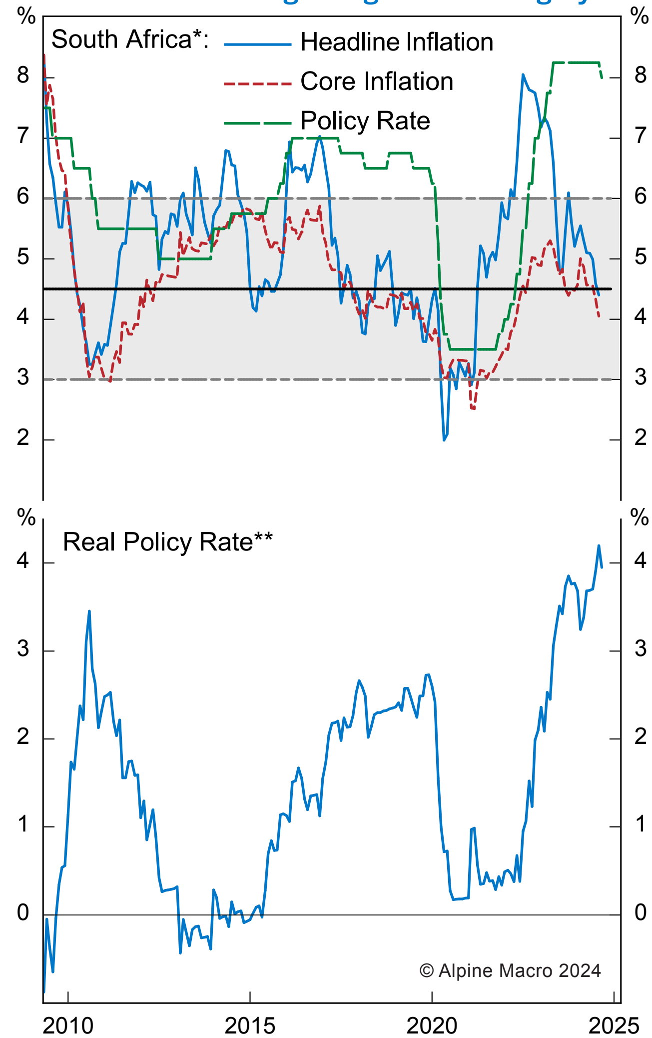
3 Alpine Macro *EM & China Strategy* "Buy Malaysia: Riding On The Tech Boom" (August 20, 2024).

Chart 4 Fed Easing Allows The PBoC To Follow



*Series are rebased to Oct 2023=100

Chart 5 South Africa: The Beginning Of An Easing Cycle



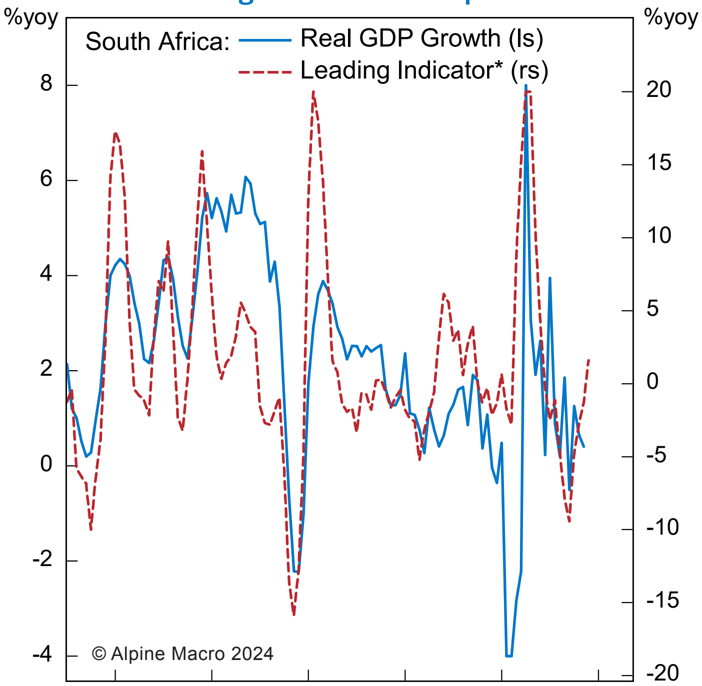
*Shaded area denotes inflation target
**Deflated by core CPI

Even the People's Bank of China has been prompted into action, with another 10-basis-point cut to its 14-day reverse repo rate yesterday. The PBoC has been far behind the curve and should have eased much more aggressively. The hesitation may be due to the perceived "impossible trinity" – the concern being that the interest rate differential in the dollar's favor would inflict excessive downward pressure on the RMB (Chart 4). As the dollar's yield advantage wanes and the RMB begins to appreciate, the PBoC is likely to follow the Fed's move with rate cuts. In other words, the Fed rate cut should at least marginally be positive for China's policy reflation.

South Africa: Budding Green Shoots, Long ZAR

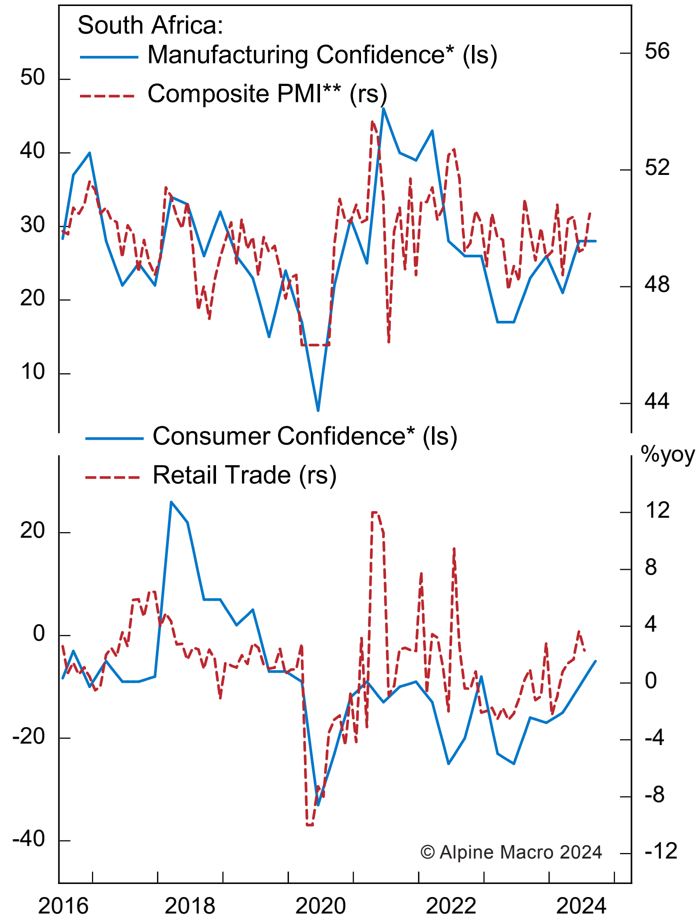
The Reserve Bank of South Africa immediately followed the Fed by cutting rates last week, marking the first cut since May 2023, when it pushed the policy rate to nearly a 15-year high. The rationale behind the rate cut is straightforward, as both headline and core CPI inflation have fallen precipitously and are well within the central bank's target range (Chart 5). Even after the latest rate cut, South

Chart 6 South Africa: Signs Of Growth Improvement...



*Advanced by one quarter; source: South African Reserve Bank
Note: Series are truncated for legibility purposes

Chart 7 ... Are Fairly Broad-Based



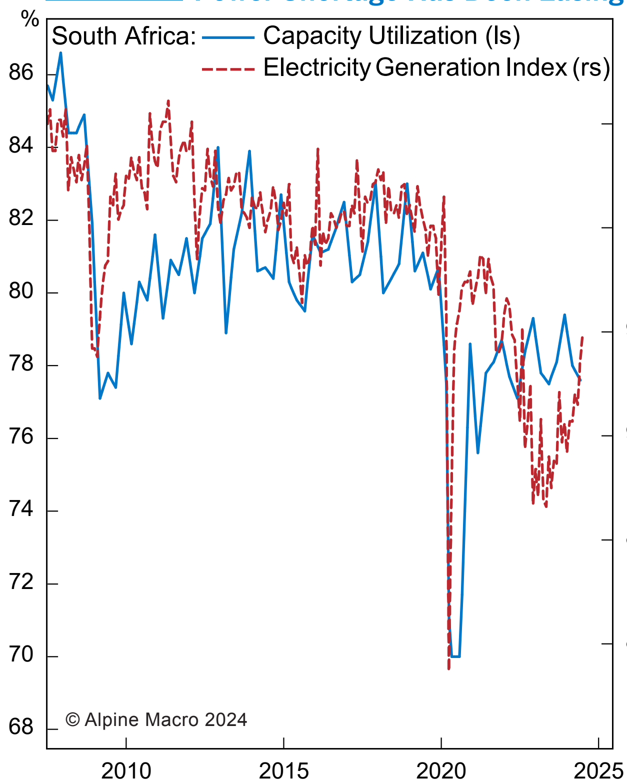
*Source: BER
**Source: S&P Global
Note: Series are truncated for legibility purposes

Africa's real policy rate, adjusted for core inflation, remains near historically high levels. This indicates that the monetary environment is still very tight, leaving ample room for further policy easing.

The South African economy, however, has shown surprising resilience despite these tight monetary conditions. Real GDP growth only briefly dipped below zero in Q3 last year, and forward-looking indicators suggest a quick recovery (Chart 6). Importantly, this improvement appears to be broad-based. Business confidence has been gradually increasing from last year's low, and the composite PMI has recently moved into expansionary territory (Chart 7). Similarly, consumer confidence has been improving, fueling an acceleration in retail sales. Even the country's chronic electricity shortages, known as "load shedding," have eased considerably, as electricity generation has surged in recent months (Chart 8). This has relieved a major bottleneck in the economy, providing further positive news for business activity.

On the other hand, South Africa's economic growth is by no means robust, which helps keep inflation in check. Capacity utilization remains below historical averages, the unemployment rate is exceptionally high, and real wage growth is negative. Together with the very high real policy rate, this suggests that the central bank will likely continue to ease to boost growth.

Chart 8 South Africa: Power Shortage Has Been Easing

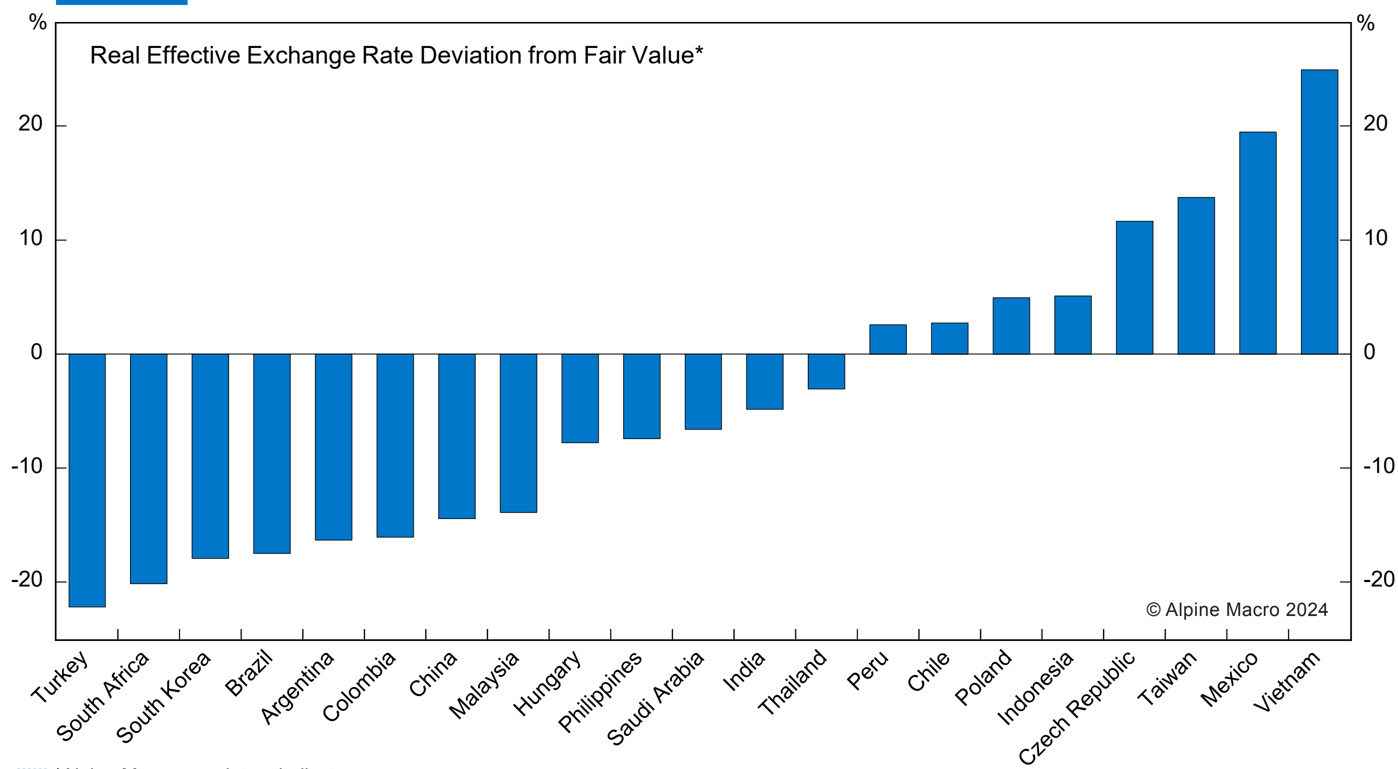


Note: Series are truncated for legibility purposes

In terms of investment strategy, we upgraded South African equities to overweight within EM after the general elections earlier this year, as political uncertainty subsided. This view remains unchanged. Additionally, this week we are also recommending going long on the South African rand. We expect the ZAR to strengthen both against the dollar and in trade-weighted terms.

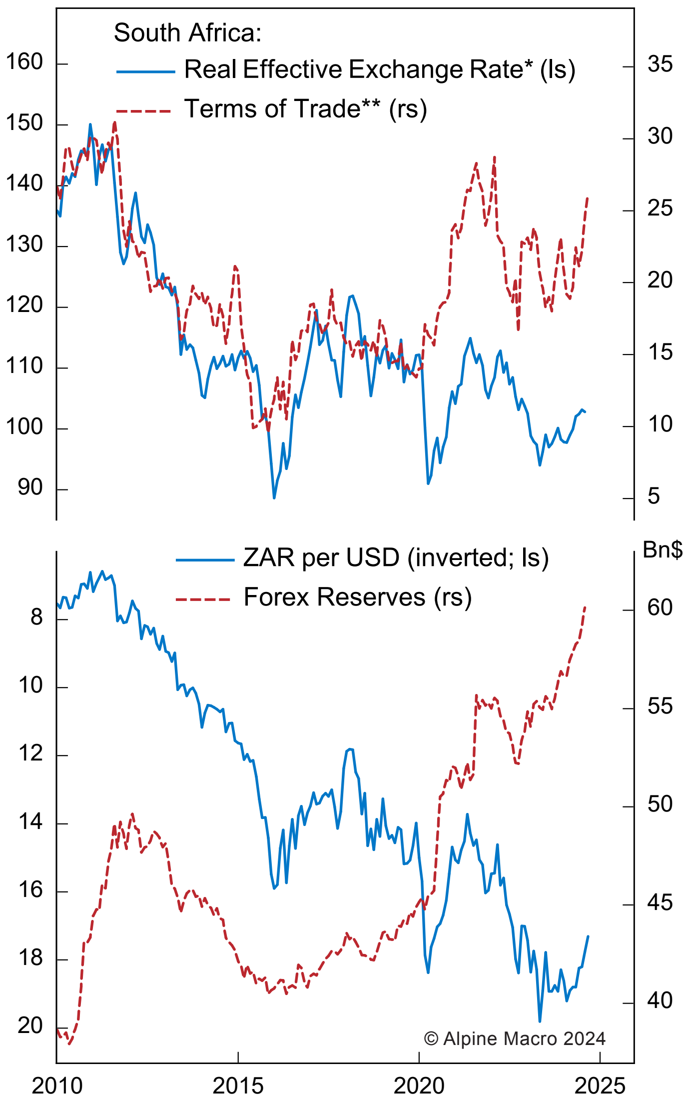
- The ZAR is deeply undervalued. It is among the cheapest in EM based on our fair value assessment (Chart 9).
- There has been a significant improvement in South Africa's terms of trade, which historically bodes well for its currency (Chart 10).
- The ZAR's depreciation since the COVID-19 pandemic has been accompanied by a sharp increase in the country's foreign reserves (Chart 10, bottom panel). This contrasts with

Chart 9 Ranking EM Currency Valuations



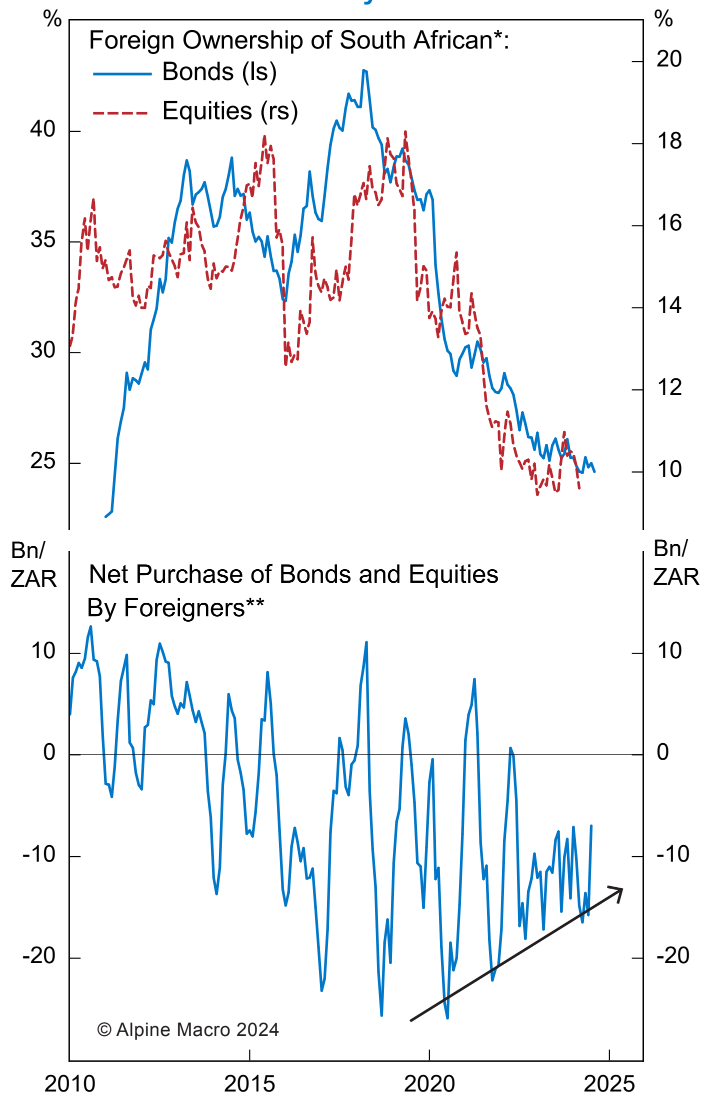
*Alpine Macro proprietary indicator

Chart 10 South African: Budding Upward Pressure On Exchange Rate



*Source: BIS
**Source: Citi

Chart 11 South Africa: Foreign Capital Exodus May Be Advanced



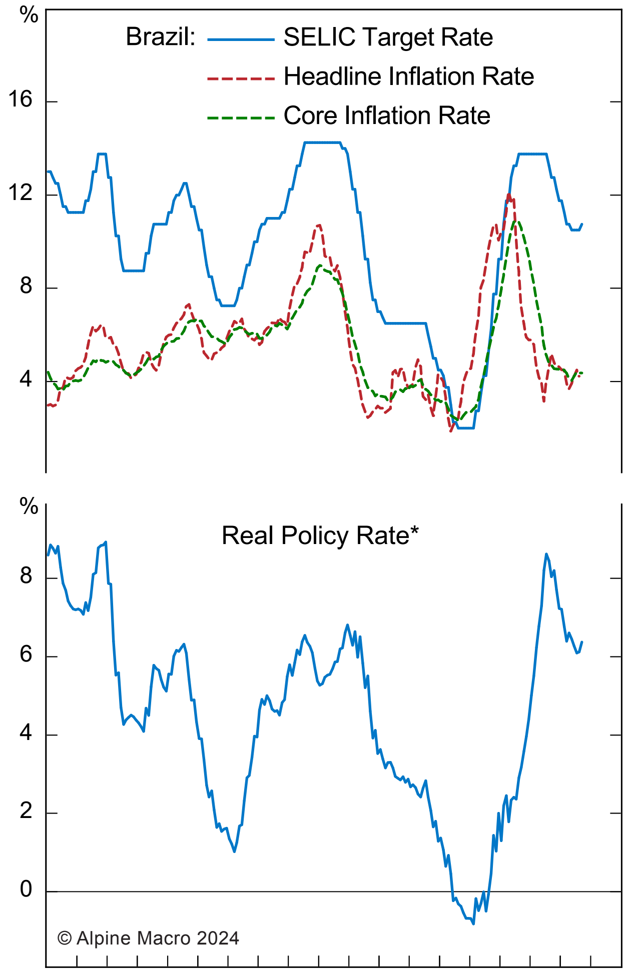
*Source: SARB, South African National Treasury
**Shown as 5-month moving average

previous episodes, where ZAR weakness typically forced the central bank to liquidate reserve assets to support the exchange rate.

- There has been a massive exodus of foreign capital from South African assets in recent years (Chart 11). Foreign investors have been consistent net sellers, and foreign ownership of South African bonds and equities has nearly halved from pre-pandemic levels. The bottom panel of Chart 11 shows that the pace of foreign net selling has slowed. While further liquidation cannot be ruled out, the odds are higher that foreign capital may start to flow back, especially if growth conditions improve.

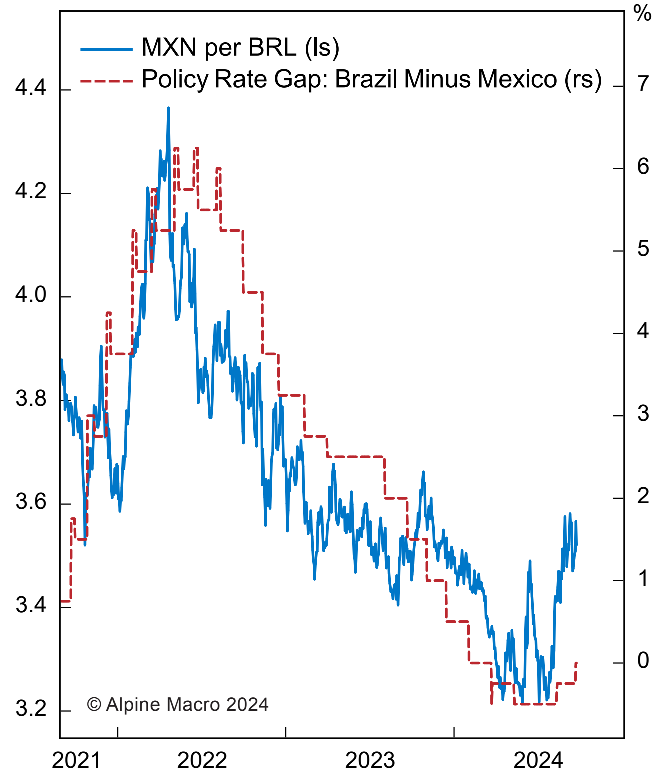
Bottom line: Go long ZAR versus the USD.

Chart 12 Brazil: Real Policy Rate Is Already Very High



*Deflated by core CPI

Chart 13 Long BRL Versus MXN



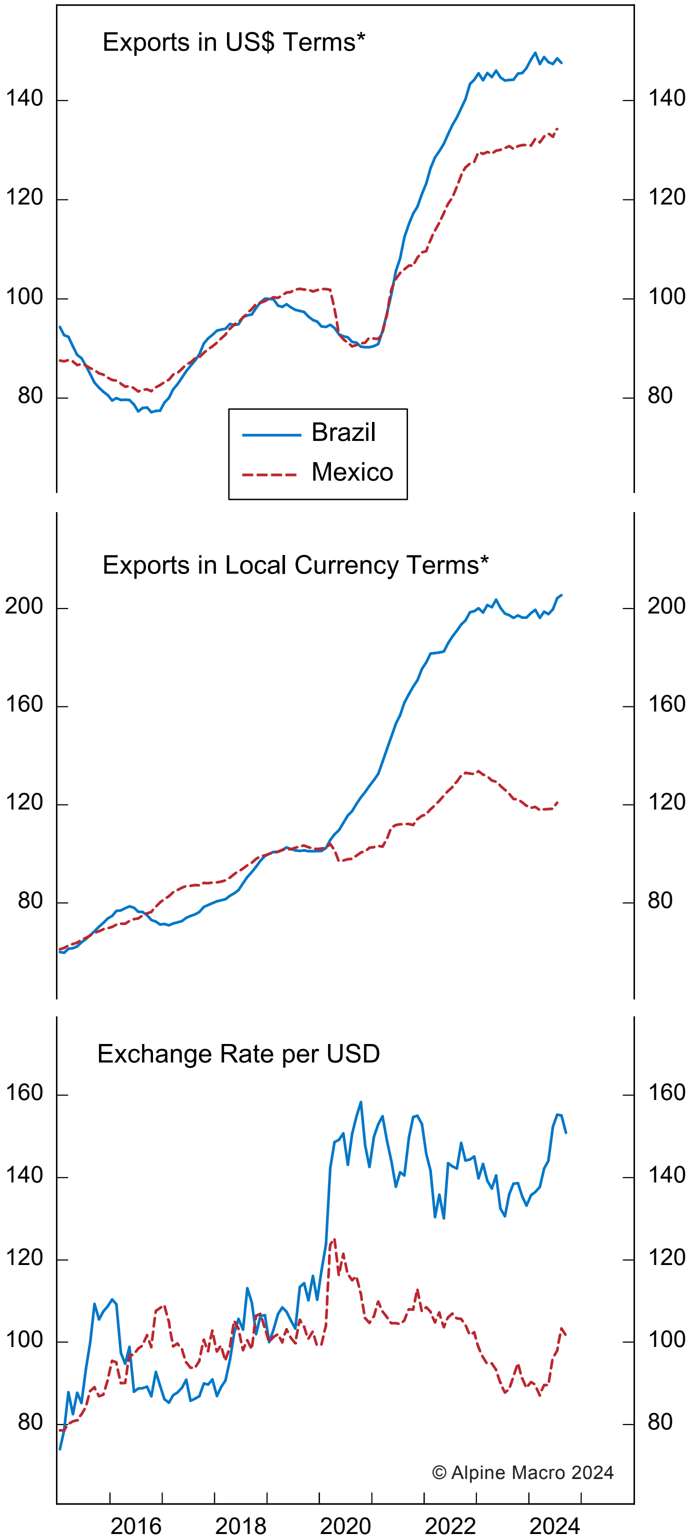
Brazil And Mexico: Capitalize On The Policy Divergence

Bucking the global trend of monetary easing is Brazil. The Central Bank of Brazil (BCB) raised the policy benchmark by 25 basis points last week and hinted at more to come. Although this decision was communicated to the market in advance to avoid major shocks, the move does not seem justified in our view, as Brazil's inflation is well anchored, and the real policy rate is near the highest level in recent years (**Chart 12**). Our hunch is that the latest rate hike may be akin to a declaration of central bank independence, ahead of a new governor to be appointed by President Luiz Inácio Lula da Silva. It may be designed to show BCB's priority to maintain price stability without yielding to political interference. The central bank may have also aimed for tighter monetary policy amid recent market concerns on the country's fiscal situation.

In contrast, the Mexican central bank is widely expected to cut 25 basis points later this week. As such, we see a compelling case to go long on the Brazilian *real* versus the Mexican peso to capitalize on the policy divergence between the two central banks (**Chart 13**).

First, the MXN is among the most overvalued currencies in EM, while the BRL is among the

Chart 14 Brazil: Massive Export Boom



*Shown as 12-month moving average
Note: All series are rebased to Jan 2019=100

cheapest, as Chart 9 on page 5 shows. More fundamentally, an expensive MXN is inherently incompatible with Mexico's goal of attracting foreign businesses as a "near-shoring" destination, as we have argued in detail in several recent reports.[4] The MXN has weakened by 16.5% in real effective terms from last year's peak, but the adjustment process still has much further to go.

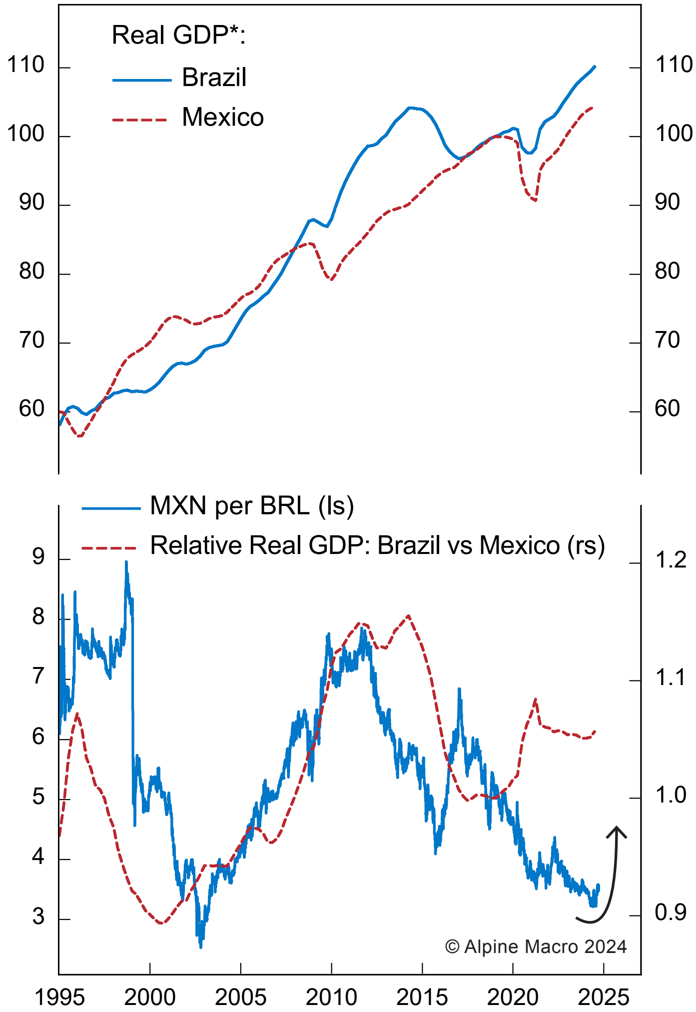
Second, the divergence between the two exchange rates may have played an important role in the post-COVID growth gap between the two economies. Even though Mexico's exports have surged sharply since the pandemic, Brazilian exports have been far stronger, even when measured in U.S. dollars (Chart 14). The outperformance is even more dramatic in local currency terms.

The strong external sector has helped Brazil's GDP outperform Mexico's since the pandemic. Importantly, the growth gap between the two economies has been a key factor in defining the broader trend of the cross rate between the two currencies (Chart 15). Historically, the BRL usually appreciates against the MXN when the Brazilian economy outperforms Mexico's, and vice versa. Since COVID, however, Brazil's stronger growth relative to Mexico has not been reflected in the exchange rate movement. We expect the BRL to appreciate against the MXN to catch up with historical norms.

From a tactical point of view, going long on the BRL versus the MXN is also supported by investors' positioning. Chart 16 shows that investors still hold net speculative long positions on the MXN, even

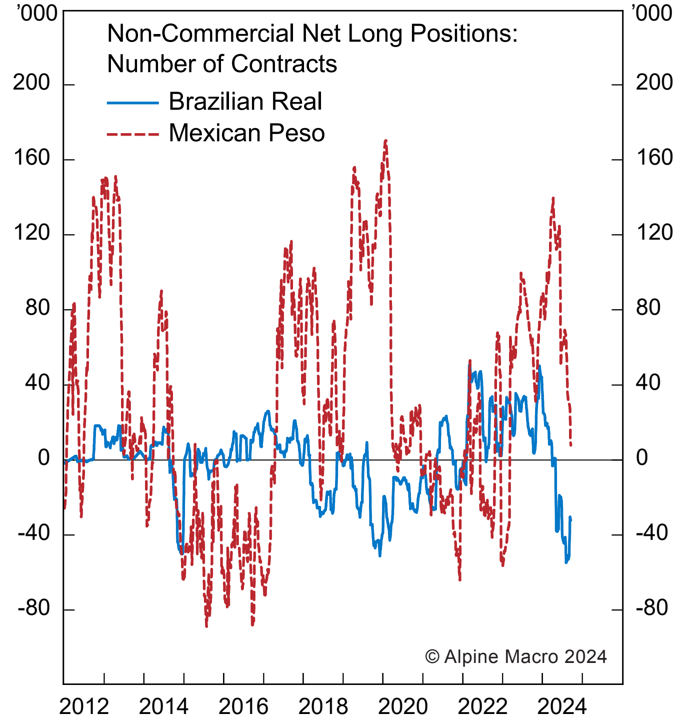
4 Alpine Macro *EM & China Strategy* "Mexico: How Far Can "Near-Shoring" Go?" (September 19, 2023) and "ASEAN's Breakout, Mexico's Adjustment And China's Slump" (September 17, 2024).

Chart 15 **Brazil And Mexico: Growth Trend And Exchange Rate Performance**



*Both series are rebased to Jan 2019=100

Chart 16 **Positioning Favors BRL Versus MXN**



Source: Commodity Futures Trading Commission (CFTC)

though these positions have unwound significantly in recent months. In comparison, speculators still hold near-record net short positions on the BRL. Further unwinding of these positions will strongly favor the BRL over the MXN.

Finally, a word on Brazil's recent "fiscal storm." Both the BRL and government bonds sold off yesterday, triggered by the government's decision last Friday to authorize additional spending of BRL 1.7 billion (USD 305 million) through the end of the year. The government is aiming for a balanced primary budget with a tolerance band of +/- 0.25% of GDP. Following last week's adjustment, the primary deficit is now projected to reach BRL 28.3 billion, or 0.245% of GDP, still within the acceptable range.

For a country grappling with debt sustainability, any sign of fiscal slippage is a serious concern and warrants close monitoring. However, we do not view this latest development as alarming, and we believe the market's negative reaction is overblown. President Lula is unlikely to pursue excessive fiscal expansion as long as the Brazilian economy remains resilient.[5] Additionally, he faces domestic constraints in parliament, limiting his ability to adopt radical policy changes.

5 Alpine Macro *EM & China Strategy* "Brazil: Which Lula Is Showing Up?" (July 2, 2024).

Bottom line: The latest BRL selloff is a good buying opportunity. Go long BRL versus MXN.

Housekeeping

Our short Taiwanese dollar position against Latam currencies has not performed as expected. This trade has exceeded our tactical time horizon, and we are closing the position for now, with a 0.1% profit. We still believe the TWD will underperform its EM peers and will continue to closely monitor the market for potential trade ideas.

Yan Wang, CFA
Chief Emerging Markets & China Strategist

Investment Recommendations

Strategic Positions (6 - 12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long Colombian 10-year Government Bond, Currency Unhedged	11/21/2023		12.5%	Long Colombian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long MSCI Greece Equity Index	11/21/2023		12.9%	Long MSCI Greece Equity Index in US$ terms; stop point at -10%.
Long Indian 10-year Government Bond, Currency Unhedged	06/04/2024		3.9%	Long Indian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long Malaysian Equities, Currency Unhedged	08/20/2024		6.0%	Long MSCI Malaysia Equity Index in US$ terms; stop point at -10%.
Long ASEAN Equities, Currency Unhedged	09/17/2024		1.7%	Long MSCI EM ASEAN Index in US$ terms; stop point at -10%.
Long BRL/MXN	09/23/2024		-	Long Brazilian *Real* versus Mexican Peso; stop point at -10%.

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Short CZK/HUF	06/05/2023		4.1%	Short Czech Koruna versus Hungarian Forint; rolling stop point at -5%, or -3.4% from current level.
Short TWD/ A Basket of BRL, COP and CLP	11/28/2023	09/23/2024	0.1%	Short TWD versus A Basket of Latam Currencies (Equal-Weighted of BRL, COP and CLP); position closed.
Long MSCI China Equity Index	02/20/2024		10.2%	Long MSCI China Equity Index in US$ terms; rolling stop point at -10%, or -7.9% from current.
Short COP/CLP	03/05/2024		7.9%	Short Colombian Peso versus Chilean Peso; rolling stop point at -5%, or -3.9% from current level.
Long ZAR/USD	09/23/2024		-	Long South African Rand versus U.S. Dollar; stop point at -10%.

EM Equity Country Allocation				
Strong Overweight	**Overweight**	**Neutral**	**Underweight**	**Strong Underweight**
	Brazil Chile China Colombia Greece Malaysia South Africa	Indonesia Philippines India	South Korea Czech Republic Hungary Mexico Peru Poland Taiwan Thailand Turkey	

EM Equity Sector Allocation	
Strong Overweight	**Overweight**
	Energy Materials Health Care Consumer Discretionary
Neutral	
Communication Services Information Technology Financials	
Strong Underweight	**Underweight**
	Industrials Consumer Staples Utilities

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
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