

# *SOM Macro Strategies*

State Of the Markets: Covid-19—Part 3: The Fall Of The USD & The Rise Of EM

June 16, 2020 (Updated)

Alan Brazil

# *SOM Macro Strategies*

## State Of the Markets: Covid-19—Part 3: The Fall Of The USD & The Rise Of EM

- ***Step 1: Macro Theme: The Sell-off In Commodity EM Assets Is A Buying Opportunity***
  - EM x-China equities have lagged the rebound in US and China equities
  - EM x-China FX are at historical lows on a real basis
- ***Step 2: Fundamental Economic Framework***
  - EM economies will be harder hit than DM economies from the Covid-19 lockdowns
  - The fall in commodity prices adds to the downward pressures on EM
  - Capital outflows from EM is almost twice as large as in previous EM risk-off events
  - EM Covid cases and deaths seem to be accelerating vs DM countries
- ***Step 3: Find Potential Repricing Catalysts***
  - The return of US QE could push commodity EM assets higher by weakening the USD
    - Weaker USD could increase capital flows to EM
    - Weaker USD could strengthen commodity prices
    - Weaker USD could provide a tail wind to commodity EM GDP
  - Commodity EM countries have the capacity to deploy substantial fiscal stimulus to support their economies
  - EM countries are bending the Covid infection curve using even stricter lockdown strategies relative to the US
- ***Step 4: Find Asymmetric Trade***
  - Trade: Buy commodity EM FX vs the USD

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## State Of the Markets: Covid-19—Part 3: The Fall Of The USD & The Rise Of EM

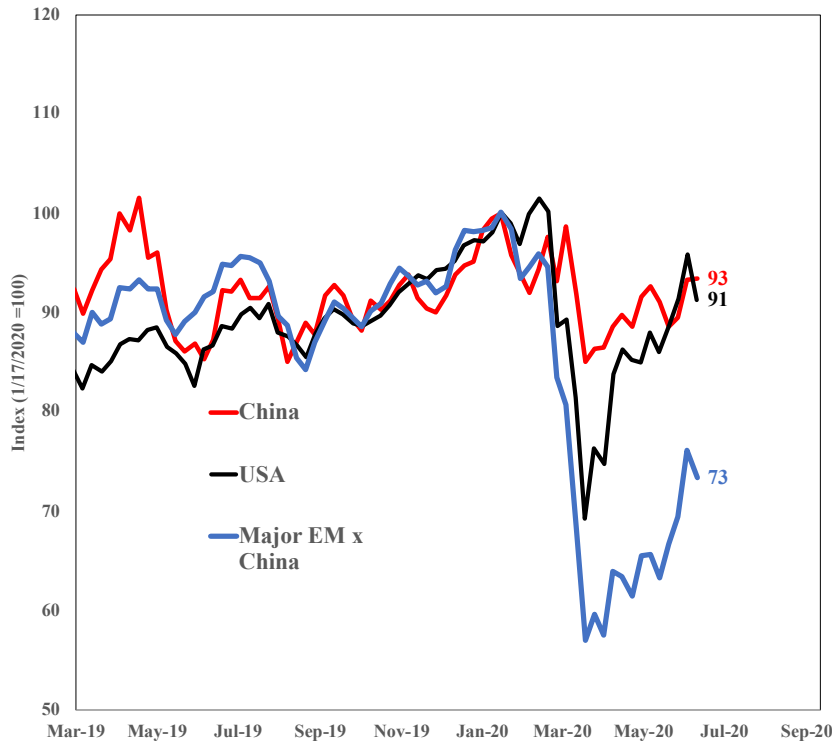
*Step 1: Identify Macro Theme*

### The Sell-Off In Commodity EM Assets Is A Buying Opportunity

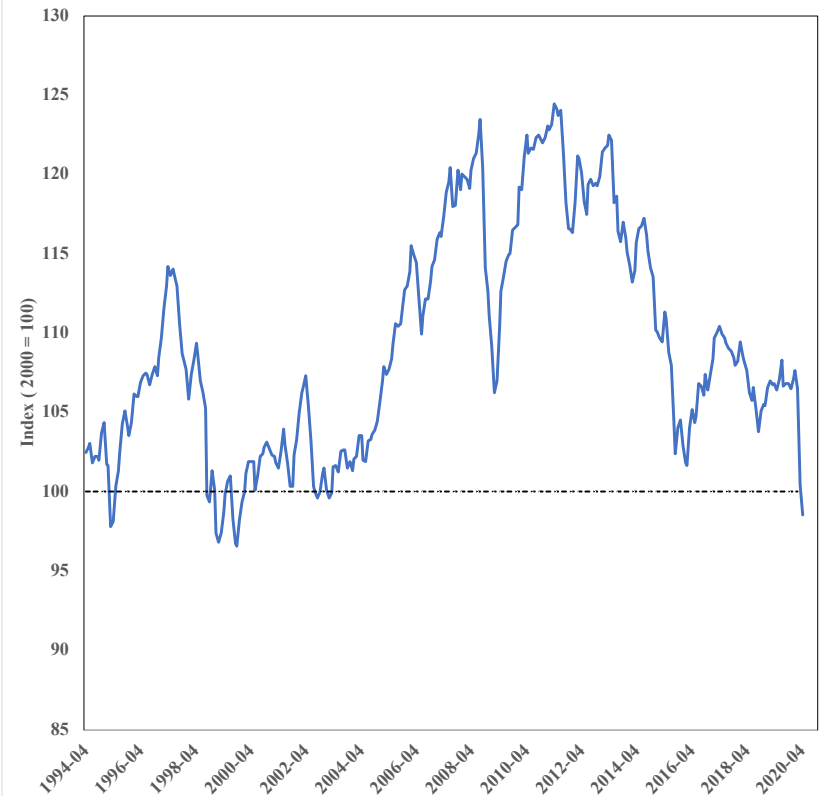
EM x-China Equites Still Down over 25%..<sup>1</sup>

EM x-China FX At Historical Lows On A Real Basis<sup>2</sup>

Selected Equity Indexes In USD



EM REER FX Index (x China)



1. Bloomberg  
2. BIS

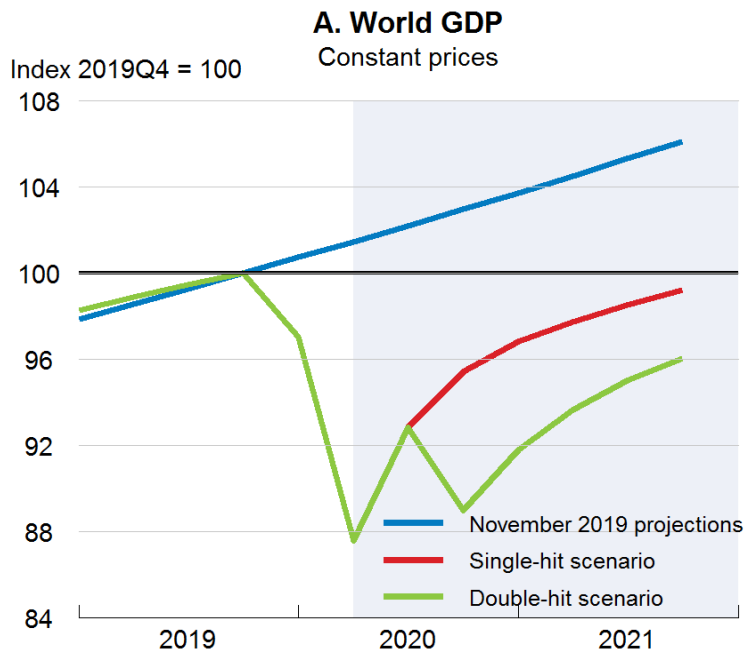
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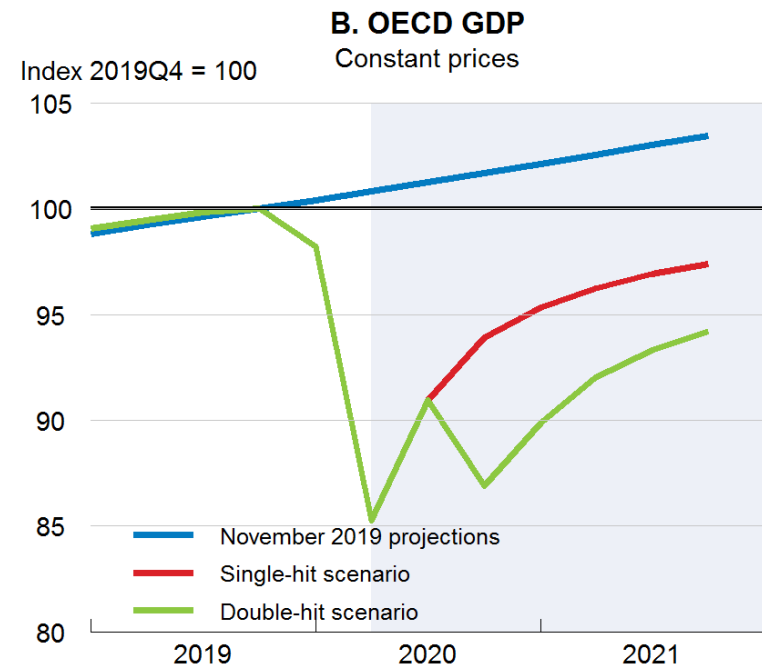
### Step 2: Fundamental Economic Framework

### Economic Recovery Will Likely Be U-Shaped At Best Not V-Shaped<sup>1</sup>

#### World GDP a “U” or A “W” Recovery



#### Advanced Economy Look Similar



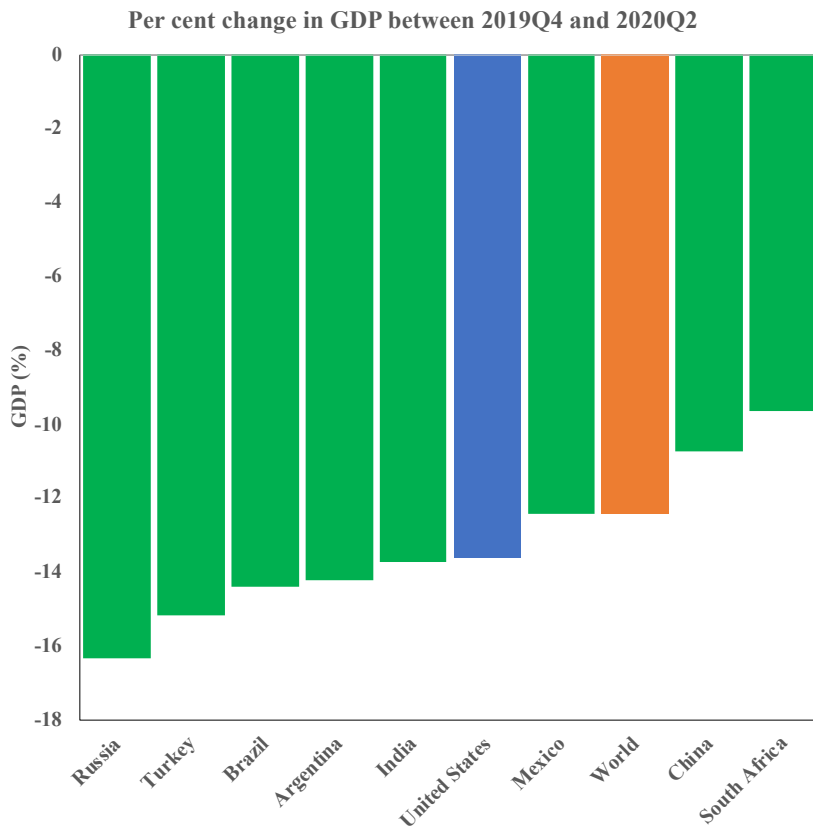
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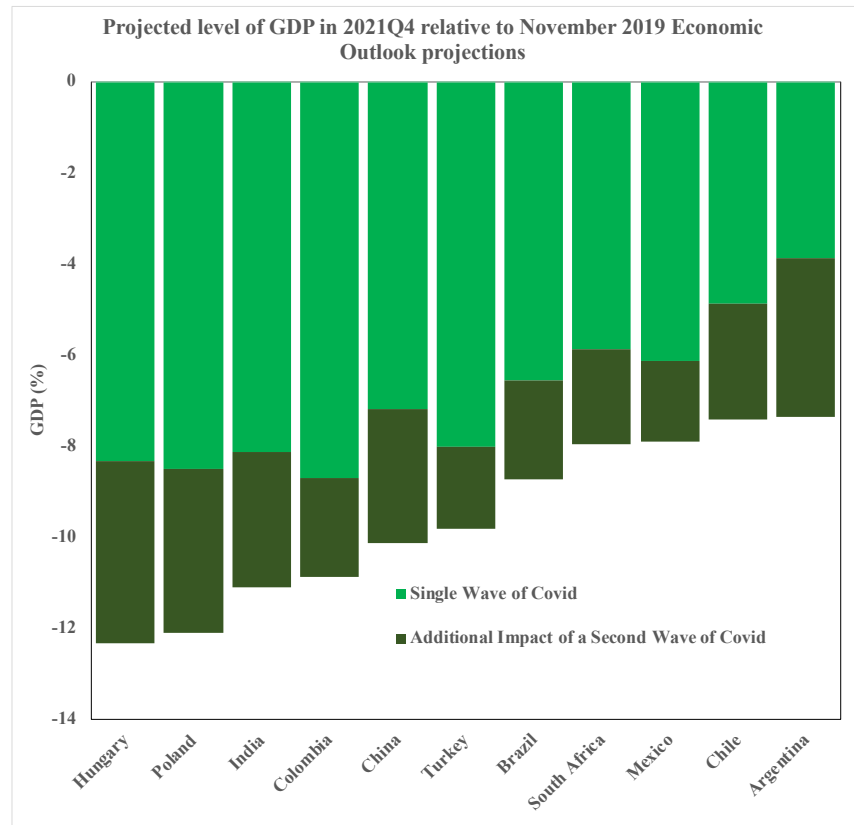
### Step 2: Fundamental Economic Framework

### EM Growth Could Fall Even More Than Advanced Economies<sup>1</sup>

#### Near-term Growth Hit Is Substantial



#### Longer Term Still Great And Could Fall Even More With A



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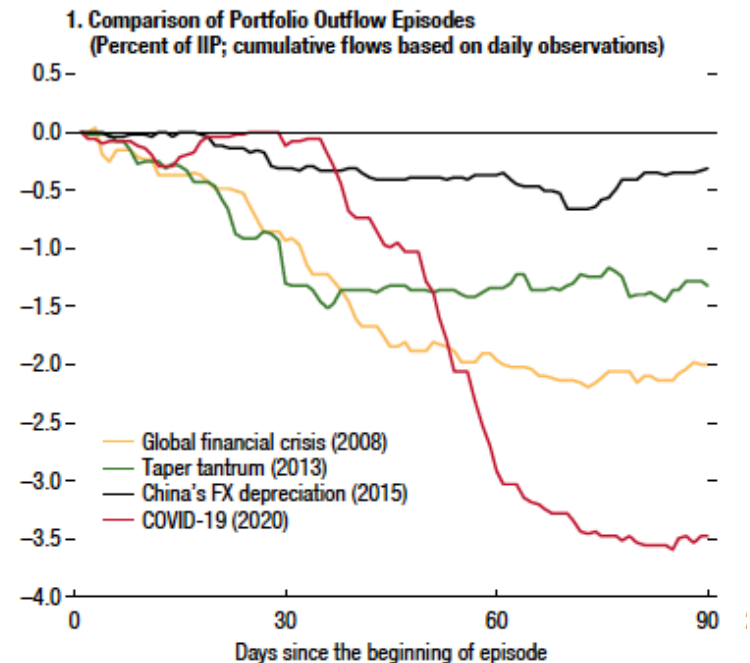
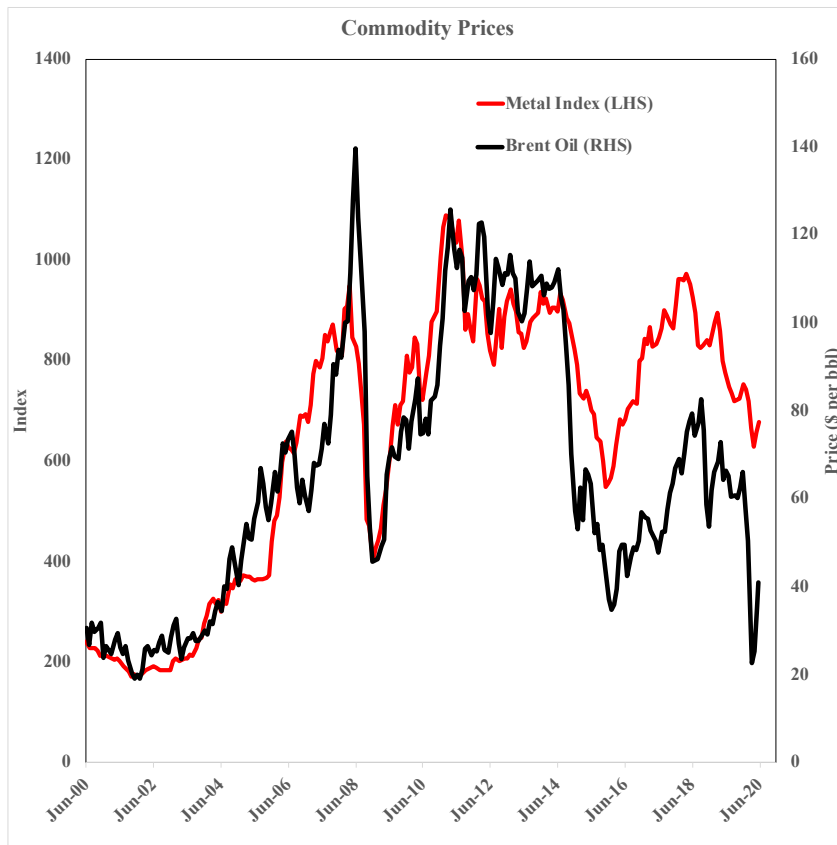
## State Of the Markets: Covid-19—Part 3: The Fall Of The USD & The Rise Of EM

### *Step 2: Fundamental Economic Framework*

### Falling GDP Combined With The Fall In Commodity Prices Led To Capital Outflows From EM

Demand Erosion Led To A Sudden Drop In Commodity Prices<sup>1</sup>

Capital Outflows From EM Worse Than In Other Events<sup>2</sup>



Sources: IMF, World Economic Outlook database; national authorities; and IMF staff  
Note: Economies included in panel 2 are Brazil, China, Hungary, India, Indonesia, Korea, Province of China, Thailand, and Ukraine. EM = emerging market; FX = foreign exchange

1. Bloomberg  
2. IMF, Financial Stability Report, April 2020

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### Step 2: Fundamental Economic Framework

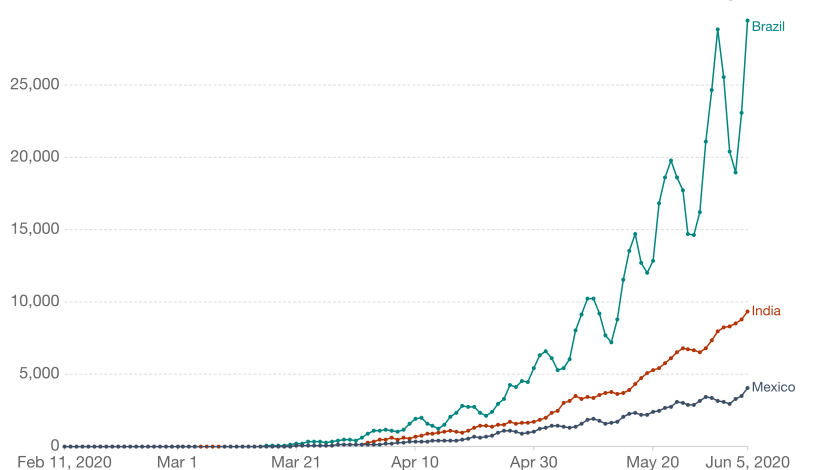
### Compounding The Problem Was The Surge In Covid Cases In EM<sup>1</sup>

Cases Are Rising In EM While Falling For DM....

Along With Deaths

#### Daily confirmed COVID-19 cases, rolling 3-day average

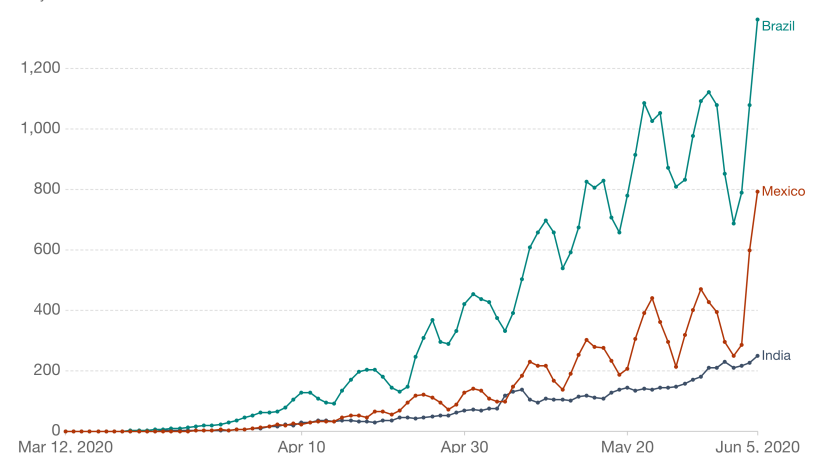
The number of confirmed cases is lower than the number of total cases. The main reason for this is limited testing.



Source: European CDC – Situation Update Worldwide – Last updated 16th June, 11:00 (London time) OurWorldInData.org/coronavirus • CC BY  
Note: The rolling average is the average across three days – the confirmed cases on the particular date, and the previous two days. For example, the value for 27th March is the average over the 25th, 26th and 27th March.

#### Daily confirmed COVID-19 deaths, rolling 3-day average

Limited testing and challenges in the attribution of the cause of death means that the number of confirmed deaths may not be an accurate count of the true number of deaths from COVID-19.



Source: European CDC – Situation Update Worldwide – Last updated 16th June, 11:00 (London time) OurWorldInData.org/coronavirus • CC BY  
Note: The rolling average is the average across three days – the confirmed deaths on the particular date, and the two previous days. For example, the value for 27th March is the average over the 25th, 26th and 27th March.

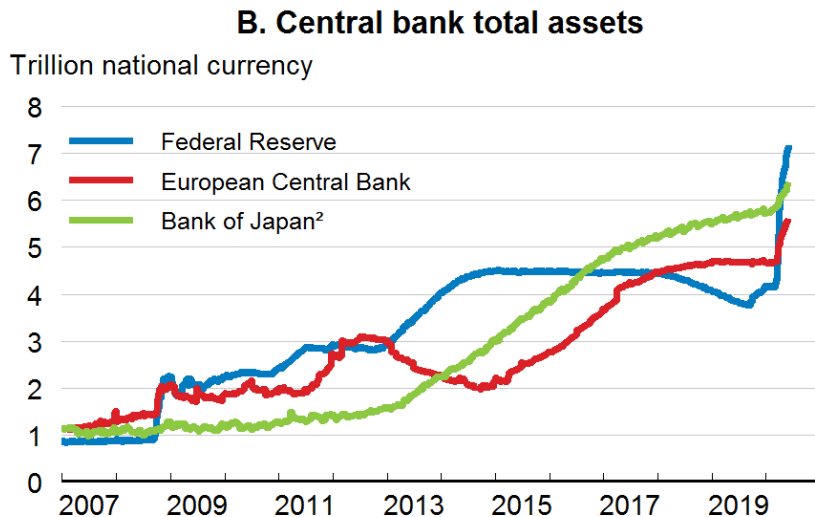
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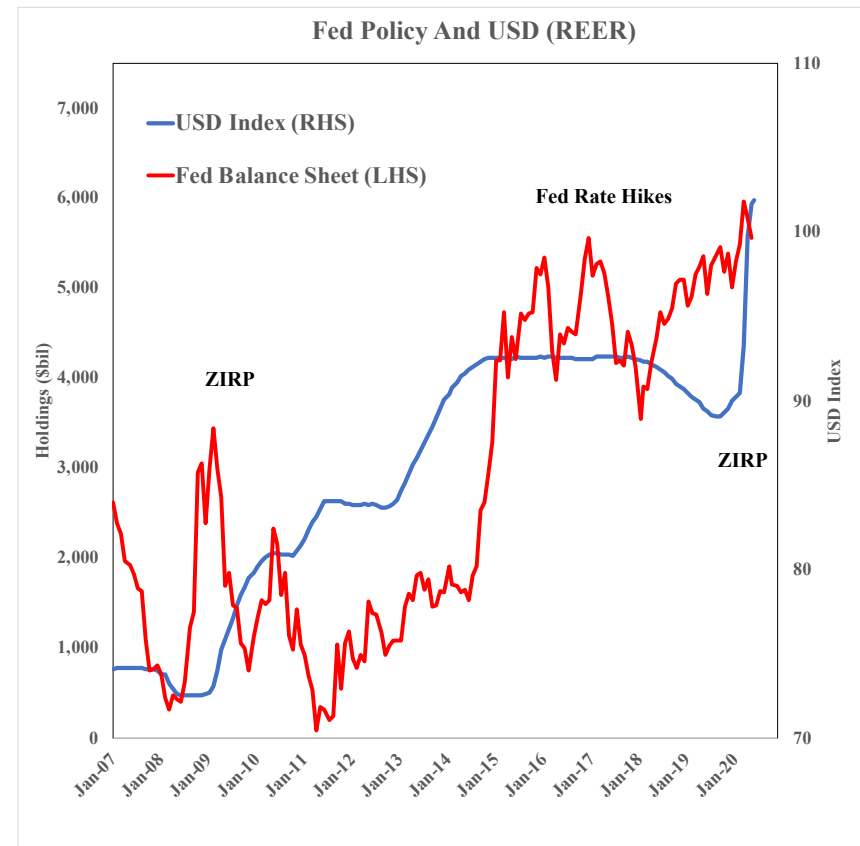
### Step 3: Find Potential Repricing Catalysts

#### Catalyst 1: The Return Of US QE Weakens USD

Developed Countries Are Returning To QE<sup>1</sup>



At That Could Mean A Weaker USD<sup>2</sup>



1. OECD Economic Outlook, June 2020

2. Bloomberg



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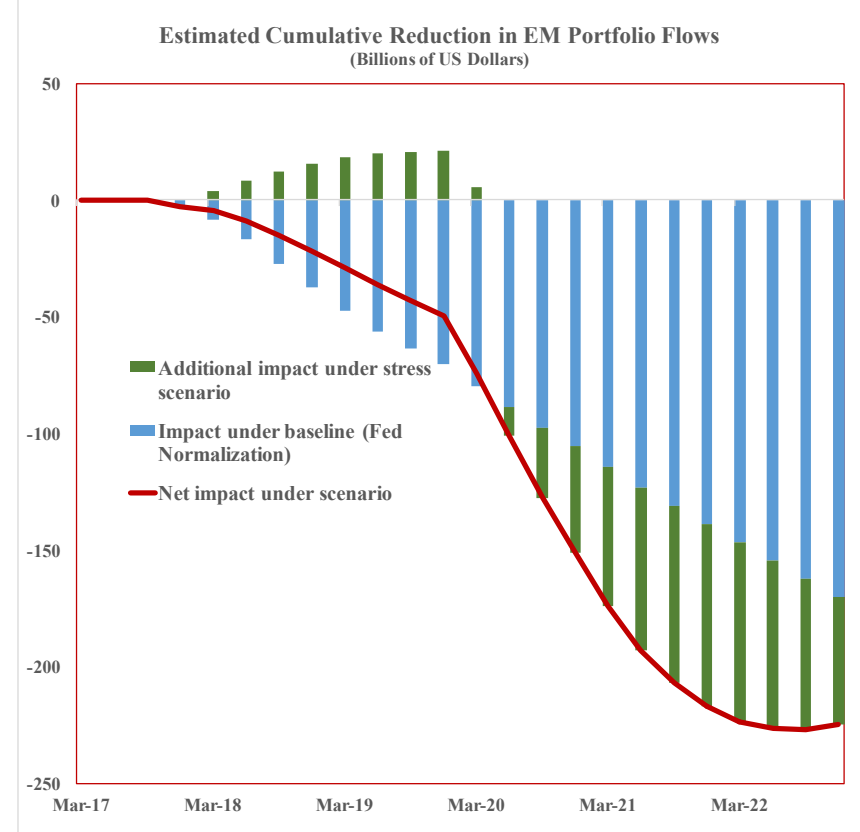
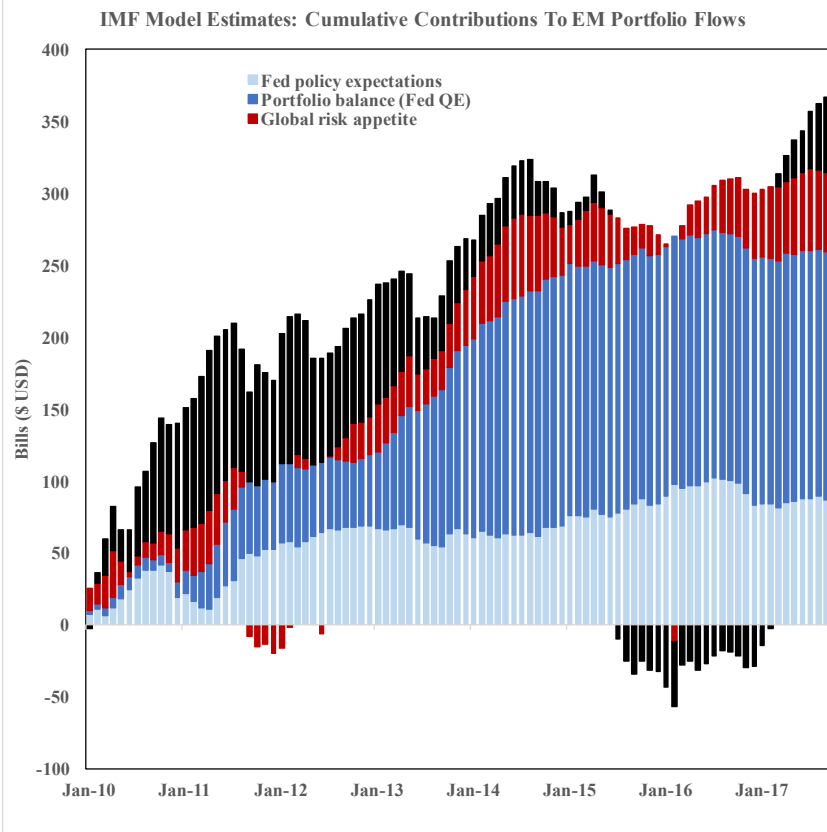
## State Of the Markets: Covid-19—Part 3: The Fall Of The USD & The Rise Of EM

### *Step 3: Find Potential Repricing Catalysts*

### Catalyst 1: Return Of US QE Weakens USD-- Increases Capital Flows And Drives Up EM FXI<sup>1</sup>

US QE Was A Major Factor in Driving Capital Flows To EM...

While The Unwinding Of QE Reverse Those Flows



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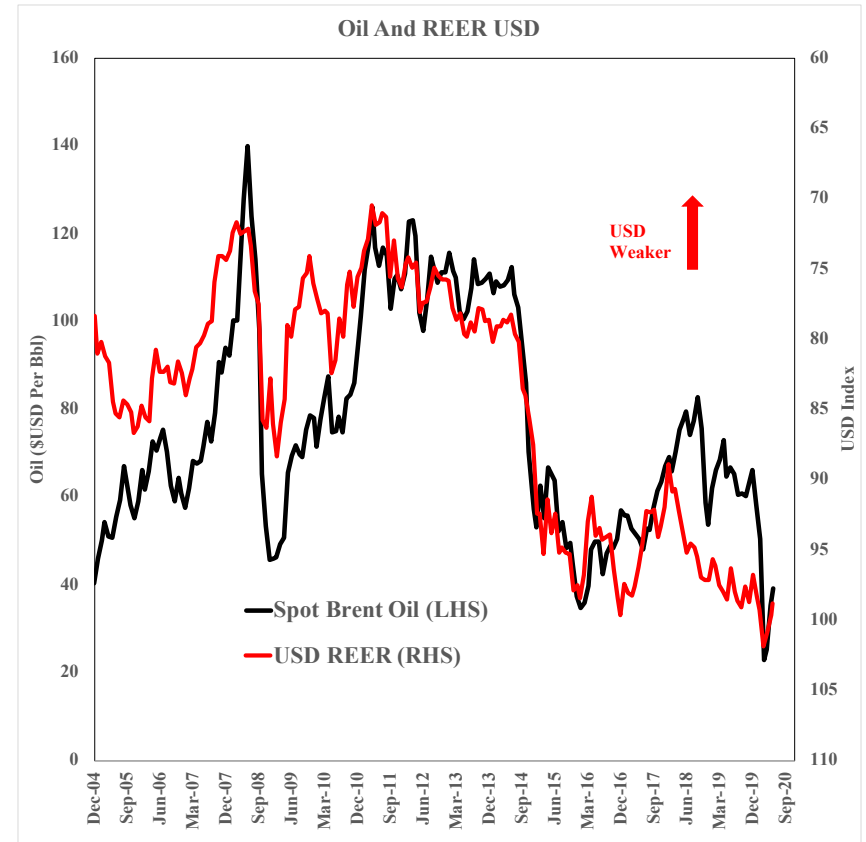
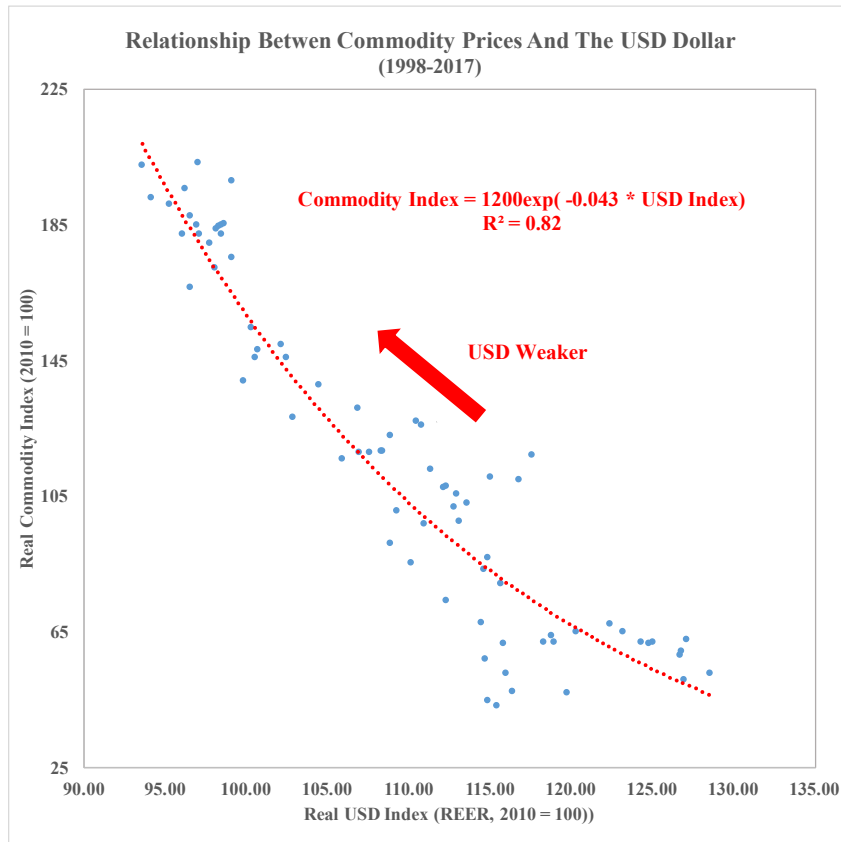
## State Of the Markets: Covid-19—Part 3: The Fall Of The USD & The Rise Of EM

### Step 3: Find potential Repricing Catalysts

#### Catalyst 1: Return Of US QE Weakens USD---Drives Up Commodity Prices And Commodity EM GDP<sup>1</sup>

Stronger USD Could Affect EM Through A Fall In Commodity Prices

Up Until Recently Oil Seemed Immune To the USD But...



1. Bloomberg and Author's calculation

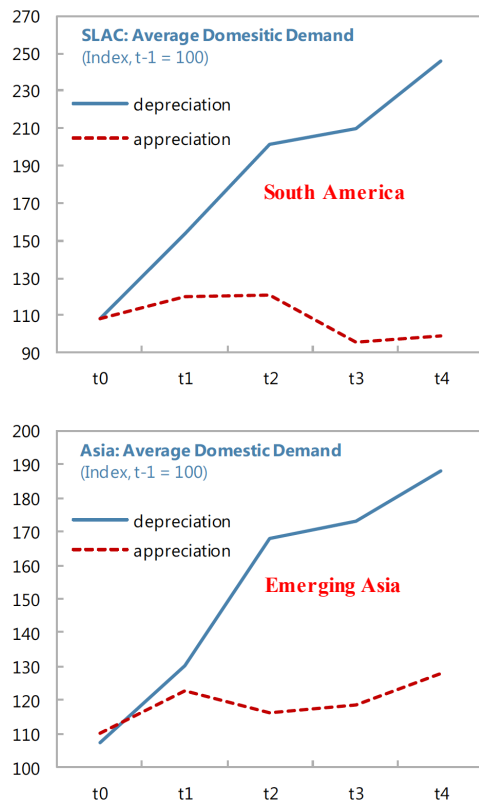
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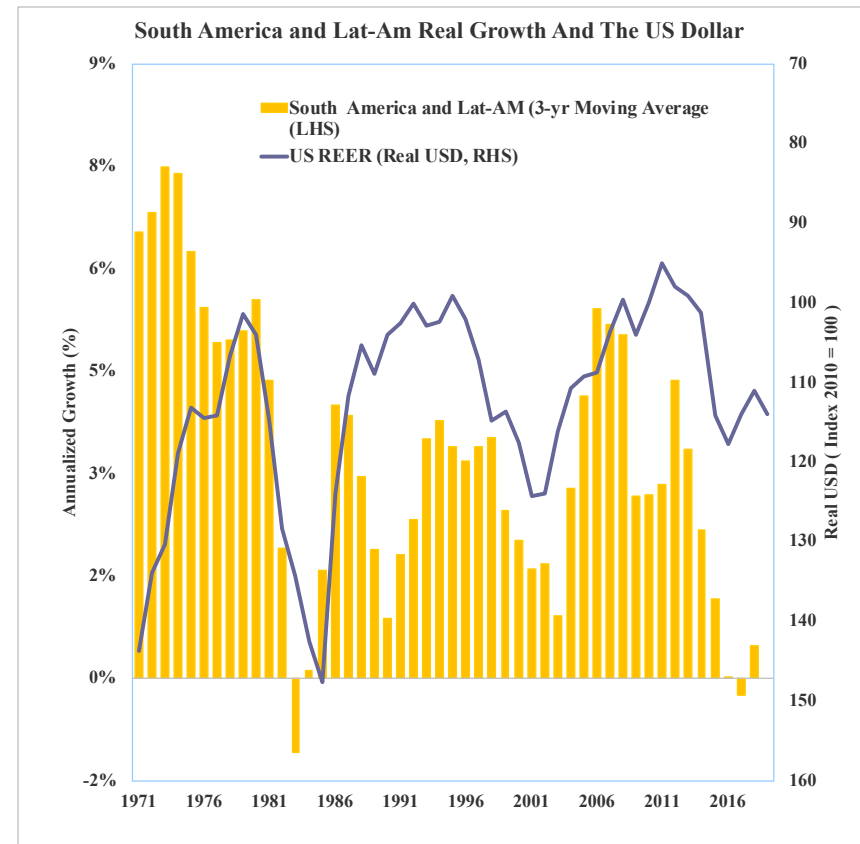
### Step 3: Find Potential Repricing Catalysts

#### Catalyst 1: Return of US QE Weaken USD--- That Provides Tailwind To Commodity EM Economies<sup>1,2</sup>

##### The USD Has Rallied As The Fed Hikes Rates



##### Historical Impact of Dollar On Lat-Am Growth



1. IMF, World Economic Outlook  
2. St. Louis Fed, Fred data base

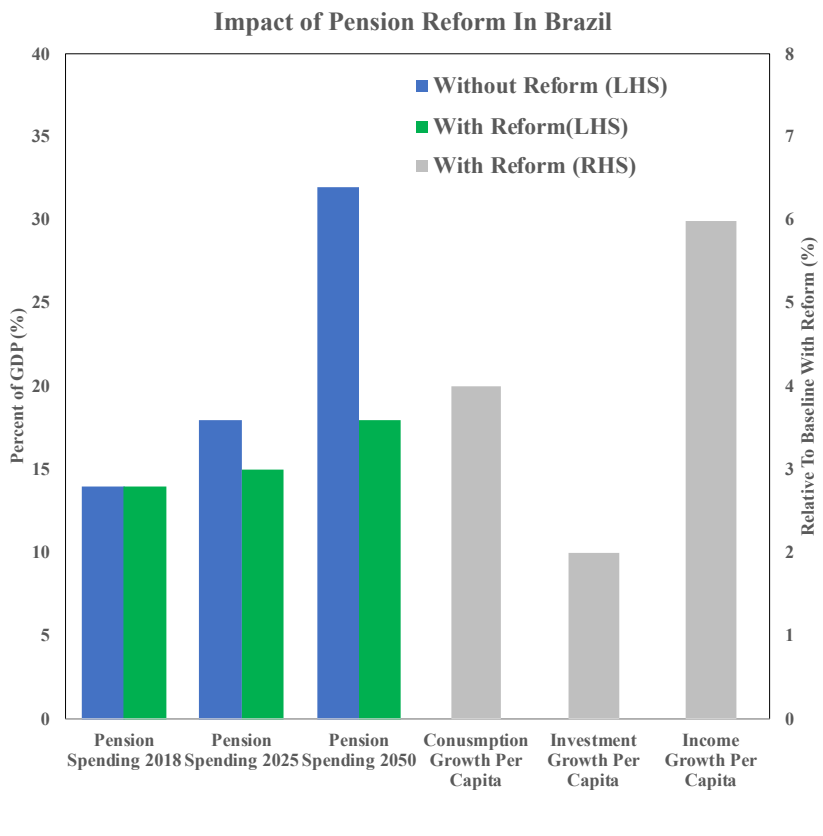
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### *Step 3: Find Potential Repricing Catalysts*

### Catalyst 2: Commodity EMs Has Room To Deploy Monetary And Fiscal Stimulus--Case Of Brazil<sup>1</sup>

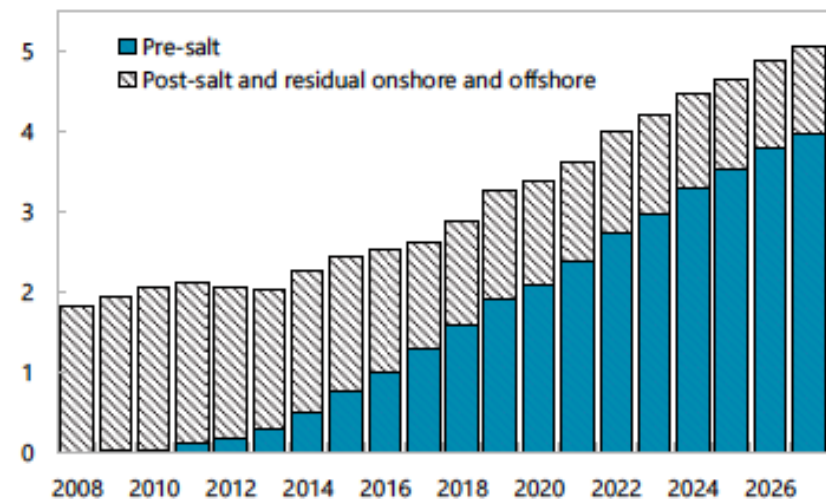
#### Pension Reform Reduces Fiscal Pressures



#### Brazil's Commodity Footprint Growing: Example of Oil

##### Oil Production

(Million of barrels per day)



Sources: ANP (historical data), EPE (projections), and Fund staff calculations.

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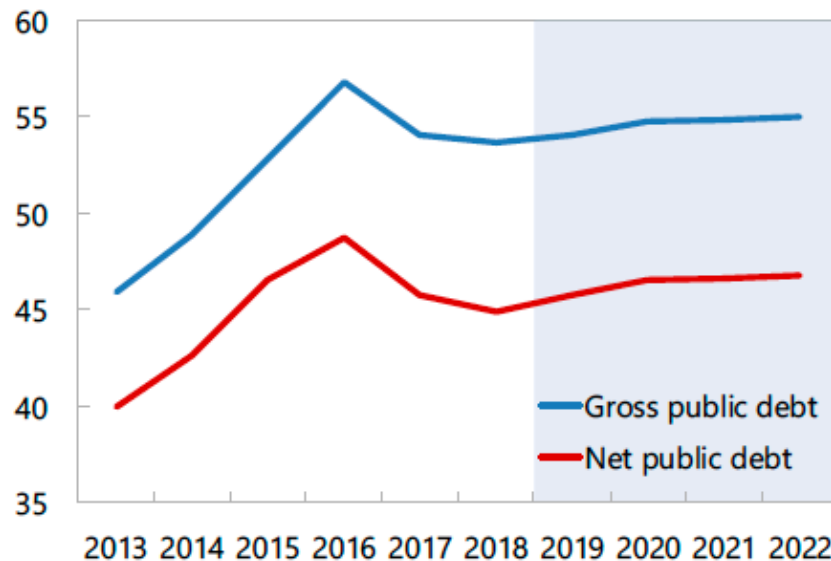
### *Step 3: Find Potential Repricing Catalysts*

### Catalyst 2: Commodity EMs Has Room To Deploy Monetary And Fiscal Stimulus--Case Of Mexico<sup>1</sup>

Fiscal Restraint Now Given Mexico Room For Fiscal Stimulus

#### Public Sector Debt Path

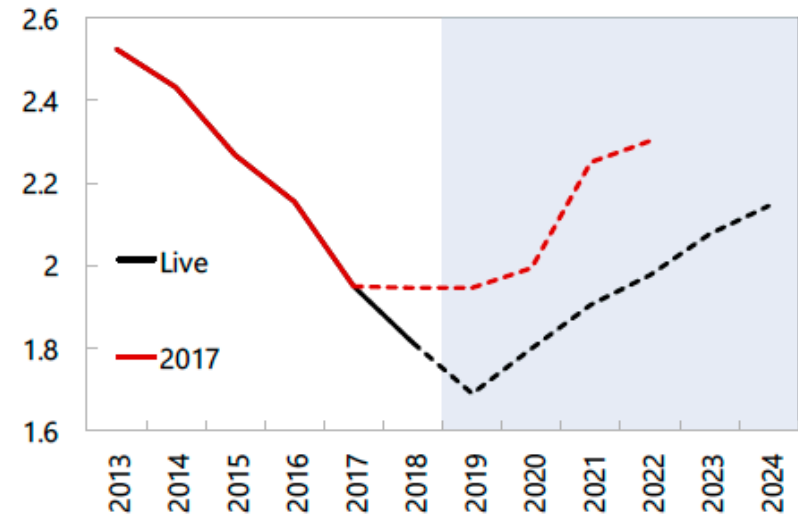
(In percent of GDP)



Investment in Pemex Will Increase Future Oil Production

#### Oil Production Forecast Vintages

(In millions of barrels per day)



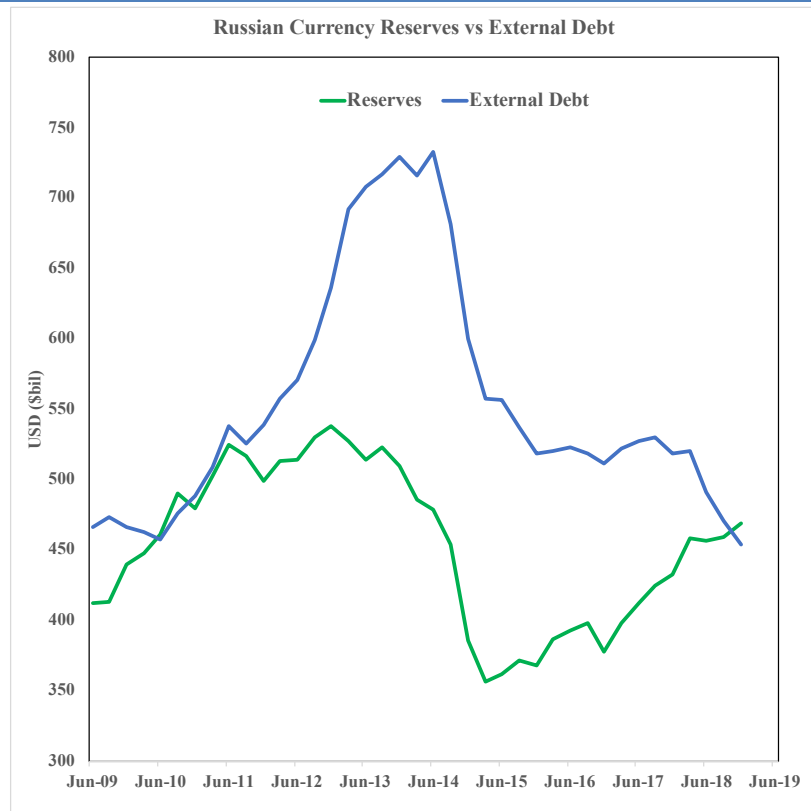
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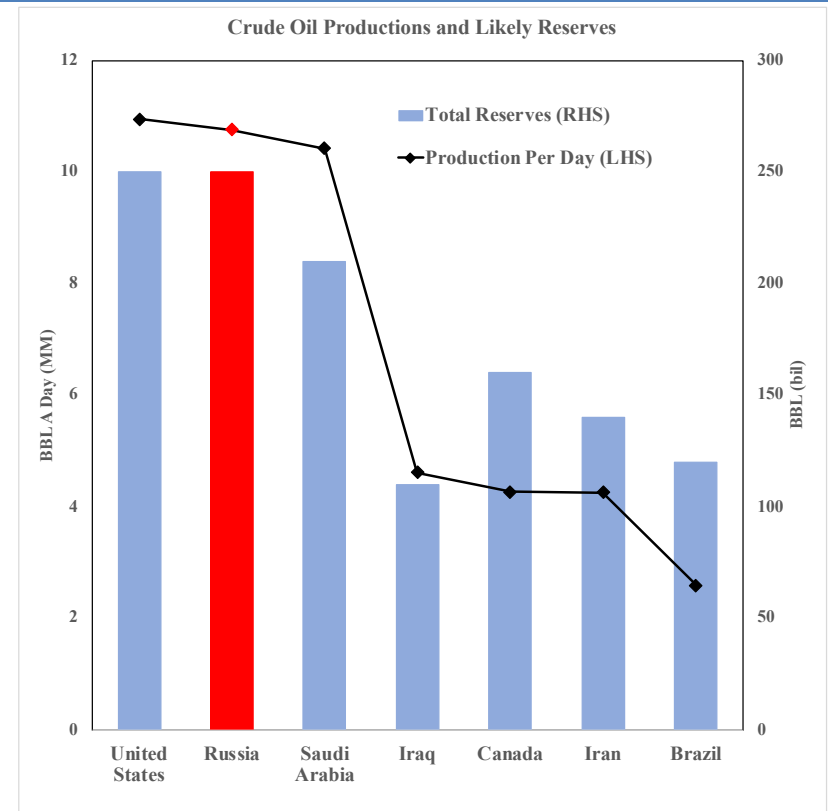
### Step 3: Find Potential Repricing Catalysts

### Catalyst 2: Commodity EMs Has Room To Deploy Monetary And Fiscal Stimulus--Case of Russia<sup>1,2</sup>

Reserves Have Surged While External Debt Exposure Has Shrunk



Russia Commodity Production Is Large: Example of Oil



1. Bloomberg  
2. IMF, External Debt Data Base

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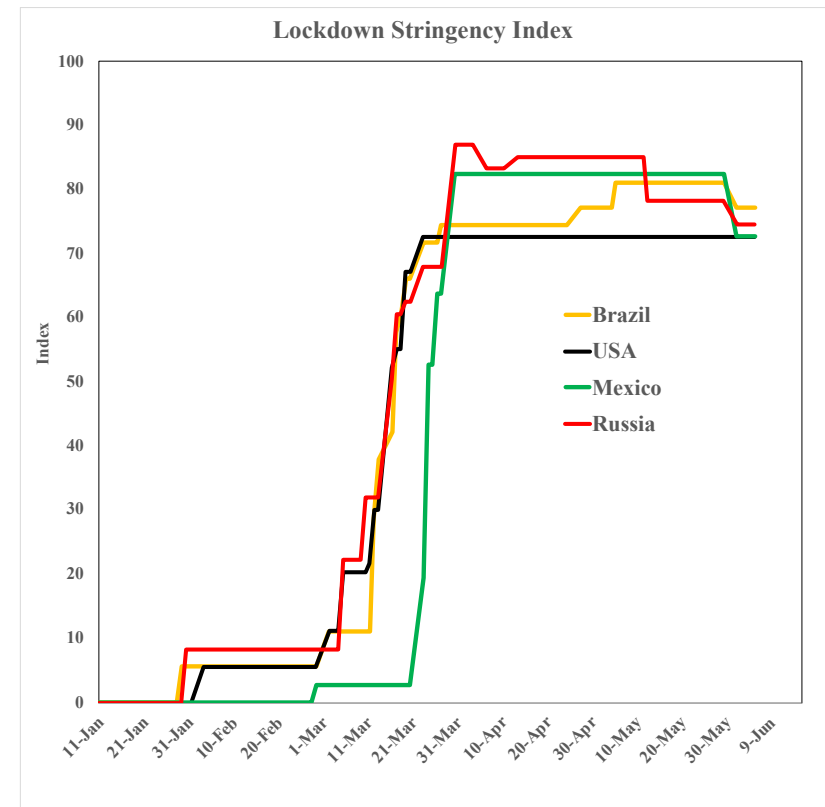
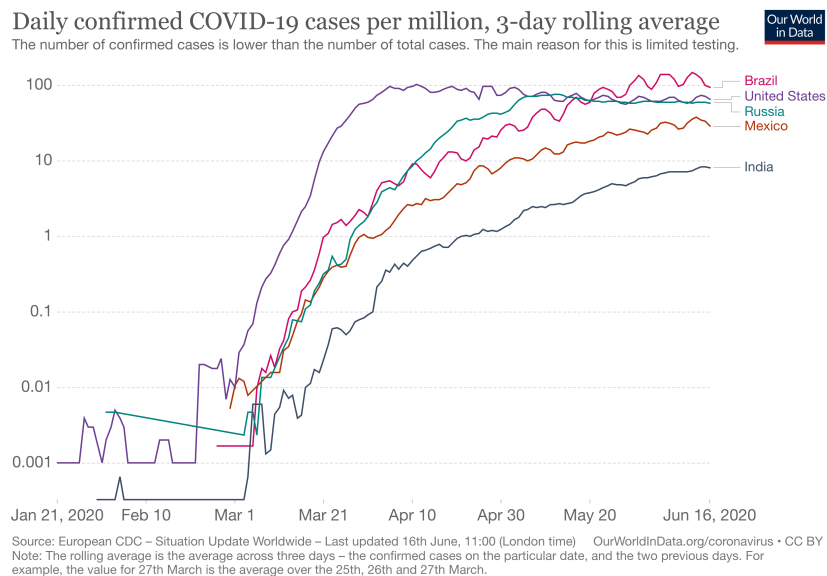
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### Step 3: Find Potential Repricing Catalysts

### Catalysts 3: EM Is Bending The Curve Of Covid Using The Same Lockdown Strategy As DM

New Cases Are Slowing Converging To The US<sup>1</sup>

Slowing Reflects Impact of Similar Containment Strategies As US<sup>2</sup>



1. Max Roser, Hannah Ritchie, Esteban Ortiz-Ospina and Joe Hasell (2020) - "Coronavirus Pandemic (COVID-19)". Published online at [OurWorldInData.org](https://ourworldindata.org/coronavirus). Retrieved from: '<https://ourworldindata.org/coronavirus>' [Online Resource]  
2. Hale, Thomas, Sam Webster, Anna Petherick, Toby Phillips, and Beatriz Kira (2020). Oxford COVID-19 Government Response Tracker, Blavatnik School of Government. Data use policy: Creative Commons Attribution CC BY standard.

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### Step 4: Identify Asymmetric Trades

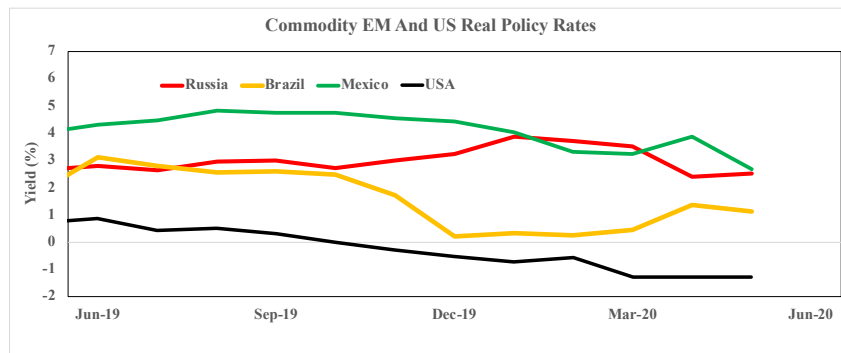
#### Buy A Basket of Commodity EM FX Vs USD Cases<sup>1</sup>

##### Trade Thesis

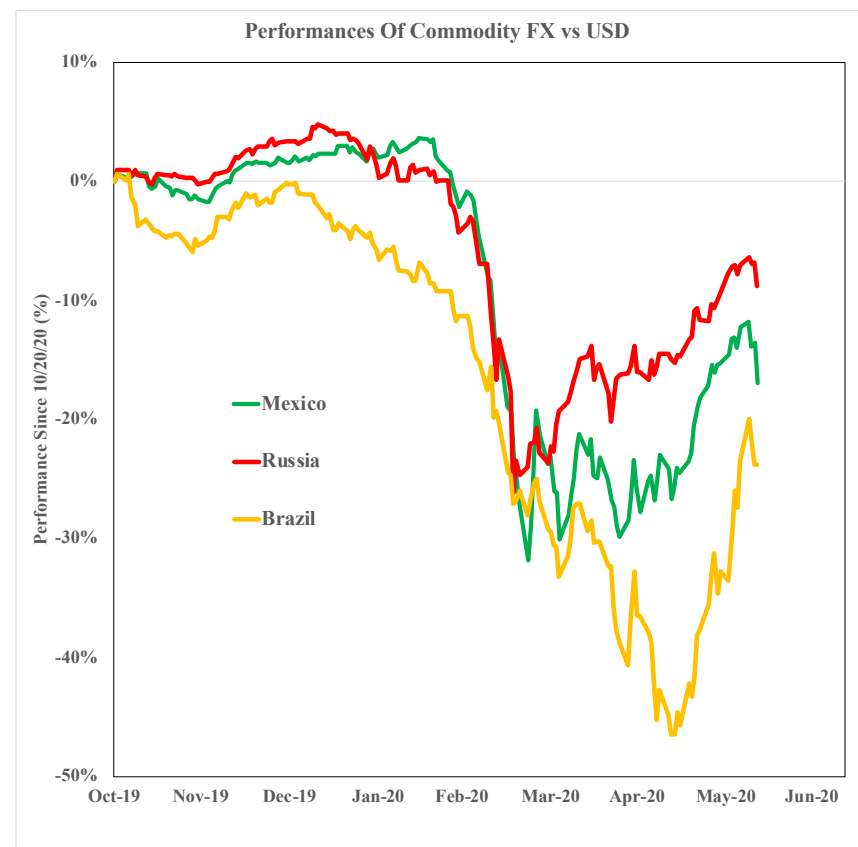
- EM commodity country FX should appreciate vs the USD
- US QE will weaken the USD vs commodity EM FX
  - QE will drive capital flows to EM
  - Weaker USD will drive up commodity prices helping commodity EM Countries
- Commodity country EMs have the capacity for fiscal stimulus that should support their economies and reduce risk
- EM countries have used even stricter containment strategies vs the US to bend the Covid curve

*Risk is a second wave and a general risk-off environment*

##### Negative Real Policy Rates In The US



##### Commodity EM FX Still Have Room To Rally vs USD





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