Ostrum ASSET MANAGEMENT

MyStratWeekly
Market views and strategy

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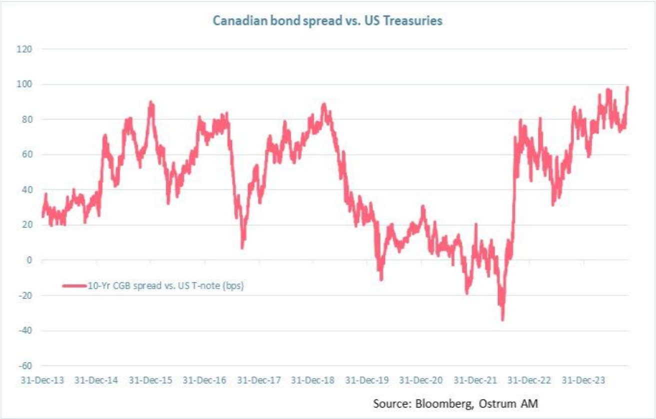
Topic of the week: Emerging market currencies in the shadow of US elections
by Zouhoure Bousbih

- Despite the Fed's rate cuts, emerging market currencies have not performed;
- This is due to the strengthening of the dollar and to the uncertainty about the U.S. election outcome;
- Trade policy, a reduction in foreign direct investment (FDI) and remittances from migrant workers, are the three main specific risks for emerging market currencies;
- However, beyond the election, fiscal risk remains the main market mover for EM currencies, particularly those in Latin America, such as the Mexican peso, whose growth prospects are deteriorating;
- The volatility in the Brazilian real seems excessive to us, given the improvement in growth prospects and the external position;
- We favor cross-currency strategies rather than those against the dollar.

Market review: Relative Calm Before the Storm
by Axel Botte

- Markets are focused on the U.S. election;
- The T-Notes is stabilized around 4.2 %;
- Stocks are declining in Europe, with profits under pressure in several sectors;
- Gold as the ultimate safe haven.

Chart of the week



The Bank of Canada has accelerated its monetary easing cycle by lowering its key interest rate by 50 basis points to 3.5%. This follows three previous rate cuts of 25 basis points each.

This has widened the 10-year interest rate differential with the United States to 100 basis points, for the first time since 2013.

Further rate cuts are expected due to the deterioration of growth prospects linked to weak consumption. The bulk of GDP growth in Q2 was driven by government spending.

Figure of the week

6 %

This is the forecast for the French budget deficit as a percentage of GDP by 2029 according to the International Monetary Fund, which is the current level. Public debt is expected to reach 124.1% of GDP at that time.
Source: IMF

Topic of the week

Emerging Market Currencies in the shadow of US elections

Despite the Fed's interest rate cuts, emerging market currencies have not appreciated against the U.S. dollar. This is due, on one hand, to the strengthening of the greenback linked to the upward reassessment of the Fed's terminal rate by financial markets, following positive economic surprises in the U.S. On the other hand, there is uncertainty surrounding the outcome of the upcoming U.S. election on November 5. The outlook for the dollar is, of course, crucial for the prospects of emerging market currencies. We focus on three specific risks for emerging markets, namely U.S. trade policy, foreign direct investment (FDI), and remittances from migrant workers. The case of China will be addressed in another edition of *MyStratWeekly*.

Tariffs

Mexico is the most vulnerable in the event of U.S. tariffs imposed on its exports...

The primary concern for emerging markets is U.S. trade policy. Since the trade war against China initiated by the Trump administration in 2018, global production chains have been reorganized to circumvent the rising tariffs on Chinese products. This reconfiguration of global trade has benefited several countries, such as Mexico, as well as various Southeast Asian nations like Vietnam, Malaysia, and Thailand. The adjacent chart shows the share of exports to the U.S. as a percentage of GDP for the countries.

Mexico appears to be the most vulnerable in the event of tariffs imposed on its exports (27.4% of GDP) of vehicles and agricultural products to the U.S. However, the threat is not immediate. Indeed, Mexico signed the Canada-United States-Mexico Agreement (CUSMA) on September 30, 2018, replacing the North American Free Trade Agreement (NAFTA), the terms of which are set to be renegotiated in 2026, particularly regarding the "rules of origin", which aim to determine the origin of manufactured goods based not on the assembly country but on the percentage of components sourced from abroad, especially from China.

... .. But ASEAN countries, such as Vietnam, could also be targeted.

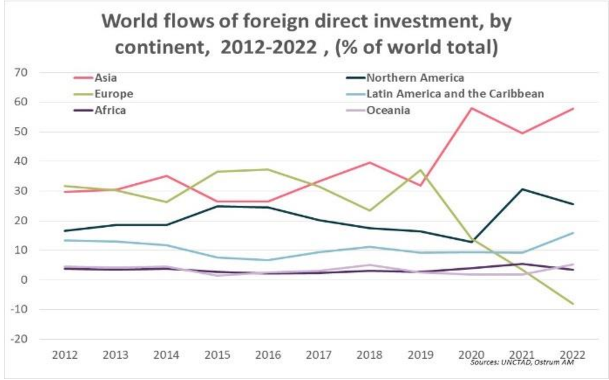
ASEAN could also be targeted by U.S. tariffs. Vietnam, whose exports to the U.S. account for 22.3% of its GDP, has quickly become an alternative manufacturing hub to China and could face a decline in global demand if trade tensions escalate. Malaysia (8.9% of GDP) and Thailand (9.4% of GDP) also rely heavily on their exports to the U.S.

South Korea is deeply integrated into global value chains, particularly in the semiconductor, automotive, and electric battery sectors. The U.S. (6.8% of GDP) and China (7.3% of GDP) are its primary trading partners. The imposition of tariffs or an increase in taxes on U.S. companies could reduce demand for South Korean products, harming the dynamics of its exports and, ultimately, its growth prospects.

Foreign Direct Investment (FDI)

A slowdown in FDI could impact the economic growth of countries that have benefited from the Sino-American trade war, such as Mexico.

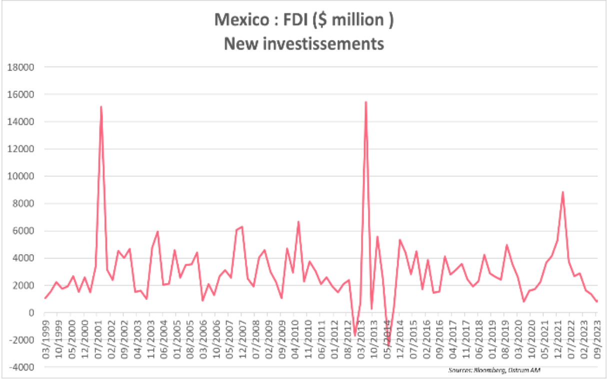
To circumvent U.S. trade sanctions against China, companies worldwide have relocated part of their production to Mexico and Southeast Asian countries. This has resulted in a reallocation of global foreign direct investment (FDI) flows, as illustrated in the following chart.



Since 2018, the dynamics of FDI have changed, reflecting geopolitical tensions and the COVID-19 crisis. The share of global FDI flows to Asia (60%) has significantly increased since 2020, while that to Europe has declined. As a result, in 2022, Europe became the second-largest source of FDI after Asia but did not benefit from it.

FDI flows into Europe were negative at -101 billion euros, while FDI flows from Europe were much higher at 213 billion euros. This reflects the diversion of investments aimed at bypassing U.S. trade sanctions. The imposition of new tariffs may worsen the economic outlook for countries that have benefited from FDI.

In Mexico, U.S. companies have relocated part of their production. The adjacent chart shows new FDI into Mexico, which increased by over 100% between March 2020 and June 2022, reflecting strong U.S. demand following supply chain disruptions related to COVID-19.

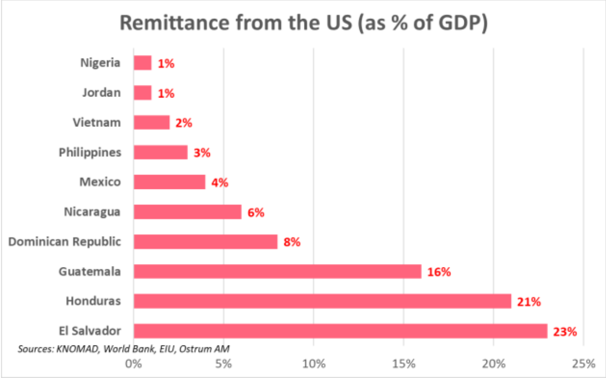


However, this trend quickly reversed with the normalization of supply chains. This will impact the Mexican labor market, where the unemployment rate began to deteriorate to 3% in August, after reaching a low of 2.3% in March.

Remittances from Migrant Workers

Remittances from migrant workers in the United States to Central America and the Caribbean can account for up to 20% of the GDP of these countries.

A change in U.S. immigration policy could lead to a decrease in remittances from migrant workers. These funds are a crucial support for household consumption, investment, poverty reduction, and economic growth in recipient countries, particularly in Latin America. Indeed, the United States is the primary source of remittances from migrant workers in the region, as shown in the adjacentchart.



Central American and Caribbean countries are particularly vulnerable to a tightening of U.S. immigration policy. A reduction in remittances from the United States could result in a slowdown of growth in these countries, putting pressure on their currencies.

Another Risk: Sanctions

Another risk for emerging market currencies is sanctions. These can penalize currencies, as seen with the threats of trade sanctions against South Africa in May 2023, which was accused of supplying arms to Russia. The over 20-year preferential tariff agreement between the two countries was at risk of being called into question. U.S. trade sanctions against Turkey's steel and aluminum also led to increased volatility in the Turkish lira.

What are the Implications for Emerging Market Currencies?

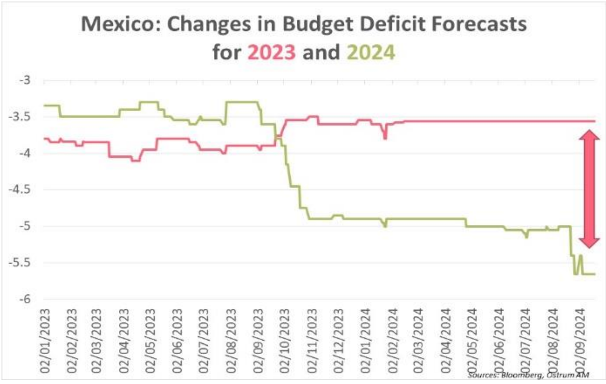
The Mexican peso, the currencies of Central America and the Caribbean, as well as the Korean won, are the most vulnerable...

Emerging market currencies exposed to the three specific risks related to the U.S. election—trade policy, reduced FDI flows, and remittances from migrant workers—such as the Mexican peso, currencies from Central America and the Caribbean, as well as the South Korean won, appear to be the most vulnerable. However, beyond the election, budgetary risk remains a key factor for volatility in currencies, particularly for those in Latin America.

Beyond the U.S. Election: Budget Risk

... But budgetary risk remains the main catalyst for emerging market currencies.

In the context of the charged electoral environment in emerging markets, pressure to increase public spending has led to a deterioration of deficit prospects, as seen in Mexico. The adjacent chart illustrates the worsening deficit forecasts for the country between 2023 and 2024. The budget deficit is expected to rise from 3.5% of GDP in 2023 to 5.7% of GDP in 2024.

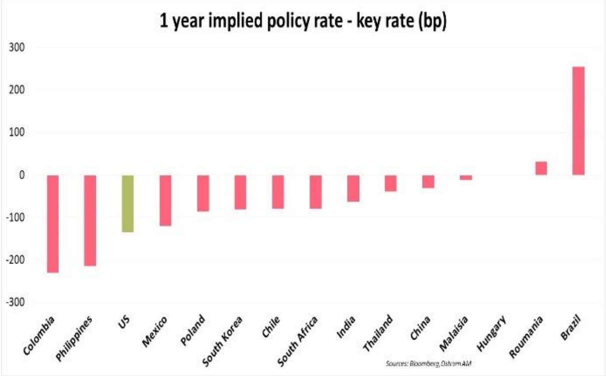


Concerns regarding the country's budgetary outlook have negatively impacted the Mexican peso, which has not returned to its pre-election parity against the dollar. The Mexican government is set to present its 2025 budget on November 5, amid significantly deteriorated growth prospects. In its global economic outlook, the IMF has sharply downgraded its growth forecast for Mexico by -0.7 percentage points to 1.5% for 2024 and by -0.3 percentage points to 1.3% for 2025. Thus, the room for maneuver to reduce the deficit is limited.

Budgetary Pressure Becomes the Main Risk for Central Banks in Emerging Markets

The volatility in the Brazilian real seems excessive given its strong fundamentals.

As central banks in emerging markets have begun to cut rates, budgetary pressure has emerged as the primary risk. The Central Bank of Brazil has been forced to initiate a rate hike cycle, as shown in the adjacent chart representing the differential between market expectations for the one-year key rate and the current key rate. For Brazil, financial markets anticipate 250 basis points of rate hikes, reflecting the country's strong growth as well as budgetary risk.



However, the Brazilian Finance Minister has expressed a commitment to maintaining budgetary credibility. Brazil has benefited from the highest growth revision by the IMF, increasing from 2.1% to 3% for 2024 and from 2.2% to 2.4% for 2025. Earlier this month, the rating agency Moody's upgraded the country's external sovereign rating to Ba1, bringing it one step closer to regaining "investment grade" status. Thus, the volatility in the Brazilian real seems excessive, considering the strong growth dynamics and high trade balance of the country.

Conclusion

The high uncertainty surrounding the U.S. election has led to increased volatility in emerging market currencies. A strengthening of the dollar is negative for emerging market currencies, albeit to varying degrees. Trade policy, reduced FDI, and remittances from migrant workers are the three specific risks for emerging markets. From this perspective, the Mexican peso, currencies from Central America and the Caribbean, as well as the South Korean won appear to be the most vulnerable. The outcome of the election will have either positive or negative implications for currencies, depending on the political choices made. However, beyond the elections, budgetary risk remains the primary catalyst for currencies, particularly for those in Latin America. The volatility in the Brazilian real appears excessive given the improvement in growth prospects and its external position. Therefore, we favor cross-currency strategies rather than those against the dollar.

Zouhoure Bousbih

Market review

Relative Calm Before the Storm

The upcoming U.S. elections present a risk to long-term interest rates, which central banks are striving to contain. Credit and equities continue to weather the rate volatility, while gold remains the ultimate safe haven.

Financial markets appear fixated, almost paralyzed, by the upcoming US elections. The investment horizon is shortening and asset prices reflect the broad range of expectations of market participants. Fiscal deficits are exerting upward pressure on long-term rates through a higher term premium. This is also reflected in the underperformance of government bonds against swaps. Inflation breakevens fail to account for long-term risks to price stability, in stark contrast to gold, which stands as a universal safe haven. The yen, currently trading at 152 against the dollar, is ensnared by political pressures and has long lost its safe-haven status.

Recent economic publications were largely overlooked by financial markets. This week, leading up to the US election and the Federal Reserve meeting, will be more eventful. These ten days are critical for market direction in the coming months. Globally, policy rates are being eased at an accelerated pace to mitigate pressures stemming from excessive public deficits. Gilts are under pressure, along with long-term T-bonds, given Donald Trump’s slight lead in the polls. Central banks are leaning against upward pressure on bond yields. The European Central Bank appears to be painting a bleak picture of economic activity in the euro area, preparing markets for a more aggressive policy stance. The BoE’s Andrew Bailey echoed this dovish policy stance in the United Kingdom. The steepening of yield curves remains a significant trend across bond markets. In Japan, the yen’s weakness is symptomatic of political pressure on the Bank of Japan and the possible escalation of the trade war should the Republican candidate win in November. Currencies are likely to adjust swiftly in response to any increase in tariffs. This context bolsters both the dollar and gold, which seems orthogonal to movements in major currencies. Chinese stimulus is generating nearly as much hope as it is raising questions, as regional public entities face increasing difficult to repay debt.

The T-note hovers around 4.20%, while the Bund trades at 2.25%, near fair value. The narrowing of swap spreads is intensifying under the dual influence of expected ECB rate cuts and quantitative tightening. This trend also signals a lack of confidence in public debt overall. Sovereign spreads against Bunds have, however, stabilized, with France trading around 73 basis points at the ten-year mark. The Italian BTP is slightly above 120 basis points. The Gilt underperforms as markets await the budget announcements scheduled for October 30, which will be critical for 2025 issuance. Meanwhile, credit markets are navigating uncertainty with relative ease. The moderate growth environment and contained leverage levels favor this asset class. In equity markets, several large-cap US companies are set to report this week, which will set the tone for a U.S. stock market trading at historic highs. In Europe, the earnings season is characterized by challenges faced by consumer stocks, as markets shed 1% last week.

Axel Botte

Main market indicators

G4 Government Bonds	28-Oct-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.07%	-11	0	-33
EUR Bunds 10y	2.26%	-2	+13	+24
EUR Bunds 2s10s	18.9bp	+9	+13	+57
USD Treasuries 2y	4.11%	+7	+55	-14
USD Treasuries 10y	4.25%	+5	+50	+37
USD Treasuries 2s10s	13.8bp	-2	-5	+51
GBP Gilt 10y	4.22%	+8	+24	+68
JPY JGB 10y	0.98%	+2	-2	-40
€ Sovereign Spreads (10y)	**28-Oct-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	74bp	0	-6	+20
Italy	121bp	-2	-12	-46
Spain	70bp	-2	-10	-26
Inflation Break-evens (10y)	**28-Oct-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	1.94%	-7	+0	-20
USD 10y Inflation Swap	2.46%	-5	+6	+5
GBP 10y Inflation Swap	3.55%	-3	+7	+1
EUR Credit Indices	**28-Oct-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	104bp	-1	-13	-34
EUR Agencies OAS	61bp	-1	-7	-9
EUR Securitized - Covered OAS	54bp	-4	-8	-25
EUR Pan-European High Yield OAS	343bp	-4	-10	-56
EUR/USD CDS Indices 5y	**28-Oct-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	56bp	0	-2	-2
iTraxx Crossover	306bp	+0	-5	-8
CDX IG	52bp	+0	-1	-4
CDX High Yield	329bp	+1	-2	-28
Emerging Markets	**28-Oct-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	338bp	+1	-30	-46
Currencies	**28-Oct-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.082	0.009	-2.865	-2.0
GBP/USD	$1.299	0.039	-2.879	2.0
USD/JPY	JPY 153	-1.147	-5.872	-7.6
Commodity Futures	**28-Oct-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$71.6	-$2.7	$0.1	-4.5
Gold	$2 734.1	$14.3	$99.6	32.5
Equity Market Indices	**28-Oct-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 808	-0.96	1.22	21.8
EuroStoxx 50	4 937	-0.09	-2.58	9.2
CAC 40	7 502	-0.46	-3.72	-0.6
Nikkei 225	38 606	-0.90	-3.07	15.4
Shanghai Composite	3 322	1.66	7.60	11.7
VIX - Implied Volatility Index	19.39	5.55	14.33	55.7

Source: Bloomberg, Ostrum AM

Additional notes

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