THE COMEBACK OF THE EMERGING CURRENCIES

We anticipate a challenging environment for the US dollar for a number of reasons: GDP growth is more constrained (the IMF expects the US to slow from 2.9% in 2018 to 2.5% in 2019), the Fed's rate-hiking cycle is at a late stage, and US dollar valuations are stretched with the real effective measure 14% above its 10-year average.

If and when the US dollar tops out, it is likely to be along a bumpy path as a US growth slowdown means more uncertainty about the global economy, with higher cross-asset market volatility. Moreover that volatility is being pushed upwards anyway by the ongoing global spread of monetary policy normalisation.

This backdrop means that not all EM currencies will be able to glide smoothly higher against the US dollar. From a top–down perspective, though, we can argue that they generally will: unlike the US, EM GDP growth should hold, at around 4.7% in 2019 (similar to 2018 by the IMF's forecasts); also, EM currency valuations are generally attractive after a number of years of depreciation against the dollar. The best EM currencies are the ones that are the least structurally vulnerable to swings in global market conditions. Historically a number of key factors indicate low susceptibility to such fluctuations, including a low level of accumulated portfolio inflows from foreign investors, a current account surplus or small deficit, sensible past rates of domestic credit expansion, and an orderly real exchange rate path, and high forex reserves. In our analysis a number of EM currencies satisfy most of these criteria while also having some good cyclical factors to argue for an appreciation against the US dollar. These currencies include, in order of preference, the Brazilian real, the Indonesian rupiah, the Indian rupee, and the Polish zloty.

The **Brazilian real** benefited from a reduced political risk premium after the election of a pro-business president in October of 2018. There are still potentially positive dividends that could push up the real in the months to come, including the incoming administration's goal to sell some state company shares, oil exploration rights and state-owned real estate, and progress on the much-needed pension reform in Brazil. The privatisations and any associated deregulation policy steps would be the most promising for the real because they could unlock faster GDP growth and returns on investments in Brazil.

We believe **the Indonesian rupiah** could make more headway against the dollar. Indonesia's current account is likely to improve from an already reasonable level, helped by the government's decision to throttle back on public-sector capital investment, and by the central bank's 175bps of rate hikes in 2018. These will probably be able to push down imports without significantly weighing on GDP growth. The IMF expects a -2.4% GDP deficit in both 2018 and 2019, while we think the outcome could be better in 2019.

The **Indian rupee,** besides showing lower structural vulnerability, is currently being supported by low oil prices and a much reduced import bill for the country. The improvement in the current account dynamic and still decent rates of GDP growth should help pull portfolio money back into the country, reversing the USD 6.6 bn worth of equity outflows (2018) caused by previously high oil prices and high inflation.

We like the **Polish zloty** because of cheap valuations and the prospect of continuing robust domestic-driven GDP growth in Poland. The zloty tends to perform as a levered version of the euro against the US dollar, i.e. when there is a positive European fundamental backdrop for euro appreciation against the dollar, the zloty does even better because of the positive economic spill to Poland. For the early part of 2019, this characteristic will probably be a hindrance because the recent (temporary) slowdown in the euro area economy, Italy's budget crisis, and Brexit will likely weigh on the EUR/USD exchange rate. When these negatives subside, the euro should be able to appreciate against the dollar, giving the zloty an additional lift.