Brown Brothers Harriman

FOREIGN EXCHANGE

OUTLOOK FOR THIRD QUARTER 2023

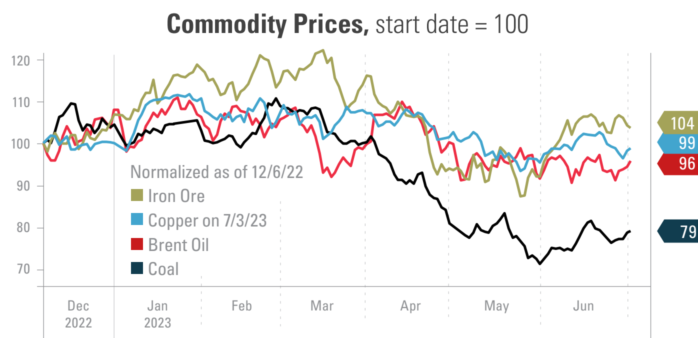
Proving Forecasts Wrong

As we enter H2, many of the major investment themes that held at the beginning of the year have been proven wrong on several fronts:

- While the eurozone avoided a worst-case scenario due to a warmer than expected winter, the outlook remains quite weak. Germany and France are already flirting with recession and it's only a matter of time before Italy and Spain are dragged down as well. European Central Bank tightening has not yet been fully felt even as the bank continues hiking into the fall.
- In the U.S. many had penciled in a recession that would lead the Fed to cut rates in H2. The March banking sector crisis increased bets of further cuts by year-end but the resilience in the U.S. economy has led the market to finally price out those cuts in favor of more tightening.
- Many expected broad-based dollar weakness for much of this year. Instead, the U.S. dollar index started the year off around 103.50 and has largely traded in a 101-106 range. The ebbs and flows have been largely dictated by gyrations in market pricing for Fed policy. Given underlying strength in the economy, we believe the dollar will eventually break out to the upside in H2.
- Many were bullish on emerging markets and China's reopening in December. Yet China has turned increasingly inward and export data in Asia and Europe remain weak six months after reopening. In addition, EM commodity prices are now lower than when reopening began.

Simply put, interest rates are likely going higher for longer, led by the Fed. This means global liquidity will likely continue to recede, with the obvious negative implications for risk assets that thrive on abundant liquidity. Emerging markets are likely to remain under pressure, especially considering the disappointing China reopening. Global growth is likely to disappoint in H2, with many major economies seen tipping into recession. Given this outlook in which the U.S. economy continues to outperform, we expect the dollar to strengthen in H2.

Commodity Prices, start date = 100



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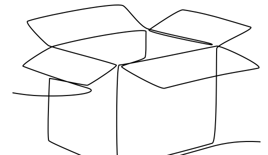

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MAJOR MARKETS GLOBAL OVERVIEW

ALL EYES ON THE FED

By Win Thin

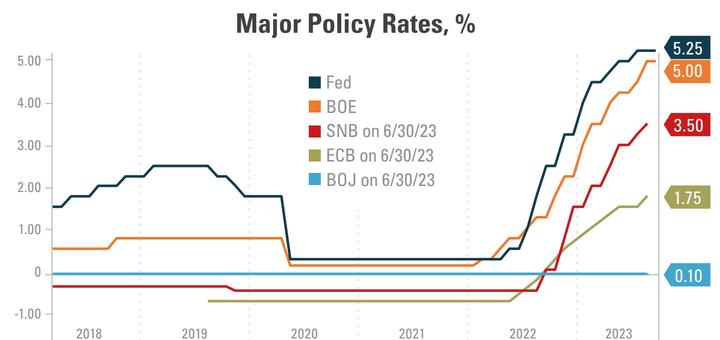
The Fed has left the markets with more questions than answers. Was the decision to stand pat in June a skip, as it claimed? If so, how high will rates eventually go? Was it a pause? If so, how long? Or was it the end? If so, when do rates start coming down?

It will all come down to the data. As this FX Quarterly was written, the Atlanta Fed's GDPNow model is tracking nearly 2% SAAR in Q2. The labor market remains strong, and that momentum should carry over into H2. Meanwhile, most inflation measures continue to fall, albeit slowly. The doves at the Fed want to give past tightening time to work and they remain concerned about a potential credit crunch from the banking sector stresses earlier this year.

On the other hand, the hawks see an economy that's still adding over 300,000 jobs per month, and they remain concerned that the Fed is falling further behind the curve. We viewed the June skip as a compromise between the two camps but with all indications that the U.S. economy remains robust, we believe the hawks will eventually prevail in H2.

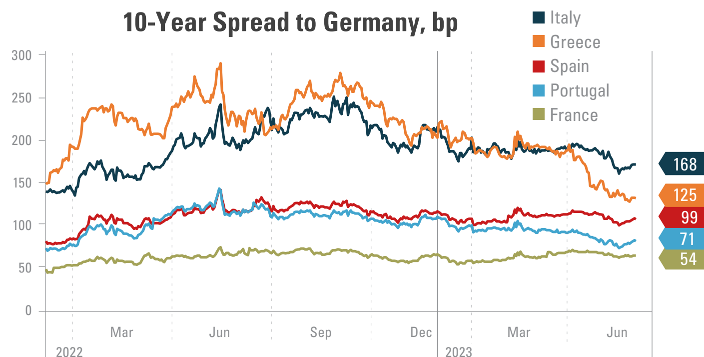
Fed tightening expectations are finally picking up. A 25 bp hike is about 90% priced in for July and fully priced in for September. With the data remaining strong in Q2, markets are finally starting to price in that second hike this year as implied by the June Dot Plots. Those odds top out near 45% in November but that will rise if the data continues to come in firm, as we expect.

More importantly, market pricing for the start of an easing cycle has been pushed out until June 2024. That sounds about right, but with risks tilted later rather than sooner. As far as the pace goes, the market is pricing in 75 bp of easing by end-2024. That is slightly less than what the June Dot Plots suggest but a lot can happen between now and H2 2024.



The European Central Bank is nearing the end of its tightening cycle. Or is it? The split between the hawks and the doves remains as wide as ever. The hawks continue to focus on elevated core inflation, while the doves are focused on falling headline inflation and rising recession risks. The eurozone economy has contracted for two straight quarters with little relief in sight. June PMI readings suggest France has tipped into recession, with Germany not far behind. We expect it's only a matter of time before Italy and Spain do so as well.

Another 25 bp hike is priced in for July, followed by another 25 bp hike in Q4 that would see the deposit rate peak near 4.0%. While headline inflation has fallen due to lower energy prices, core inflation remains elevated and will pose a challenge for the ECB. Italian political leaders are already starting to complain about tight monetary policy.



The Bank of England will likely be forced to continue hiking rates, potentially triggering a recession in the U.K. Faced with persistently high inflation, the bank hiked 50 bp to 5.0% in June and signaled more tightening ahead.

Another 50 bp hike is largely priced in for August, followed by 25 bp hikes in September, November, and December that would see the bank rate peak near 6.25%. This would represent the most aggressive tightening cycle in the majors so far in terms of absolute magnitude and yet the benefits to sterling are starting to wane. That's because a recession is now back on the table after some earlier optimism.

The BOE will have to recognize this in its next set of updated macro forecasts in August. While the economy has proven resilient, growing 0.1% q/q for two straight quarters after only one quarter of contraction last year, the more aggressive rate path that's shaping up is likely to take a huge toll on the economy in H2 and beyond.

The Bank of Japan remains an outlier. Despite high and still-rising non-energy inflation, the bank has steadfastly refused to pivot from its ultra-loose policy. This year began with expectations of an imminent shift after the BOJ's unexpected tweak to Yield Curve Control in late December. Incoming BOJ Governor Kazuo Ueda was expected to be more hawkish than Kuroda but has instead remained firmly in the dove camp. We expect YCC to eventually be abandoned in H2 but believe it is more likely to come in Q4 rather than Q3.

Odds of liftoff this year remain low, starting at around 15% in July and rising to 70% in December. With recent data showing a loss of momentum in the economy, signs are emerging that policymakers are reluctant to remove accommodation at this juncture. To us, this may signal continued strength of the dollar against JPY.

Simply put, if the BOJ continues to run easy monetary policy, then widening monetary policy divergences with the Fed argue for a weaker yen. The main reason FX intervention worked last fall was that it was accompanied by heightened expectations of BOJ liftoff in 2023. Since then, it's become clear that Governor Ueda is just as dovish as Kuroda was and the bank is nowhere near removing accommodation, even as the Fed continues to be as hawkish as ever. There will be more official jawboning and the FX market will remain jumpy but at the end of the day, we believe USD/JPY is likely heading higher in H2.

The Swiss National Bank downshifted to a 25 bp hike in June but signaled that further tightening would be needed. President Jordan said, "We are not at the end – most likely there could be more rate hikes necessary in order to bring inflation on a permanent basis below 2%." Another 25 bp hike is around 70% priced in for September and becomes fully priced in for December. The odds of another 25 bp hike after that top out near 70% in June 2024.

Dollar Bloc and Scandies

The Bank of Canada was the first of the major central banks to pause its tightening cycle back in March. After another pause in April, the bank delivered a hawkish surprise in June with a 25 bp hike to 4.75% and noted that "Overall, excess demand in the economy looks to be more persistent than anticipated." It added that "Monetary policy was not sufficiently restrictive to bring supply and demand into balance and return inflation sustainably to the 2% target," citing what it called an "accumulation of evidence."

Lastly, the bank stressed "Concerns have increased that CPI inflation could get stuck materially above the 2% target." There was no forward guidance given, which suggests the bank joins many others in becoming data dependent. There are nearly 50% odds of another hike in July and that hike becomes fully priced in for September. Odds of another 25 bp hike after that top out at around 10% in October.

The Reserve Bank of Australia was the next major central bank to pause its tightening cycle back in April. That was it for the pause, as the bank then delivered back-to-back hawkish surprises in May and June with 25 bp hikes at both meetings. The bank noted in June that "The board remains alert to the risk that expectations of ongoing high inflation contribute to larger increases in both prices and wages, especially given the limited spare capacity in the economy and the still very low rate of unemployment." Looking ahead, it warned that "Some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe. But that will depend upon how the economy and inflation evolve." Odds of another 25 bp hike are around 20% for July, 75% for August, and fully priced in for September. Odds of another 25 bp hike after top out near 60% for December.

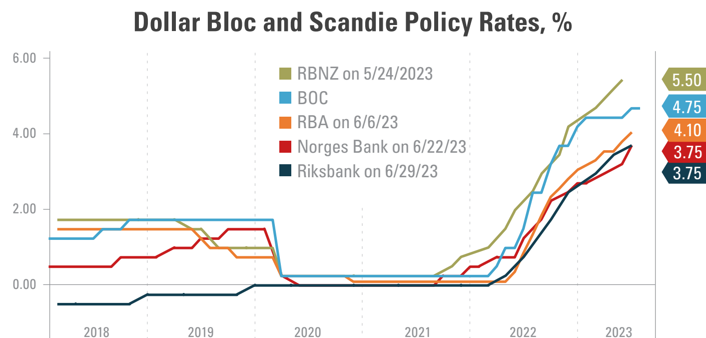
The Reserve Bank of New Zealand was initially the most hawkish of the major central banks. It was the first of the majors to hike back in October 2021 and quickly got the policy rate up to 5.5%. However, in May, the bank hiked rates 25 bp but unexpectedly declared a halt to its tightening cycle. It remains to be seen whether the RBNZ will eventually be forced to restart rate hikes, as the New Zealand economy has contracted for two straight quarters with little relief in sight. It remains to be seen whether the RBNZ is eventually forced to restart the tightening cycle but as of this writing, the market sees around 35% odds of one more rate hike.

Norges Bank delivered a hawkish surprise in June with a 50 bp hike to 3.75% vs. 25 bp expected. Officials said after the June hike that rates will "most likely be raised further in August" while the expected rate path was shifted up to a peak of 4.25% this year vs. 3.5% previously. The market believes the Norges Bank and is pricing in a peak policy rate of 4.25% over the next six months.

Sweden's Riksbank hiked rates 25 bp to 3.75% in June and said they would be hiked at least one more time this year. It also pledged to strengthen a weak krona by accelerating quantitative easing to SEK5 billion per month.

Forward guidance shifted slightly more hawkish as the policy rate is now seen peaking at 4.05% in Q2 2024 vs. 3.65% in the April forecasts and staying there through Q2 2025 before falling to 3.75% by Q2 2026. The market sees two more 25 bp hikes by mid-2024 that would see the policy rate peak near 4.25%.

Dollar Bloc and Scandie Policy Rates, %



U.S.-CHINA RELATIONS

Unresolved Issues Continue to Simmer

By Jay Foraker

The U.S.-China relationship warrants continued focus due to unresolved issues simmering below the surface.

We categorize these issues broadly as economic and strategic with the potential to escalate, particularly as the U.S. political campaign cycle gears up for 2024. We take a cautiously optimistic view on the former and urge caution on the latter.

Both countries would benefit from taking a step back to prevent risking material damage to over forty years of integration achieved since signing a bilateral trade agreement in 1979.

Positive Persistence

There remains resilience in their economic relationship, however. This is remarkable given that Trump-era tariffs and trade restrictions have largely remained in place under the Biden Administration due to a strong bipartisan desire in Washington and throughout the country to take a tough stance on China. In 2022, U.S. exports to China were the highest ever at $153.8 billion, while U.S. imports from China were $538.8 billion, second only to 2018 levels *(See Figure 1)*.

Both countries' economic performances are now pivoting to post-COVID realities. The U.S. is addressing persistent inflation and a higher-for-longer interest rate environment. Yellen is expected to raise concerns over China's new national security and espionage law, while encouraging collaboration on urgent challenges such as climate change and debt distress faced by multiple countries.[1] China, on the other hand, is facing the prospect of a lower longer-term economic growth trajectory, as its reliance on infrastructure and state-driven investment to boost growth hits diminishing returns.

They must therefore consciously avoid strategic missteps that could risk a serious setback in relations.

We are encouraged by Treasury Secretary Janet Yellen who, at the time of writing this quarterly, was set to visit Beijing as part of ongoing efforts to stabilize the relationship with China. In testimony given to the US. House Financial Services Committee on June 13, she said decoupling would be a "big mistake", echoing statements made by the G7 in May.[2] To the extent these sentiments prevail in Washington, effective guardrails in the U.S.-China relationship should develop in the near term.

In keeping with Yellen's constructive tone, U.S. Treasury's most recent, twice-yearly report on *Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States*[3] issued June 16 did not name China (or any other major trading partners) as a "currency manipulator." Seven economies including both China and Taiwan remain on Treasury's "Monitoring List" meriting close attention to their currency practices and macroeconomic policies. The Report also reiterated Treasury's call for increased transparency from China concerning its foreign exchange intervention and key features of its exchange rate mechanism. Treasury noted that most intervention by trading partners during the period was selling dollars to strengthen their own currencies, versus intervening to purchase and strengthen their own currencies at sustained levels deemed manipulative. We view this move as neutral and largely driven by economic conditions that have strengthened USD, not political factors.

Strategic Minefields Proliferate

The U.S. and China should tread carefully on the following strategic minefields:

1. **China's "Developing Country" status:** The U.S. Senate Foreign Relations Committee recently passed a bill requiring removal of China's Developing Nation Status in international organizations, paving the way for its consideration by the full Senate. This has long been a source of advantage for China and a source of contention with the U.S., particularly under the auspices of the World Trade Organization (WTO). This status effectively permits China to use state subsidies that are otherwise prohibited under WTO rules; such subsidies are distortive on a global scale when used by what could arguably be considered the world's newest superpower. The U.S., its allies, and China must work to enhance the role of multilateral institutions, including the WTO and IMF, to function effectively while acknowledging the current state of the global economy.
2. **Taiwan engagement risks rapid escalation:** Biden's pledge of a U.S. defense guarantee and senior congressional leaders arriving in Taiwan on official visits could be seen as provocative. Equally provocative, however, are Chinese military exercises in the region and opaque statements by Chinese leaders about Taiwan's military future. Continued dialogue at the highest levels of militarily are critical, with this issue having the highest potential for escalation due to miscommunication. That said, according to reports, Secretary Blinken's proposal to set up communication between the Chinese and American militaries was rejected during his recent trip to Beijing.

1 https://www.reuters.com/world/treasurys-yellen-visit-china-this-week-expand-communications-2023-07-03/

2 https://www.reuters.com/markets/yellen-says-g7-members-looking-how-counter-chinas-economic-coercion-2023-05-11/

3 Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States

3. **Russia/Ukraine Conflict:** This issue poses the biggest long term strategic risk for China because its miscalculations run the risk of inviting targeted sanctions by the U.S. and western allies. China must maintain relations with Russia and demonstrate its potential as a major world power to help resolve the conflict, while not provoking sanctions by the West for supporting Russia. A misstep that triggers sanctions for China could reverse investment and connectivity on an exponentially larger scale than what was seen following Russia's invasion of Ukraine.
4. **Geostrategic Alliances:** This issue poses the biggest risk of a misstep by the U.S., in terms of both what it does and fails to do. For more than a decade, China has been extending its global influence via the Belt & Road Initiative, growing its influence in international organizations and aggressively extending its version of global standardization in the technology sphere. In doing so, the country is emulating much of what the U.S. has done over the past century. Missteps by the U.S. would include significant and continued inward focus of its industrial policy and disengagement from multilateral ties such as the Trans-Pacific Partnership. These actions would alienate traditional allies and fail to build new alliances among those countries being courted by China today.

U.S. Secretary of State Blinken's recent visit to China is encouraging. The trip reestablished communication channels that had been frozen since the Spy Balloon incidents earlier this year, culminating in a 35-minute encounter between Secretary Blinken and President Xi. Underscoring our optimism on the economic front is that this meeting could portend an Xi-Biden meeting at the APEC summit in San Francisco in November. On the strategic front we urge caution, as while Xi and Blinken met, it was reported that China continues active dialogue with Cuba about creating a new joint military training facility on the island nation.[4]

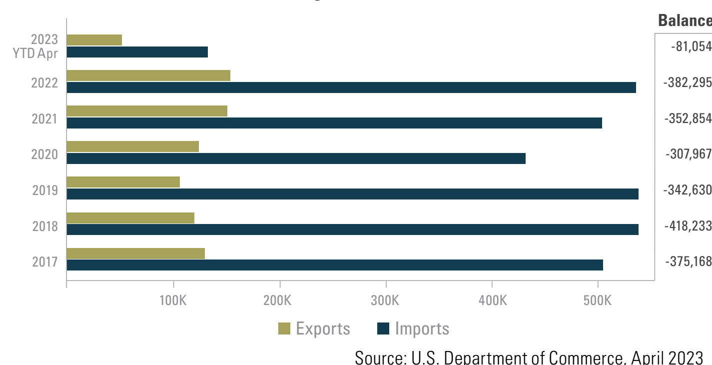
Investment Outlook

Our view is that any enthusiasm from positive economic headlines must be tempered by lucid recognition of the accumulated strategic challenges and risks thereof. Here are some broad investment considerations:

- There remains little appetite to remove the Trump-era tariffs, due to the bipartisan hawkish-China stance that persists in Washington and is reflective of the country at large. According to Pew Research *(see Figure 2)* Americans' views of China have grown strongly negative in just the past five years. Further, trade isn't top on the Biden agenda, but is part of a broader domestic-focused (some would argue protectionist) set of priorities (CHIPS Act, IRA, etc.). Considering that removing tariffs would be a relatively simple way to fight inflation, and the fact that this has not been done in an inflationary environment, points to how broadly and deeply the hawkish-China view is held.
- Investors in China must now be prepared for the long-haul. With years of rapid economic growth and rapid returns largely behind in the rear-view mirror, China will face several headwinds for the remainder of the decade, including demographic change and contending with what some would argue is excessive growth in its property market. People's Bank of China's recent rate cut is further evidence of official concern about the economy and highlights the ongoing downside risks to growth. Lastly, there is real risk in terms of how China plays its cards vis-à-vis Russia/Ukraine and Taiwan which could trigger sanctions and/or escalated conflict.

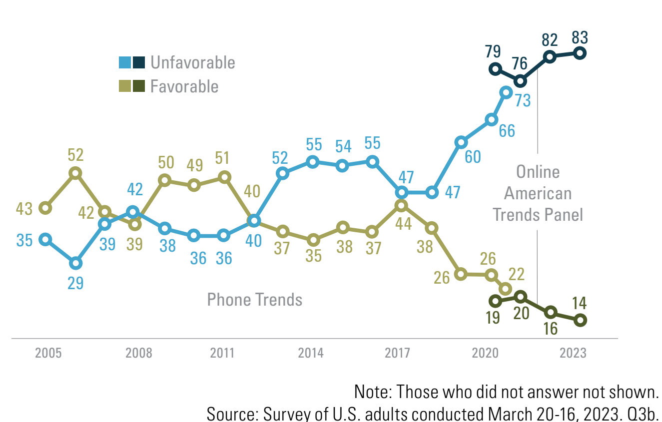
As this quarterly went to press, China imposed export controls (from August 1) on critical inputs for telecommunications, semiconductor and electric vehicle hardware;[5] concurrently the U.S. has announced steps to restrict access to U.S. cloud-computing services by Chinese companies. Given the two countries account for a combined total of 40% of world GDP, actions taken and dialogue sustained in the weeks and months ahead will shape the global economy for years to come.[6]

Figure 1: U.S.-China Economic Ties Remain Resilient
(U.S. trade in goods with China $M)[7]



Source: U.S. Department of Commerce, April 2023

Figure 2: U.S. Opinion of China Remains Negative[8]

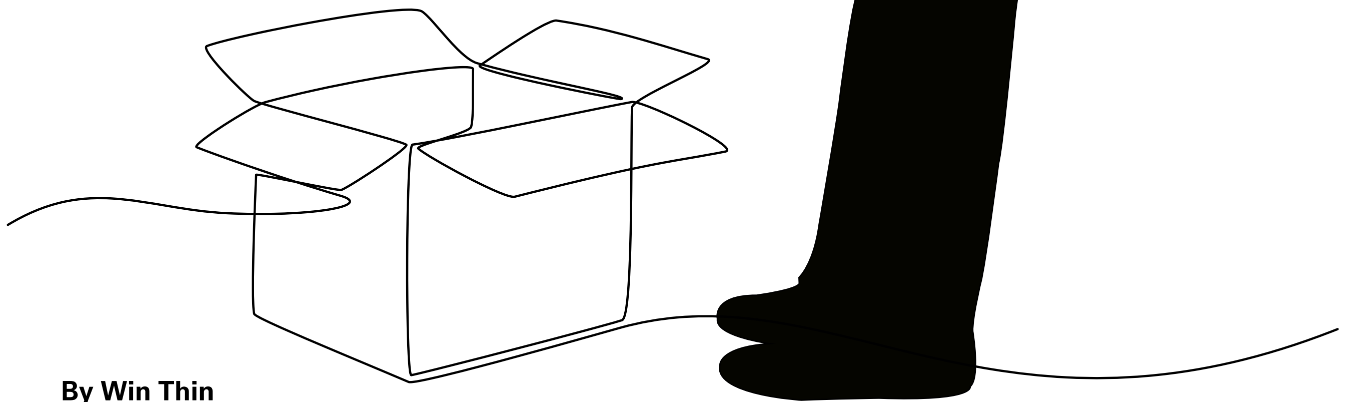


Note: Those who did not answer not shown.
Source: Survey of U.S. adults conducted March 20-16, 2023. Q3b.

4 https://www.politico.com/news/2023/06/20/china-negotiating-with-havana-about-joint-military-training-facility-in-cuba-00102636
5 https://www.reuters.com/markets/commodities/china-adviser-warns-chipmaking-export-curbs-are-just-start-yellen-visit-looms-2023-07-05
6 https://www.wsj.com/articles/u-s-looks-to-restrict-chinas-access-to-cloud-computing-to-protect-advanced-technology-f771613?mod=tech_lead_pos7
7 https://www.census.gov/foreign-trade/balance/c5700.html
8 https://www.pewresearch.org/global/2023/04/12/americans-are-critical-of-chinas-global-role-as-well-as-its-relationship-with-russia/

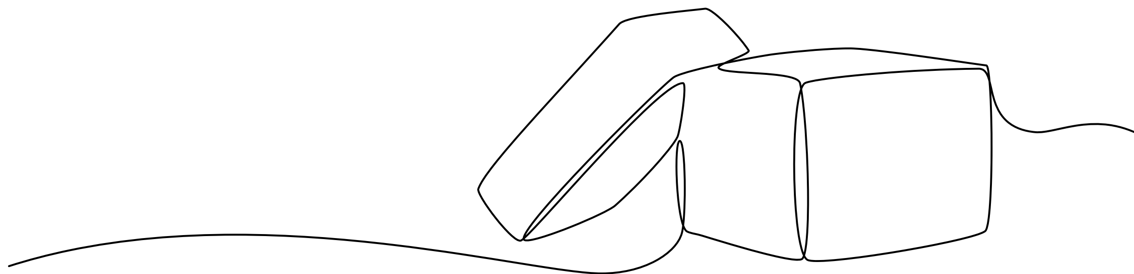
EMERGING MARKETS GLOBAL OVERVIEW

(Less Than) A Grand Reopening



By Win Thin

To us, the biggest story for EM is that China reopening has had very little impact on global growth and commodity prices. This is not surprising given President Xi Jinping's focus on boosting domestic demand, but even that has been disappointing. The People's Bank of China cut interest rates in June and is likely to do so again in Q3.



With the economy slowing, there is likely to be growing pressure on policymakers to inject fiscal stimulus to help complement modest monetary stimulus. The problem is that sharply rising debt loads really limit the ability of policymakers to push the usual levers to boost the economy. As such, we expect the mainland economy to continue underperforming expectations. This has negative implications for EM and commodities.

Americas

Latin America should continue to outperform in the second half. The best performing currencies in EM are COP, MXN, HUF, BRL, and PLN. They are followed by CLP, PEN, and CZK.

Latin America continues to benefit from relatively high interest rates as central banks hiked early and aggressively. Tight monetary policy has restrained growth in Latin America but if these regional central banks do start easing in H2 as we expect, this should help soften the blow from slowing global growth. Political risk in the region also appears to be ebbing.

BRAZIL:

President Lula da Silva has been forced to be more moderate due to his reliance on coalition partners in Congress to pass his legislative agenda. The recently passed fiscal framework suggests a willingness to be pragmatic when needed and central bank easing is just around the bend. The market is pricing in the start of the easing cycle at the August 2 meeting. 50 bp of easing is seen over the next three months followed by another 125 bp over the subsequent three months. This strikes us as just about right given the bank's cautious stance.

CHILE:

The Constitution is being rewritten. While the Chilean populace does want to see significant reforms and improved social condition, it does not want to see an unfettered lurch to the left. Meanwhile, the economy should pick up in H2 as the swaps market is pricing in the start of an easing cycle with 125 bp of easing seen over the next three months and another 200 bp over the subsequent three months. This strikes us as overly aggressive considering the bank's cautious stance.

COLOMBIA:

President Gustavo Petro's administration has been ensnarled in several corruption scandals that has seen his popularity drop significantly this year. As far as the markets are concerned, this sort of gridlock is good for Colombian assets. The economy should pick up as the swaps market is pricing in the start of the easing cycle with a 25 bp cut over the next three months, followed by another 100 bp over the subsequent three months.

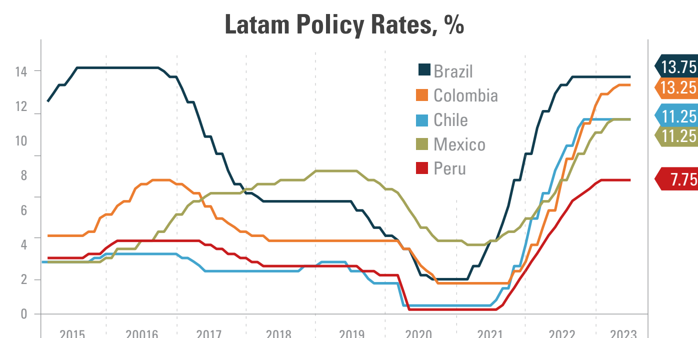
MEXICO:

President Andres Manuel Lopez Obrador is already firmly the traditional lame duck after half of his six-year term. With the next election to be held in June 2024, the search is on for his likely successor. Right now, it's anyone race to win. That said, some political risk is rising as AMLO's attempts at electoral reform have been rejected by the Supreme Court.

The swaps market sees steady rates for the next three months followed by the start of an easing cycle with a cautious 50 bp of easing over the subsequent three months.

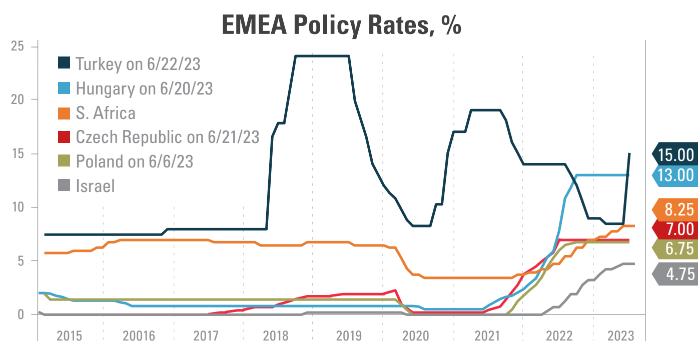
PERU:

After several failed attempts in Congress to move the elections forward to 2023, President Boularte said she plans to stay in power until 2026, when regularly scheduled elections will be held. One can never bet on longevity for any government but there seems to a growing fatigue with regards to political turmoil. Bloomberg consensus sees the start of an easing cycle in Q3 with a 25 bp cut. Looking ahead, another 75 bp of easing is seen in Q4, followed by another 75 bp in Q1 and another 100 bp in Q2.



Europe/Middle East/Africa

Eastern Europe is likely to underperform in the second half. With the eurozone likely to fall deeper into recession under the weight of ECB tightening, the region is likely to struggle. The major economies in this region are already slowing and so the central banks are already or very close to starting rate cuts despite much higher than targeted inflation.



RUSSIA:

The political situation remains unsettled. While markets had become numb to the daily news of death and destruction, something has changed within Russia. In June, Yevgeniy Prigozhin of the Wagner Group mounted a shocking challenge to President Putin before backing down. We suspect those cracks will only widen in the coming months. Whatever happens, Russia remains un-investible. Furthermore, the prospects of prolonged political uncertainty and instability in Russia are enough to add to our ongoing concerns regarding risk assets.

CENTRAL AND EASTERN EUROPE:

In Hungary, the central bank has already begun the easing cycle with two 100 bp cuts in the 1-day deposit rate. The swaps market is pricing in cuts in the base rate over the next three months totaling 150 bp, followed by another 250 bp over the subsequent three months. This strikes us as way too aggressive given how stubbornly high inflation remains. Such an aggressive rate path would likely weight on the forint, which in turn would push up imported inflation.

In the Czech Republic, the swaps market is pricing in 75 bp of easing over the next three months, followed by another 25 bp over the subsequent three months. This also strikes us as too aggressive given that inflation is still running so high.

In Poland, the swaps market sees 50 bp of easing over the next three months followed by another 50 bp of easing over the subsequent three months. Much will depend on how quickly inflation falls in H2.

SOUTH AFRICA:

At the last meeting May 25, the South African Reserve Bank hiked rates 50 bp to 8.25%. After experiencing significant weakness through June 1, the rand has since gained over 5% against the dollar and this should help push down inflation further this month. Next policy meeting is July 20 and if the rand remains firm, no change in policy is expected. The swaps market is pricing in steady rates over the next twelve months, followed by the start of an easing cycle over the subsequent twelve months.

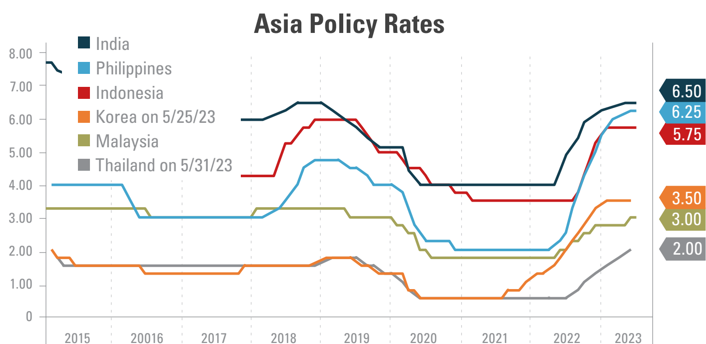
TURKEY:

The central bank under new Governor Hafize Gaye Erkan hiked rates 650 bp to 15.0% vs. 1150 bp expected. This hike was very disappointing to those looking for a bigger dose of orthodoxy, even though it was accompanied by a pledge to hike rates gradually.

The next meeting is July 20 and much will depend on the lira and the data. If currency weakness picks up, the central bank may be forced to deliver a much larger hike then. As of this writing, the swaps market is pricing in 775 bp of tightening over the next three months followed by another 250 bp over the subsequent three months that would take the peak policy rate up to 25.25%. With inflation still running near 40%, that would likely not be enough tightening to bring down inflation and stabilize the lira.

ASIA

Asia is likely to underperform in the second half. China's reopening has done little to boost regional trade and activity. Because most of the central banks in the region tightened modestly, there is not much carry to cushion their currencies, even as several of the central banks gear up for an easing cycle in H2.



CHINA:

The economy continues to struggle despite the reopening in December. Monthly indicators suggest any initial momentum has been lost. The PBOC recently cut its key MLF rates by 10 bp as it sticks to very modest easing.

Ongoing monetary policy divergences have seen spreads continue to move in favor of the dollar, supporting our view that yuan weakness will continue in H2.

Taking a longer-term view, we fear that China will end up caught in a deflationary spiral as Japan once was. The parallels appear numerous: a property market bubble that has burst, a highly indebted economy, and a bloated banking sector with heavy exposure to that property bubble. Mix in a shrinking population along with an anemic economy with little to no price pressures, and you may have a recipe for disaster.

It's not too late for China to avoid this vicious circle, but it may have to act aggressively and quickly. One thing that's limiting an aggressive fiscal response right now is that the PBOC announced back in April that China's debt to GDP ratio had risen to 290% in Q1 2023. Compare this to Japan's ratio, which was around 225% for the same period.

INDIA:

Given China's inward focus, many investors are pivoting to India. With a huge domestic market and limited exposure to global economic cycles, India offers a haven of sorts for global investors.

The World Bank forecasts GDP growth of 7.2% in FY23 and 6.3% in FY24, which is more remarkable as the Reserve Bank of India has undertaken an aggressive tightening cycle that took the repo rate from 4.0% to 6.5% over the course of nine months.

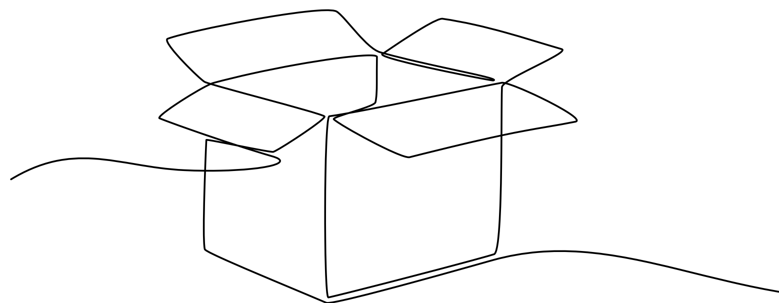
After the last hike in February, the RBI has kept rates on hold, but the market is pricing in the start of an easing cycle in H2. The swaps market sees 25 bp of easing over the next three months followed by another 25 bp over the subsequent three months.

KOREA:

Exports continue to contract year-on-year. Korea is being hurt not only by weakness in the mainland economy but also by a loss of competitiveness due to the weak yen. The JPY/KRW cross is trading at levels not seen since 2015 near 9, well below the key 10 level that Korean exporters desire. Relations with Japan are set to improve further after Japan recently restored Korea to its list of preferred trading partners, to take effect July 21. This comes about three months after Korea made a similar move and Japan rolled back export restrictions on key semiconductor materials for Korea. The market is pricing in steady rates from the Bank of Korea over the next twelve months.

TAIWAN:

Export orders continue to contract year-on-year, suggesting little relief for shipments over the next six months. Taiwan's Vice Premier Cheng Wen-tsan visited Japan last month to improve economic ties and to discuss the semiconductor industry. Here too, the regional powers are trying to boost cooperation to offset China's presence. Taiwan is in a particularly difficult situation as the mainland has made no secret of its desire to eventually unify across the Taiwan Strait. The market is pricing in steady rates from Taiwan's central bank over the next twelve months.



EM SPECIAL REPORT – NIGERIA UPDATE

Cleaning House

Nigeria's new President Bola Tinubu has wasted no time in enacting long-awaited economic reforms

By Win Thin, Shannon Horrigan, and Derrick Leonard

Nigeria is on track[1] for an improved economic performance that should eventually lead to ratings upgrades and attract much-needed foreign investment.

In his inaugural speech, President Tinubu criticized the existing FX regime and pledged to unify the multiple exchange rates. Days later, the Central Bank of Nigeria (CBN) abolished that regime and folded exchange rates all into one. Deputy Governor Folashodun Shonubi, in charge of operations at the bank, took over as Acting Governor, succeeding Godwin Emefiele who was suspended and then detained by Nigeria's state security service.

In addition, fuel subsidies were suspended, and the funds were re-channeled towards public infrastructure, education, health care and jobs.

The ratings agencies should respond positively. With current ratings in deep junk territory, it may be difficult for investors to recall that Nigeria was once rated as high as BB- by both S&P and Fitch. Moody's was slightly less generous and only had Nigeria as high as B1 (equivalent to B+). Fitch recently said that ending the fuel subsidy and unifying the exchange rate were "positive developments for Nigeria's credit profile." Fitch did acknowledge that expectations for the new Tinubu government to be more reform-oriented and market-friendly than his predecessor were "an important factor" in its decision in May to affirm Nigeria's B- rating with stable outlook.

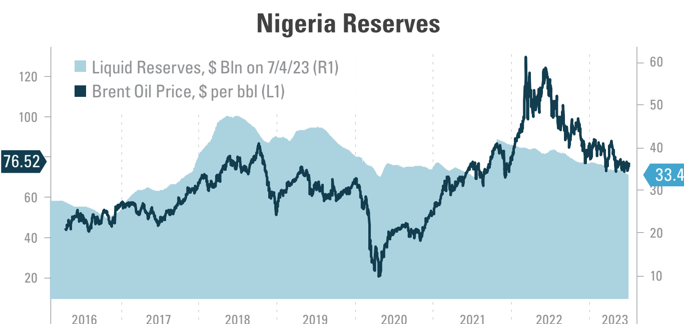
Moody's and S&P yet to weigh in. Of note, S&P cut its outlook on Nigeria's B- rating to negative from stable back in February and noted that "Limited and expensive access to international capital markets, and a consequent increasing reliance on significant domestic funding at relatively high interest rates, is further weighing on net interest costs and the government's fiscal position." We expect the outlook to be moved back to stable and perhaps eventually to positive if the reforms progress.

Lastly, Moody's downgraded Nigeria to Caa1 with stable outlook from B3 back in January and noted "Moody's expectation that the government's fiscal and debt position will continue to deteriorate is the main driver behind the rating downgrade.'' The bar for an upgrade is high but if Tinubu succeeds with his reform agenda, Caa1 is too low and will eventually be upgraded.

Economic Outlook

Foreign reserves have fallen this year. At $33.9 billion in mid-June, reserves are the lowest since January 2015. We believe the incoming Tinubu administration decided that a defense of the multiple exchange rate regime was no longer economically feasible nor desirable. If foreign investment finally returns as we expect, reserves should increase in the coming months. The IMF noted in its annual Article IV consultation in April that "While the current account is estimated to have improved in 2022, foreign currency reserves declined amidst capital outflow pressures."

Nigeria Reserves



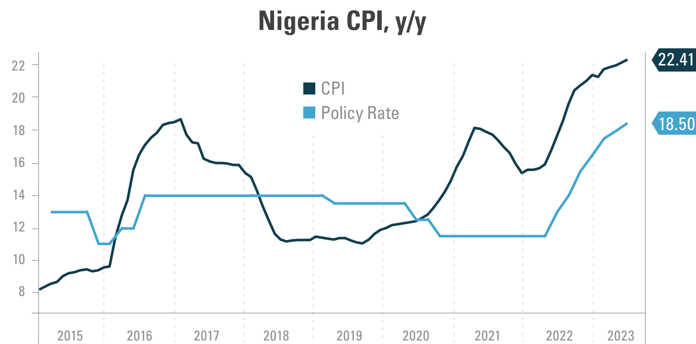
The cut in fuel subsidies should help narrow the budget deficit, which was unsustainable. The IMF warned back in April that "Despite rising oil prices, the general government fiscal deficit is estimated to have widened further in 2022, mainly due to high fuel subsidy costs."

The economy is still sluggish. GDP growth slowed to 2.3% year on year in Q1 vs. 3.5% in Q4. Growth is forecast by the IMF at 3.2% in 2023 vs. 3.0% in 2022 but given the slowdown in place, that forecast is probably too optimistic.

Nigeria GDP, y/y%

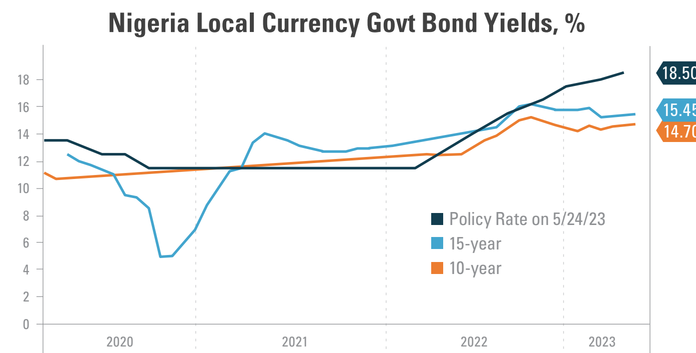
1 https://www.bloomberg.com/news/articles/2023-06-19/how-nigeria-s-new-president-bola-tinubu-is-shaking-up-economy

Price pressures are still rising. CPI accelerated to 22.4% year on year in May, the highest since September 2005. The central bank last hiked rates 50 bp to 18.5% in May and so real rates remain deeply negative. The next policy meeting is July 25 and we would expect a significant hike then as policymakers seek to restore orthodox policies. The IMF warned back in April that "Monetary policy should continue its tightening bend to prevent risks of de-anchoring of inflation expectations." We concur.



Investment Outlook

We remain cautiously optimistic with regards to investing in Nigeria. While the potential returns to investing in local currency bonds are high and rising, increased NGN volatility will likely eat into dollar-based returns. Of note, 10-year local currency government bonds are currently yielding around 15%. Investors may wish to consider waiting until the dust (and the naira) settles before committing to Nigeria.



We see further naira weakness ahead. The unified exchange rate has already weakened considerably from around 465 when Tinubu took power to around 728 currently, weakening more than 35% and still counting. In past devaluations across countless EM currencies, we have found that once freed, exchange rates often move towards the black-market rate. However, the longer the official rate has been kept artificially strong, the greater the risk that we see overshooting beyond the black-market rate, which has averaged around 760 per dollar since last year. How much it overshoots is anybody's guess.

On June 14, 2023, investors saw the naira weaken by 60-70%, as the CBN removed their invisible cap and allowed authorized banks to trade NGN FX freely on a willing buyer and seller basis. Market liquidity will likely remain thin for the first few weeks, until the currency finds its level. Indicative quotes since this shift in policy have ranged widely, from NGN 650 up through NGN 815. The NAFEX (official CBN rate) initially closed at 656.28 on the day of the announcement and has subsequently weakened past NGN 730. This development follows the suspension of the CBN Governor due to investigations being carried out in the Governor's office. To this point, inflows to the market remain minimal so liquidity remains limited despite the devaluation. Foreign investors have the option to set a level for their repatriations or they can accept the prevailing FX rate, if liquidity is available.

While the devaluation will be very painful for locals and investors, it has assisted in bringing liquidity into the FX market for the first time in nearly a year since the CBN stopped their 150-day forward program. Investors will be hoping, once the market settles, that this will help Nigeria move past the persistent pending queues of repatriation request in its FX market.

At BBH, we continue to maintain our reputation as leaders with recognized expertise in emerging markets. In response to the challenging regulatory requirements and conditions of markets like Nigeria, we work closely with our custody teams and local sub-custodians to establish procedures to facilitate compliance while providing our clients with flexible execution options. Please contact your BBH account manager or EMFX@BBH.com for more details.

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