CIO anticipates that most emerging market currencies will trade sideways to moderately stronger against the US dollar in the coming quarters. (UBS)

A mature EM easing cycle will likely continue, with some caution

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The anatomy of the ongoing global monetary policy cycle has been most peculiar. For the first time in modern financial history, many emerging market central banks led the way, with those in countries such as Brazil, Hungary, and Chile first tightening and later easing monetary policy well ahead of the US Federal Reserve and the European Central Bank.

With many of their easing cycles well underway, the question of how these central banks may proceed from here emerges. Jerome Powell's analogy is particularly apt in this context:

"We can think of the economy as a car approaching its destination. When you're driving and you see your exit coming up, you start to slow down. You don't wait until you're right at the exit to hit the brakes. Similarly, with monetary policy, as we get closer to our goals, it makes sense to slow the pace […]. This approach allows us to better assess how our policies are affecting the economy and to make adjustments as needed to ensure a smooth and safe arrival at our destination."

Emerging market central banks appear to be doing just that—slowing down and reassessing, giving them time to consider the impact of some unexpected bumps along the way. For instance, financial markets are recovering from a frenetic August, which had a strong—if ultimately temporary—impact on several variables, including currency valuations. These fluctuations can, in turn, affect emerging market inflation and inflation expectations. In another example, the disinflation path in several emerging market countries, such as Mexico and Chile, has been interrupted by idiosyncratic factors, including volatile and elevated prices of fresh fruits and vegetables caused by extreme weather conditions, or the increase in regulated electricity tariffs.

We believe the majority of emerging markets have room to cut interest rates further, to varying degrees. The likely start of a Fed easing cycle this September will support them along the way. This should help boost economic activity in the emerging world, which, although still resilient, has not fully lived up to expectations in recent weeks, as evidenced by economic surprise indices falling into negative territory and July's manufacturing purchasing manager indices moderating across most countries.

What does this mean for emerging market currencies?

We anticipate that most emerging market currencies will trade sideways to moderately stronger against the US dollar in the coming quarters. The US dollar remains expensive according to a wide set of valuation metrics and necessitates a constant flow of foreign capital to finance its large twin current account and fiscal deficits.

Is Brazil the canary in the coal mine?

Brazil is the only major economy expected to meaningfully increase interest rates in the coming months. We view this as a Brazil-specific phenomenon, linked to the country's unorthodox fiscal policy choices, and would not extrapolate this to other countries in Latin America or beyond. Given what's currently priced in, we also expect the Brazilian real to trade sideways to modestly stronger against the US dollar in the coming quarters.

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