# Wells Fargo
# FX Express™ – *Special Edition*

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*Analysis provided by Nick Bennenbroek, Head of Currency Strategy, Wells Fargo Bank.* Tuesday, November 13, 2012

## Which Currencies Could Fall Off The Fiscal Cliff?

**Summary:** Global equities could come under some pressure in the coming weeks, which will likely also weigh on many foreign currencies. Though the U.S. Presidential election has been decided, investors have promptly turned their attention to the looming fiscal cliff. This has increased market uncertainty following the election. In this article, we examine the recent relationship between equities and foreign exchange, as well as economic fundamentals and FX positioning, to assess which currencies are most at risk in this environment. Firstly, we find that emerging European currencies could be especially vulnerable. Secondly, the Australian, Canadian and NZ dollars as well as the Mexican peso are susceptible. Lastly, the Swedish krona and Brazilian real will likely also be impacted. Corporates with immediate hedging needs for receivables in these currencies should consider hedging at current levels. For investors, our near-term bias is for short positions in the currencies listed above, either against the U.S. dollar or Japanese yen.

### Markets Entering A More Uncertain Period

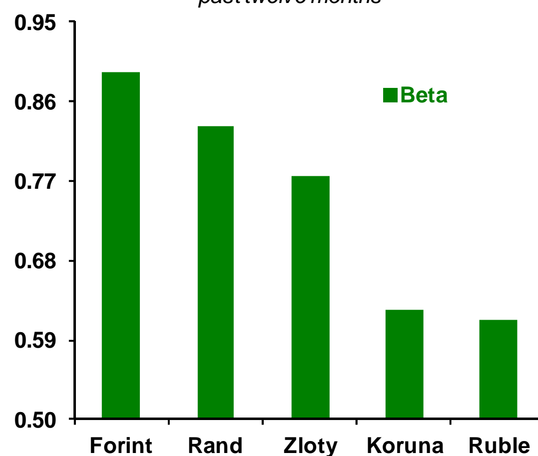
Following President Obama's re-election, the difficult task of addressing the U.S. fiscal cliff lies ahead, suggesting financial markets could become more unsettled in the coming weeks. In the absence of any new agreement, current legislation implies that a series of tax increases and spending cuts would start to take effect from early 2013, potentially amounting to around $600 billion or 4% of GDP. While we believe the worst of the fiscal cliff outcomes will be avoided, an agreement might not be reached until the last minute. As a result, financial markets are likely to struggle in the interim. One possible - though not direct - comparison is the market's performance during the August/September 2011 period, following the U.S. credit rating downgrade by S&P. During that period global equity markets dropped by 13%, while the U.S. dollar gained by 6% on safe-haven support.

In this article, we assess currencies that should be particularly vulnerable if market uncertainty escalates in late 2012. Our main metric is the sensitivity of daily currency moves to daily movements in global equity markets, measured over the past twelve months to capture recent market dynamics. That is, we identify which currencies have the highest sensitivity to equity movements, and essentially consider those currencies to be most at risk. In addition, we also consider economic factors and FX positioning to round out our analysis.

Our main findings are outlined below. Keep in mind that this list identifies only the currencies that will be most impacted and is thus not exhaustive. In all likelihood most foreign currencies will be affected, at least to some extent. Additionally, the currency views we highlight below are not necessarily consistent with our FX forecasts - instead, they are meant to indentify currencies that would be most affected by severe market dislocations.

### Emerging European Currencies Clearly At Risk

Emerging European currencies appear to be particularly at risk from any rise in market volatility. Within this region, the Hungarian forint has displayed that greatest sensitivity to global equity markets in the past year with a beta (i.e. sensitivity) of 0.89. That is, a 10% decline in global equity markets has typically been accompanied by an 8.9% decline in the value of the forint versus the U.S. dollar. Additionally, several of the region's currencies have shown a beta of 0.60 or higher over the past year.




External financing conditions offer another perspective on regional currency vulnerability. We calculate the basic balance, which is the sum of the current account, foreign direct investment and portfolio investment, to assess how well a country's current account balance is being funded. A positive basic balance means a country's external balance is being *overfunded*, while a negative basic balance means a country's external balance is being *underfunded*.

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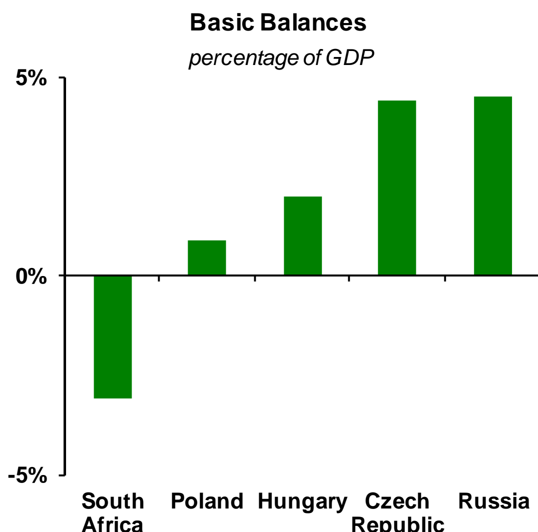
Here we find that South Africa's current account deficit is underfunded by longer-term capital inflows to the tune of 3.1% of GDP, while Poland's external deficit is only just funded by longer-term capital inflows. The external positions of the Czech Republic and Russia currently appear to be more comfortable (see following chart). Finally in terms of recent economic performance, economic growth is slowing or in recession for most of these countries. Interest rates are already at zero in the Czech Republic, while there is potential for rate cuts in Hungary, Poland and South Africa. In Russia, the outlook is for steady to higher policy interest rates.

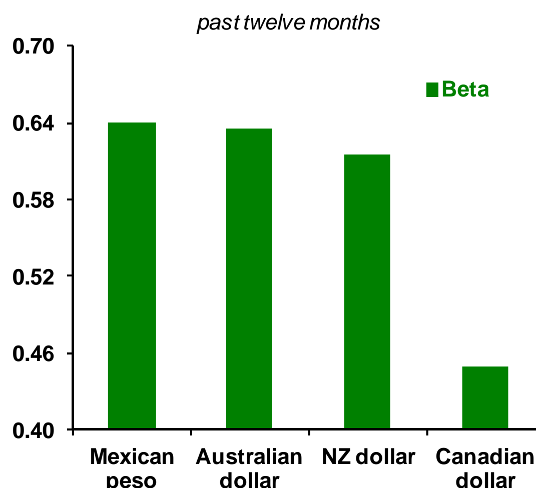



Altogether we view the South African rand and Hungarian forint at particular risk, and the Polish zloty to a lesser extent, based on sensitivity to equity markets, external financing conditions and recent economic performance. The Czech koruna and Russian ruble might be somewhat less affected, given their more comfortable external financing position.

## Dollar-Bloc/NAFTA Currencies Should Be Affected

Another group of currencies that are at risk from the U.S. fiscal cliff are the dollar bloc and NAFTA currencies – the Australian, New Zealand and Canadian dollars, as well as the Mexican peso. These currencies have also shown a reasonable degree of sensitivity to global equity moves over the past year. The betas for the Australian and NZ dollars as well as the Mexican peso are all above 0.60, though the sensitivity of the Canadian dollar is a little lower, with a beta of 0.45.

It's also worth noting that this group of currencies is entering the post-U.S. election period with generally sizeable long positions, which also hints at potential downside. This is particularly true for the New Zealand dollar and Mexican peso, where IMM currency futures show speculative long positions that are still some 84% and 82% respectively of their 2012 peaks. Speculative Australian dollar longs are still 74% of their 2012 peak, while Canadian dollar longs are at 66% of their peak.




Economic and interest rate factors perhaps offer slight protection in limiting the extent of potential FX downside for these currencies. For Canada and Mexico the outlook is for unchanged to higher policy interest rates, while interest rate futures currently anticipate only a modest decline in the NZ benchmark interest rate. While markets are currently pricing around a further 60bp of rate cuts from Australia, economic data from Australia has been firmer on balance and Chinese data has strengthened, perhaps providing a partial offset. On the basis of recent FX sensitivity to equity moves and current FX positioning, we suspect that this group of currencies all face moderate to elevated downside risk should U.S. developments cause global financial markets to come under significant pressure.

## Other Notable FX Mentions

Beyond the currencies listed above, the Swedish krona, Norwegian krone, Brazilian real and Chilean peso have also been somewhat sensitive to global equity developments during past year, with betas ranging from 0.40 to 0.50. We believe the Swedish krona and Brazilian real are the most at risk within this group. Swedish economic activity has slowed sharply and with inflation contained, further Swedish rate cuts are a distinct possibility. Brazilian growth is only just starting to recover from a prolonged slowdown, while Brazilian authorities have generally shown an aversion to excess currency strength. In Norway and Chile, by contrast, trends in economic activity have generally been steadier in recent months.

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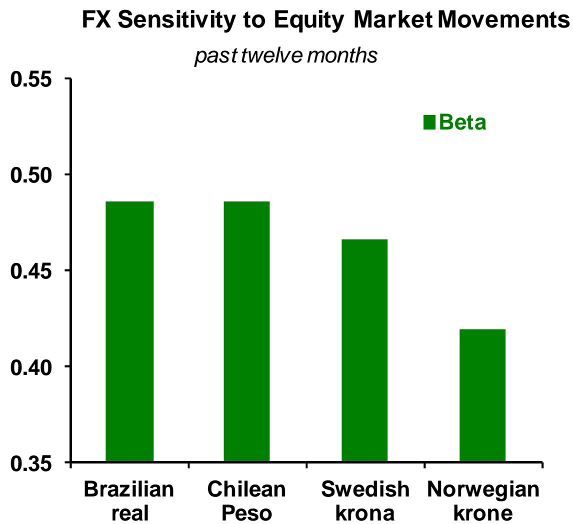


Asian currencies have typically been less reactive to equity moves than the other commodity based or emerging currencies. However, if we had to single out one Asian currency that was susceptible to downside in the coming weeks, it would be the Indian rupee. The rupee's beta of 0.33 is the highest across the Asian region. India also has a sizeable external deficit which is underfunded by direct and portfolio investment flows (India's basic balance deficit was 2.6% of GDP at the most recent reading). While the recently announced easing of foreign ownership restrictions will partly help to address the external financing issues, India still faces a challenging slow growth/high inflation environment, leaving the rupee at risk.

To repeat, this analysis does not represent an exhaustive list of currencies and, in all likelihood, most foreign currencies are likely to be impacted by the uncertain negotiations surrounding the U.S. budget outlook. And of course the extent of the FX market moves will depend on exactly how those negotiations evolve. While the rhetoric from U.S. political leaders has started on a somewhat encouraging note, we would still expect obstacles along the way to a budget agreement, which might not be achieved until very late this year. Under that scenario, we suspect equity markets could be biased to the downside.

If so, we expect the emerging European currencies could be susceptible to declines, notably the rand, forint and zloty. The Australian, Canadian and NZ dollars, as well as the Mexican peso, also appear vulnerable to downside, while the Swedish krona and Brazilian real could also be impacted. Corporates with immediate hedging needs for receivables in these currencies, or more broadly that are particularly sensitive to currency declines for this group, should hedge at current levels, if necessary using flexible options-based strategies. For investors, our near-term bias is for short positions in the currencies listed above, either against the U.S. dollar or Japanese yen.

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