

# Research

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## Emerging Markets: Looking for the safe haven

- The global credit crunch is now spreading to Emerging Markets (EM), and many of the high-risk EM currencies are now under heavy fire. In this paper we will take a closer look at where to find a “safe haven” within the Emerging Markets universe.
- What countries are most at risk? In a situation where liquidity is tightening there is no doubt that the most liquidity-“hungry” countries are those with large current account deficits and large external debt. In this category we find Turkey, South Africa, Hungary, and Iceland. Furthermore, risks are heightened in the Baltic states, Romania, and Bulgaria.
- We recommend looking for currencies supported by strong fundamentals. In particular, we like the Russian rouble, Taiwan dollar, Korean won, Malaysian ringgit, and the Singapore dollar.

### ***Credit crunch spreading to EM***

#### ***Emerging Markets under pressure***

For the last couple of weeks, we have warned that the global credit crunch could spread to Emerging Markets. This has now clearly happened, but given the major moves in the global credit and equity markets there clearly is potential for even more contagion to Emerging Markets. Therefore, there is also reason to start looking for safe havens within Emerging Markets. Here external funding needs will be the key.

#### ***Where do you run from?***

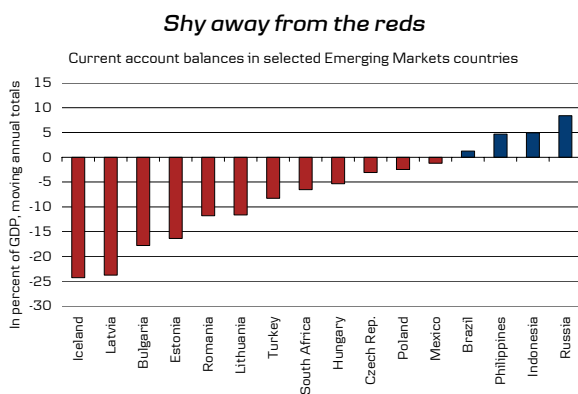
What countries are most at risk? In a situation where liquidity is tightening there is no doubt that the most liquidity-“hungry” countries are those with large current account deficits and large external debt. In the Emerging Markets universe most liquidity-hungry countries are among the EMEA countries (with the exception of CIS and

the Gulf States). We have earlier pointed out Turkey, South Africa, Iceland and Hungary as being particularly in the danger zone. Furthermore, Bulgaria, Romania and the Baltic states also run large current account deficits that make these markets vulnerable to a global liquidity squeeze. Therefore, we recommend reducing exposure to these markets.

Furthermore, in a situation with rising risk aversion, other high-beta markets such as Brazil, Indonesia and the Philippines could also come under additional selling pressures – even if these countries run solid current account surpluses. That said, these markets should be better able to withstand selling pressures in the longer run given fairly strong fundamentals in these countries.

The credit crunch has triggered a strengthening of the yen and to a lesser extent, the Swiss franc. We would in particular watch the Swiss franc as many households in Central and Eastern Europe have funded their property investments with Swiss franc loans. Hence, if the Swiss franc strengthens further then it could put additional pressures on the CEE markets mostly exposed to the Swiss franc.

If the markets continue to run away from the abovementioned markets then it will also have ramifications for monetary policy in these countries. We would particularly argue that the planned / signalled monetary easing in Turkey and Hungary will be postponed – maybe long into 2008.



Source: Ecwin. The numbers are from end Q1 07

### Where do you run to?

In a situation with tighter global credit conditions the markets' favourites will logically become the liquidity providers of the world. The liquidity providers are countries with large current account surpluses and a large FX reserve. That is particularly the Asian countries, CIS and the oil-producing Gulf States. Hence, the obvious safe haven in the present environment will be the markets in these countries and we would stress that we especially see value in these countries' FX markets.

The top picks in terms of currencies would be cousins of the yen and Chinese renminbi – the Taiwan dollar, Korean won, Malaysian ringgit, and Singapore dollar. All of these countries have very strong external balances and have large FX reserves.

Furthermore, the commodity exporters with undervalued currencies in CIS (Russia, Ukraine and Kazakhstan) and in the Gulf States should benefit in the present environment. Furthermore, it should be noted that both the CIS countries and the Gulf States are gradually “abandoning” the tight currency pegs to the US dollar. That said, if the present turmoil increases fears of a global economic slowdown and brings commodity prices under pressure, then it could make these markets more risky.

Finally it should be noted that the Czech koruna (CZK) – unlike most other CEE currencies – should be expected to strengthen in the present environment due to unwinding of CZK-funded carry trades. That said, the CZK is fundamentally not undervalued and the Czech central bank should be expected to keep interest rates below the ECB rate – especially if the CZK strengthening accelerates. That will limit the potential for strengthening of the CZK.

### Stay cautious

In conclusion, the credit crunch is spreading to Emerging Markets and there is thus reason to be extra cautious in these markets and focus on strong fundamentals – especially on strong external balances.

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