

Flash Comment

EMEA markets: Correction continues

Last Tuesday we warned that it was “*correction time*” for the EMEA markets. That prediction has proved correct and over the past week EMEA markets have sold off significantly – that has been the case for both the region’s FX and fixed income markets.

The reason we issued the call for a correction in the EMEA markets last week was that our EMEA FX Scorecard overall had moved into negative territory. A glance at the updated scorecard shows that it remains in negative territory for most currencies in the region and we therefore continue to recommend investors be positioned for weaker currencies across the region.

In our scorecard, in particular technical factors and carry erosion continue to weigh on the overall scores. Furthermore, strong US data is being outweighed by negative sentiment on the global stock markets, hence reducing support for EMEA FX from global conditions.

Positive US data have done little to help the sentiment

On Friday we got positive US GDP numbers for Q3 (see [comment](#)) and yesterday we got a positive reading on ISM for October (see [comment](#)). This is something that under normal circumstances would have increased risk appetite and lifted the EMEA currencies, but this time around the impact on the EMEA currencies has been extremely small and short-lived. This is a clear indication that the markets are already priced for a relatively strong US recovery and more is needed to increase risk appetite – especially as we are heading towards year-end.

We continue to believe that the global financial and economic conditions are extremely important for the performance of the EMEA currencies; but it is also clear that a recovery in the US economy is no longer enough to lift the EMEA markets – more is needed.

A notable correlation between financials and EMEA FX

This year a rather unexpected correlation has emerged. During 2009 there has been an extremely high correlation of global financial stocks and the performance of the EMEA currencies. Hence, financial stocks have underperformed the rest of the stock market – as have been the case over the past week the EMEA currencies in general tend to weaken.

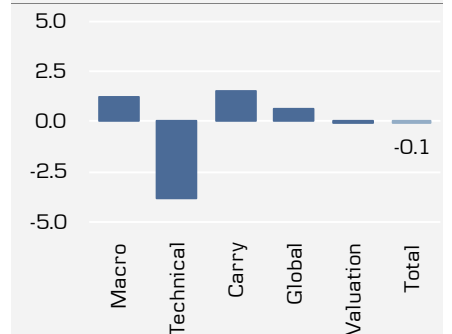
Why this correlation? The simple answer is that when risk aversion increases, it tends to hit both the financial stocks and the EMEA currencies. There is undoubtedly such an effect, but that is probably not the entire explanation as the correlation did not exist for example in 2007 or 2008. Therefore, we think that the key reason for the correlation between Financials and the EMEA currencies in 2009 can be traced back to the unprecedented loosening of monetary policy globally and to the fact that the global financial markets have been flooded with liquidity. While this has helped financial stocks, the massive increase in liquidity has also spurred a hunt for yields sparking demand for higher-yielding EMEA currencies.

Lower financials = weaker EMEA FX



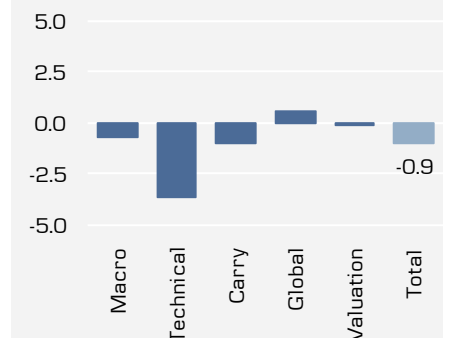
Source: Reuters Ecowin and Danske Markets

Scorecard PLN



Source: Reuters Ecowin and Danske Markets

Scorecard HUF



Source: Reuters Ecowin and Danske Markets

Chief Analyst

Lars Christensen
+45 4512 8530
larch@danskebank.dk

This led to the worrying conclusion that market participants have not really become fundamentally more bullish on the EMEA region – despite some signs of stabilisation in the EMEA economies – since the sell-off in Q1, but rather that the demand for EMEA assets has increased only because of an extreme easing of liquidity conditions. Therefore, there is a significant risk that when the extremely accommodative monetary policy – especially from the ECB – is scaled back, it could trigger a further weakening of the EMEA currencies.

There is no prospect that the ECB will scale back quantitative easing in the very near term. However, the significant carry erosion we have seen in the EMEA countries' liquidity conditions does not have to tighten much to further escalate the sell-off in the EMEA currencies.

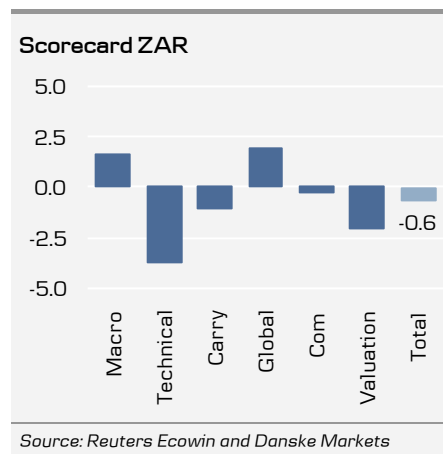
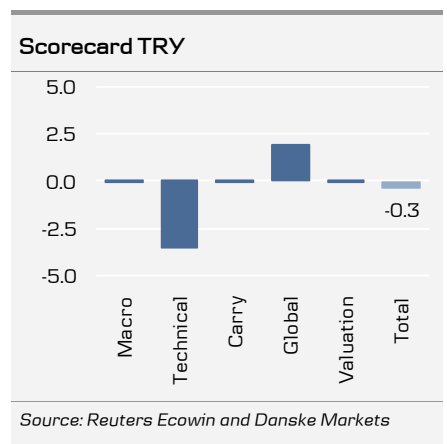
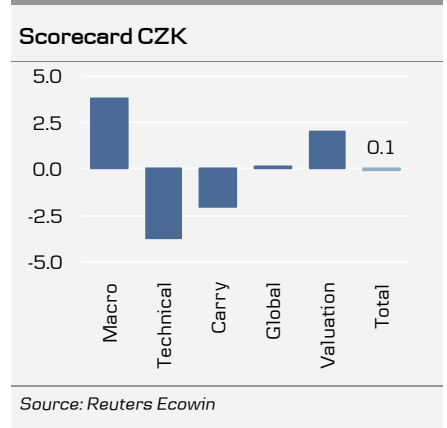
Conclusion: Stay short EMEA FX for now

Even though we do not necessarily think that the ongoing correction in the EMEA FX markets is 'the big one', we have a hard time arguing that the correction is over as long as the combination of negative technical factors, carry erosion and negative sentiment in the global markets so decisively points towards a further correction.

We would turn more bullish on the EMEA currencies once these factors start to turn in a more positive direction. We note that yields and rates have risen significant over the past couple of weeks and if that continues in the coming weeks – as we expect – then at some point we think it will be enough to stabilise the EMEA currencies. However, for now, the rise in yields has been almost large enough for the 'carry scores' in our EMEA FX Scorecard to turn positive and it is therefore also too early to call an end to the negative correction in the EMEA currencies – and there still does not seem to be any real safe havens in the region. That said, there are differences between the regional currencies and a bit longer term we think that the zloty, the Czech koruna and the Turkish lira look more attractive than the rand and the forint.

Don't lose sight of local factors

While the global financial factors, risk aversion, technicals and carry erosion undoubtedly are the key factors being the recent sell-off in the EMEA currency markets, one should not lose sight of the local – primarily political – factors across the EMEA region. We would primarily – in the short run – keep an eye on the development in the regional 'trouble spots' of Romania, Ukraine and Latvia. The next key event will be the first vote of the Latvian government's budget proposal for 2010. This vote is due on Thursday, 5 November. Latvian politicians have surprised negatively before and if they do so on Thursday, it could further dent regional sentiment.



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