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Focus Article

Contagious currency crisis?

While risks of contagion should be contained, emerging markets' currency upheaval could impact banking systems in developed economies.

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All values in U.S. dollars and priced as of September 28, 2018, market close, unless otherwise noted.

Wealth Management

Focus article

Contagious currency crisis?

Emerging market stress and Western banks

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The foreign exchange market has been buffeted by crosscurrents in emerging markets (EMs). In our view, the risks of contagion spreading further should be contained with any renewed currency weakness limited to EMs with weak fundamentals. Nevertheless, due to the global economy's intricate web, the EM currency upheaval could impact banking systems in Western economies.

EM currency dominoes?

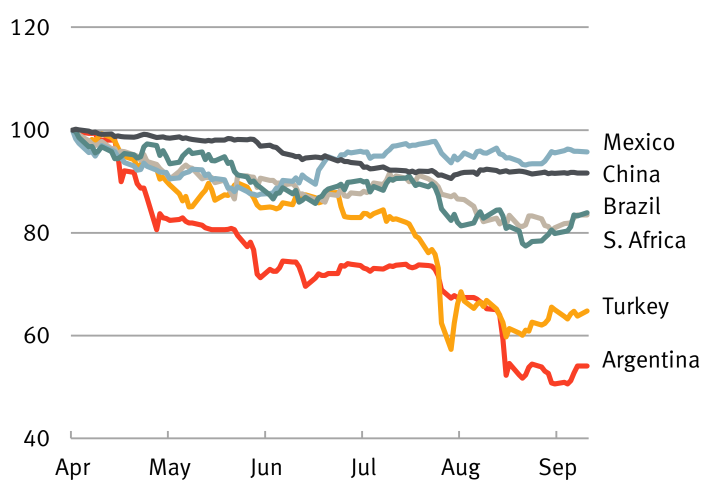
Investor fears of widespread financial stress sent EM currencies tumbling in August, aggravating earlier pressures from rising U.S. interest rates and attendant dollar strength.

The bulk of the weakness was confined to countries facing unique headwinds, namely Argentina and Turkey, and those showing the greatest vulnerability to tightening global liquidity.

During 2017, the combination of commodity prices rallying, healthy growth prospects, and still lowly valued but strong EM equity markets led global and U.S. investors to reallocate their portfolios to assets outside of the U.S. in search of greater yields. This contributed to global fund flows into EM equities and the MSCI Emerging Markets Currency Index rallied to record highs by early 2018.

Emerging market currency weakness has been contained

Currency movements against the dollar indexed to 100



EM currencies came under pressure in 2018 on the back of rising U.S. rates; although sharp declines have been limited to countries facing idiosyncratic challenges.

Source - Bloomberg, RBC Wealth Management

However, rising U.S. Treasury yields against a backdrop of growing expectations for Federal Reserve rate hikes and U.S. dollar strength sparked an about-face for EMs by April 2018. The tightening in global financial conditions underpinned the selloff in EM currencies through July. Then, a sudden flare-up of events in August spurred concerns that broader EM fragilities could be brewing under the surface.

The MSCI Emerging Markets Currency Index fell from a record high in April to a 17-month low in September. So far this year, the Argentine peso has plunged by more than 50%, followed by the Turkish lira (-35%), Brazilian real (-15%), and South African rand (-10%), all despite interventions by central banks to prop up battered currencies.

The behaviour of EM currencies is important because it often sets the tone for EM equities and fixed income. It's no wonder EM equities have lagged in recent months, falling more than 10% since April compared to a gain of 7% for the MSCI World Index of developed markets and 13% for the S&P 500 (all in U.S. dollars).

Containing contagion

The EM countries whose currencies have experienced stress are those with the weakest fundamentals: high current account deficits, low foreign currency reserves, and weak fiscal positions. Uncertainty around elections and proposed reforms are further dampening investor confidence in countries like Brazil and Indonesia.

While there are still headwinds ahead for EMs with more rate increases from the Fed in the pipeline and other developed economies dialing back monetary policy stimulus, pronounced and prolonged currency selloffs should be limited

The EM currencies that have come under the greatest stress are those with the weakest fundamentals.

Gauging the risks amongst emerging market countries

Countries (More vulnerable)	Current account (% GDP)	Budget balance (% GDP)	GDP growth (ann. %)	CPI (%)	CDS spread* (5 yr)	External debt (% GDP)	Currency reserves (% GDP)
Argentina	-5.2	-1.0	3.8	33.6	742	52.6	7.9
Turkey	-6.5	-2.0	3.1	17.9	518	28.5	9.2
Brazil	-0.7	-7.3	1.0	4.2	291	84.0	18.3
South Africa	-3.2	-4.2	0.3	5.1	242	52.7	12.9
Colombia	-3.2	-3.7	2.5	3.1	116	49.4	15.0
Indonesia	-2.4	-2.9	5.3	3.2	142	28.9	12.0
Mexico	-1.5	-2.6	2.6	4.9	124	54.2	15.0
Chile	-1.2	-0.3	3.3	2.6	57	23.6	13.3
India	-1.9	-3.4	8.2	3.7	85	70.2	14.8
Russia	4.0	-1.0	1.9	3.1	175	17.4	24.3
Saudi Arabia	2.8	-9.3	1.2	2.2	81	17.3	73.7
China	0.5	-3.7	6.7	2.3	57	47.8	25.6
Poland	0.3	-1.7	5.1	2.0	63	51.4	20.0
South Korea	4.5	2.8	2.8	1.4	39	39.8	25.8

(More robust) Vulnerable — Robust

* Credit default swap spread can be considered to be the price, in basis points, of insuring against default of the underlying fixed income asset; i.e., the higher the price, the greater the likelihood of default.
Source - Bloomberg, RBC Wealth Management

> Relatively healthy economic fundamentals alongside attractive EM asset valuations should cause concerns of widespread fragilities to eventually fade.

to countries where fundamentals are deteriorating, in our view. Timothy Ash, EM senior sovereign strategist at BlueBay Asset Management,* believes contagion risks should be controlled (see "Emerging from emergency: Why it's not all over for emerging markets").

Finding footing

There are a number of reasons why the broader EM backdrop, while bruised, remains constructive, in our view. In aggregate, EMs appear poised to remain the engine of global economic growth, gaining more ground against developed economies through 2019, at least. Relatively healthy economic fundamentals, despite notable exceptions, alongside attractive EM asset valuations should cause concerns of widespread fragilities to eventually fade.

Moreover, in our view, policy stimulus in China, ongoing EM reforms, and central banks employing measures to contain pressures should keep a lid on a spillover of idiosyncratic vulnerabilities. Pain could persist in pockets of EMs, though we believe the sharp currency rout should begin to abate.

Key risks to our view include escalating U.S.-China trade actions, a potential economic slowdown in China feeding into broader emerging economies, and further capital flows into the U.S., attracting assets away from riskier EM securities.

Chain reaction?

The crosscurrents that blew across EMs are likely to impact some developed banks due to their lending activities. Turkey is a case in point. Volatility has recently abated following the Turkish central bank's unexpected and aggressive rate hike that shored up the lira, but the country remains in the eye of the storm. Nonperforming loans are likely to spike with local interest rates now exceeding 24%. In addition, with 40% of Turkish loans in foreign currency for the banking system as a whole, the devaluation of the lira will make it more difficult for those who use local currency revenues to repay their foreign currency loans.

European banks are likely to bear the brunt of this. Their exposure to Turkey is greater than that of their U.S. counterparts, though in aggregate it remains relatively small. According to the Bank for International Settlements, the loan exposure to Turkey of Spanish, Italian, and French banks is equivalent to 1.9%, 0.5%, and 0.4% of total assets, respectively. By comparison, U.S. banks' exposure represents a mere 0.1% of total assets.

Foreign banks' claims on Turkey

A hit on Turkey would be manageable

Country	Spain	Italy	France	U.K.	U.S.
Banks' claims on Turkey ($B)	$80.9	$18.5	$35.1	$16.9	$18.1
Claims as % of banks' total assets	1.9%	0.5%	0.4%	0.2%	0.1%

Source - Bank for International Settlements, Bloomberg

* BlueBay Asset Management is one of Europe's largest specialist active managers of fixed income with over $59.6 billion in assets under management in corporate and sovereign debt, rates, and foreign exchange (as of June 30, 2018). Its investment philosophy and approach focus on delivering absolute-style returns, with an emphasis on capital preservation. BlueBay is a wholly owned subsidiary of Royal Bank of Canada with full investment autonomy and substantial operational independence.

Specifically, the three European banks most exposed to Turkey have stakes in Turkish banks: Spain's BBVA (49.9% stake in Turkiye Garanti Bankasi), Italy's UniCredit (40.9% stake in Yapi ve Kredi Bankasi), and France's BNP (72% stake in Turk Ekonomi Bankasi), according to RBC Capital Markets.

Should the Turkish exposure be written off, RBC Capital Markets calculates it would represent a 12%, 6%, and 3% hit to book value, respectively. BBVA is the most exposed but the hit would likely still be manageable. Dutch bank ING also has some exposure that should be similarly manageable as its Turkish business accounted for less than 2% of the bank's tangible book value in 2017.

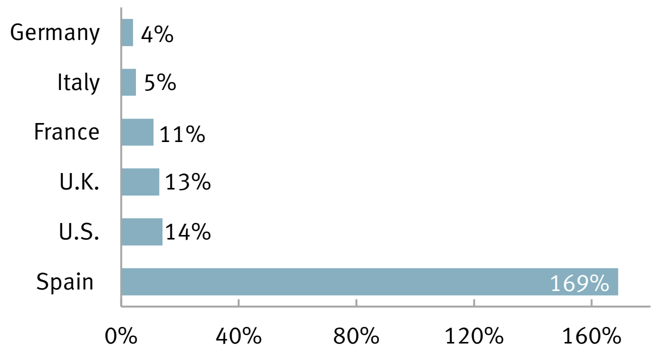
The question is, what if contagion spreads within EMs?

This is not our base-case scenario, though highly indebted countries facing hefty debt rollovers may well find it more difficult to procure financing in the current environment. In particular, Argentina, Turkey, Brazil, Indonesia, and Colombia all have to pay a substantial portion of their external debt within the next year.

Overall, our heat map of potentially problematic countries indicates that beyond Argentina and Turkey, the most at risk are Brazil, South Africa, Colombia, Indonesia, Mexico, and Chile.

Here again, exposure to potential problem countries seems to be most acute in Europe. Spain appears most vulnerable with exposure to the most fragile EM economies adding up to more than 160% of its banking system capital and reserves. Other European countries are much less directly exposed, though French banks have large exposure to Spain, while German banks have large exposure to France.

Foreign loans in most-challenged EMs as a percentage of total country bank equity

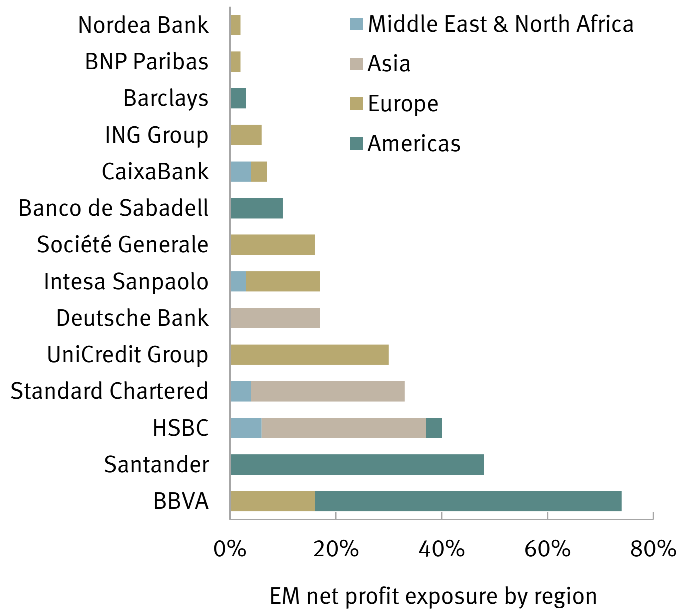


Spanish banks' EM exposure dwarfs that of other nations.

Source - Bank for International Settlements

Broadening the exercise to all EM countries, the European and U.K. banks that are most exposed to EMs are Spain's BBVA and Santander (due to Latin American exposure) and the U.K.'s HSBC and Standard Chartered (due to Asian exposure). For U.S. banks, Citi is most exposed, with some 32% of revenues generated in EMs, of which 15% is in Asia, 13% in Eastern Europe, Middle East, and Africa, and 4% in Latin America.

European banks' emerging markets exposure by region



Source - RBC Capital Markets

Exposure to Latin America is behind Spanish banks' large EM exposure.

Confinement

At this stage, EM stress seems relatively contained with Argentina and Turkey in particular in the crosshairs. While these countries have further to go to stabilize their currencies and financial systems—even if the process involves volatility and bumps along the way—we believe contagion risks are relatively limited for the wider EM universe, global financial system, and developed market banks.

This is not the late 1990s when a number of EM countries were vulnerable to contagion. More EM countries have positive current account balances, external debt denominated in local currencies, higher currency reserves, and free-floating exchange rates. These factors do not automatically immunize currencies and financial systems from stress, but they should contain it, in our view.

European banks are more exposed to volatility and stress in EMs than their U.S. counterparts. But as long as contagion remains confined, we would expect them to weather the difficulties.

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