Brexit impact on EM currencies: gone with the wind

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- We analyze the performance of EM currencies in the aftermath of the UK's EU referendum. Contrary to popular belief, which argued that Brexit would generate global shockwaves and put EM under severe pressure, we find that EMFX has by now completely shrugged off the news.
- Following the initial sell-off – which prompted analysts and academics to quickly draw parallels with the taper tantrum in 2013 – we show that EM currencies have since staged an impressive and widespread rally.
- What the "Brexit Surprise" has actually done, is to send (the already very low) DM yields to historical lows, prompting even more hunt for yield and hence putting EMFX under considerable upside pressure.
- In fact, this is the exact opposite of what happened after the Fed's taper announcement, which sent US yields surging and led to an exodus of flows from emerging markets.

Taper tantrum vs. UK leave vote: what a difference a day makes!

The UK vote to leave the European Union was a negative shock to the British economy; the extent of ripple effects to the world economy and global markets remains an issue of controversy. All along, both during the pre-vote period and in the aftermath of the result, our view has been (and remains) that the impact of the UK's exit from the EU should be largely confined to UK asset prices (mainly sterling), with few negative or lasting implications for global market sentiment. In this issue of *FX Perspectives*, we utilize the available data so far to put this view to the test and investigate the reasons behind the dynamics observed.

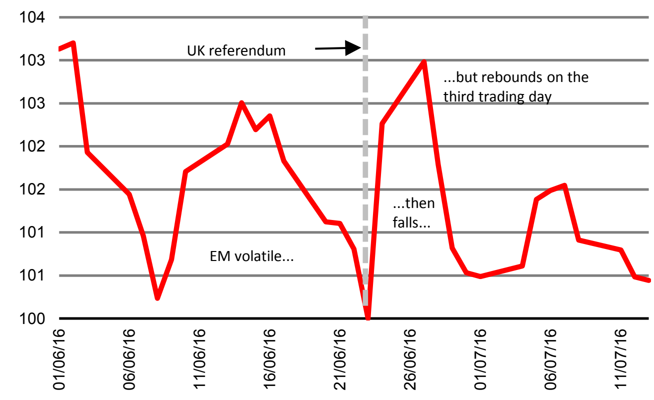
In an article published shortly after the referendum, Eichengreen et al. (2016)[1] look at EM currency depreciation in the first two post-surprise days of trading. They find that, similar to what occurred in the case of the taper announcement[2] (May 2013) "…a substantial number of emerging markets saw declines in their stock markets and dollar exchange rates…if anything, declines following the Brexit Surprise were more widespread and larger". The authors relate this to the nature of the shock, explaining that "where the taper tantrum was mainly a financial shock, the Brexit surprise is evidently perceived as having real as well as financial consequences". We find two shortcomings here that can lead to incomplete conclusions.

First, a two-day window is too short. Although the choice of such a horizon may make sense from the perspective of an event study (as it limits the influence of other contributing factors), the reality is that EMFX rebounded sharply on the third trading day after the leave-vote surprise, without any relevant event occurring on that date (Chart 1).

Second, the taper tantrum and leave-vote surprise differ in that the timing of Mr. Bernanke's announcement was unexpected (although there have been rumors about a potential leak previous to it), whereas markets had been preparing for a potential Brexit vote long before polling day. In fact, in the last few weeks before the vote, opinion polls took center stage in market reaction: the early-June shift in favor of Brexit made room for a switch back to "Bremain" in the last few days before the vote, leading to a sizeable rally in risky assets across the board.[3] With risk-sensitive assets so volatile (Chart 1), it is hard to pick a specific date for comparison of price levels.

CHART 1: USD-EMFX (REFERENDUM DAY=100)

Average of 15 most tradable EMFX



Source: Bloomberg, UniCredit Research

With more trading days to go by now, we investigate how the results of the analysis change when **1.** extending the two-day time window to the 14 trading days available up to now; **2.** using the 20D average (prior to the event) as a baseline, to control for higher volatility before the vote.

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[1] See Eichengreen, B., Gupta P., and A. Ospino, 2016. "The Brexit Surprise and emerging markets*", VoxEu Column*.

[2] Taper announcement refers to Ben Bernanke's testimony before the US Congress (22nd May 2013) when the chairman suggested that the Fed was contemplating reducing its asset purchases

[3] The UK-oriented FTSE 250 index rose by more than 8% between 16 and 23 June after having declined by 7% since 7 June.

TABLE 1: EMFX RESPONSE TO BREXIT AND TAPER TANTRUM

	2 trading days following event	14 trading days following event	14 trading days vs. 20-day avg. prior to event
% of EMFX that depreciated against the USD			
50 EM currencies			
Brexit	78%	68%	52%
Taper tantrum	70%	66%	74%
15 most tradable EM currencies			
Brexit	100%	60%	20%
Taper tantrum	87%	80%	87%
Average EMFX return vs. USD			
50 EM currencies			
Brexit	1.9%	0.7%	0.0%
Taper tantrum	0.2%	0.7%	1.4%
15 most tradable EM currencies			
Brexit	2.9%	0.4%	-1.4%
Taper tantrum	0.4%	2.7%	3.8%

Source: Bloomberg, UniCredit Research

We do this exercise for the universe of 50 EM currencies (as reported in Eichengreen et al.) but also for the 15 most tradable EMFX[4] (according to the BIS tri-annual survey). The results are reported in Table 1. We summarize our findings:

1. In line with the Eichengreen et al. results, the immediate (two-day) response of EMFX was materially larger than the reaction to the taper announcement: the vast majority of the EM currencies depreciated against the USD, with the average USD-EMFX return (for the 15 most tradable EMFX) standing at nearly 3%; the USD-EMFX reaction to Ben Bernanke's testimony in May 2013 was largely muted in the two days following his testimony (see first column of Table 1).
2. But looking beyond the very short-term response, things change quite significantly: not only the percentage of EMFX that has depreciated against the USD falls dramatically in the case of Brexit (most evident in the 15 most tradable currencies) but, more importantly, average USD gains evaporate rather quickly. In contrast, the USD consolidated its gains against EMFX following the taper announcement (see second column of Table 1).
3. The diverging paths of EMFX in the aftermath of two events become even more palpable when we control for short-term volatility and compare prices 14 trading days[5] after the events with their 20-day averages prior to the events. When doing so, we find that most EMFX (80% of the most liquidity FX) has by now appreciated (Brexit) with the average gain 1.4% against the USD; but the same calculations reveal substantial and widespread EMFX losses in the case of the taper announcement (see third column of Table 1).

[4] The 15 most tradable EMFX are: MXN, CNY, RUB, SGD, TRY, KRW, ZAR, BRL, INR, PLN, TWD, HUF, MYR, THB and CLP (we have excluded HKD and CZK due to the pegs)

[5] Here, we use the close of 13 July 2016

This story is corroborated by the reaction of global equity markets to each event, with EM stocks staging a pretty strong rally following their initial sell-off in the aftermath of the UK vote (see Table 2).

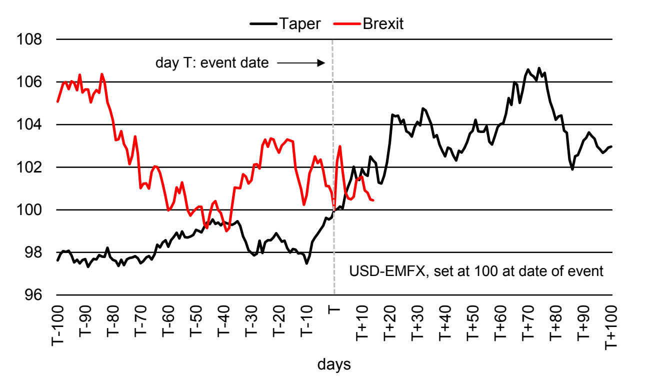
TABLE 2: EM EQUITY RESPONSE TO BREXIT AND TAPER TANTRUM (USING 25 EM EQUITY INDICES)

	2 trading days following event	14 trading days following event	14 trading days vs. 20-day avg. prior to event
% of EM equity indices that declined			
Brexit	100%	60%	48%
Taper tantrum	48%	84%	72%
Average EM equity performance			
Brexit	-3.3%	-0.4%	0.5%
Taper tantrum	0.3%	-4.2%	-2.9%

Source: Bloomberg, UniCredit Research

In short, the UK referendum on EU membership generated plenty of market volatility around the event but examination of only the short-term asset-price reaction can lead to incomplete conclusions: the impact was very short-lived and the event has not escalated to one of global proportions. This is in sharp contrast to the taper announcement in May 2013, which set in motion a pronounced and widespread decline in EMFX prices (see Chart 2).[6]

CHART 2: TAPER ANNOUNCEMENT SETS IN MOTION WIDESPREAD DECLINE IN EMFX



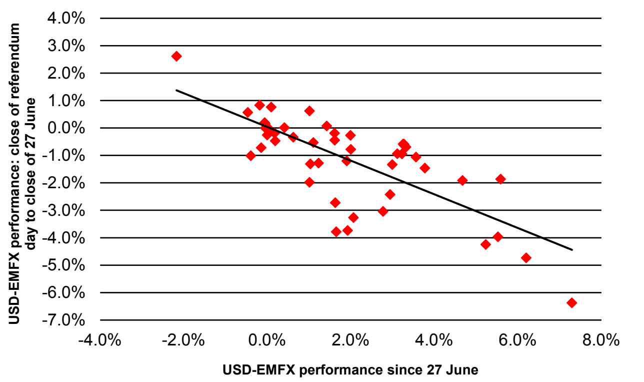
Source: Bloomberg; UniCredit Research

EMFX reaction: looking under the hood

We think that the currency depreciation emerging markets experienced in the first two days after the Brexit vote mainly reflected some mispricing as investors started to digest the ramifications of the result. Chart 3 shows a negative and significant correlation between the exchange-rate movements two days following the referendum result (23 June close to 27 June close) and movements since then. This means that those currencies that initially depreciated the most have been the ones that rebounded more strongly in the following days.

[6] Notice that EM depreciation started about ten days before Bernanke's testimony as rumors about tapering were leaked to the Wall Street Journal.

CHART 3: INITIAL MISPRICING REVERSING

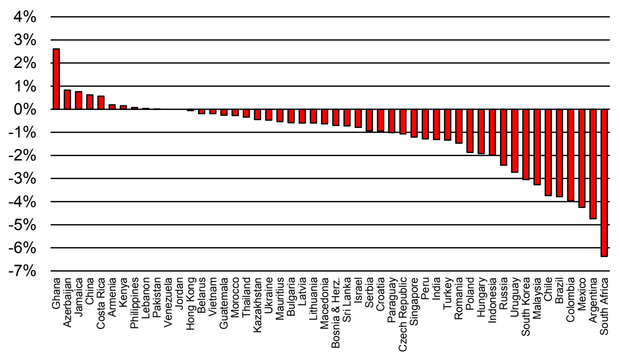


Source: Bloomberg, UniCredit Research

Having said that, there is significant heterogeneity in the degree of post-referendum appreciation across EM countries (see Chart 4). Looking at exchange-rate movements without accounting for the type of exchange-rate regime that characterizes each country (and the historical volatility of the currency) is admittedly a crude measure, but to a large extent still reflects market movements.

CHART 4: 50 SHADES OF DEPRECIATION

USD-EMFX performance since 27 June close

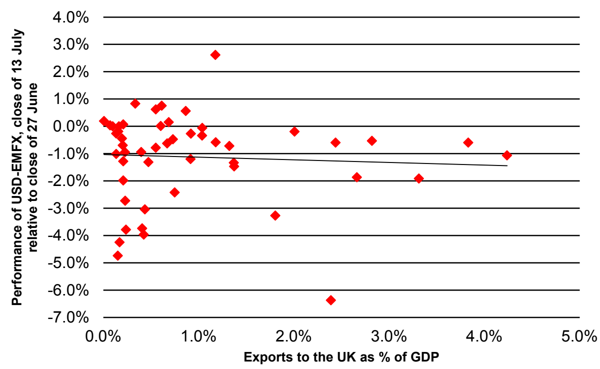


Source: Bloomberg, UniCredit Research

One of the points highlighted by Eichengreen et al. is that the depreciation that EM experienced in the two days after the Brexit referendum was related to trade links with the UK and in particular with the European Union. Their intuition was that markets recognized that in a Brexit scenario GDP growth would take the hardest hit in the UK and the EU and this would generate negative spillover to the countries with the highest export share to them.

If that was the case, the EMFX rebound since 27 June would be characterized by the currencies of countries with strong trade links with the UK appreciating the least. However, Chart 5 shows that this is not the case (we also looked at trade with the EU14 and the eurozone, and the results were very similar).

CHART 5: NO EVIDENCE OF TRADE LINKAGE



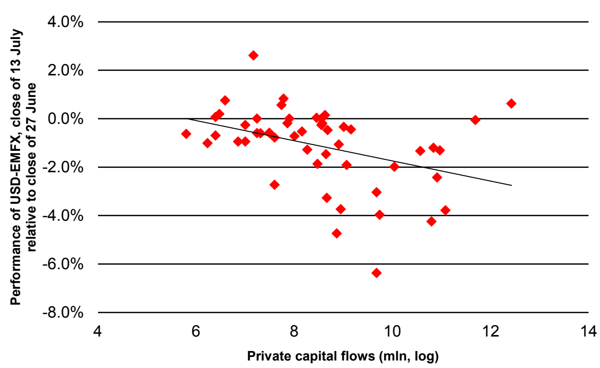
Source: Bloomberg, UniCredit Research

What we do find, however, is evidence that FX movements since 27 June are more correlated with the size of financial markets. The countries that experienced stronger exchange-rate rebounds have been the ones with larger markets.

Chart 6 shows a negative and significant correlation (at the 1% level) between post-referendum USD-EMFX movements and a proxy of financial market size: a 1% increase in the size of financial markets is on average associated with approximately 0.5% appreciation in EMFX against the US dollar (this estimated impact increases somewhat if we exclude managed currencies from our sample).

Similar to Eichengreen et al. (2016) we proxy financial-market size by looking at the average absolute value of private financial flows between 2013-2015 using data from the financial accounts of the IMF-BOPS. The results hold also if we look at a stock rather than a flow measure by taking the international investment position.

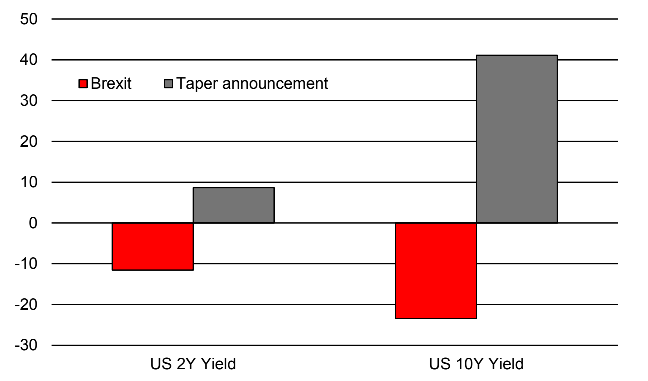
CHART 6: SIZE OF FINANCIAL MARKETS MATTERS MORE



Source: Bloomberg, UniCredit Research

This suggests that there is a liquidity story behind the post-referendum exchange-rate movements. In our view, the Brexit vote triggered expectations of a further low(er)-yield environment in developed countries due to upcoming monetary-policy easing by the BoE and potentially delayed interest-rate hikes by the Fed. This is leading investors to rebalance their portfolio towards emerging markets, hunting for yield on the back of falling US rates (in sharp contrast to the taper tantrum period – see Chart 7).

CHART 7: US YIELD MOVEMENTS (IN BP) – 14 TRADING DAYS AFTER EVENT RELATIVE TO 20-DAY AVERAGE PRIOR TO EVENT



Source: Bloomberg, UniCredit Research

In particular, the markets with higher liquidity are experiencing more pronounced currency appreciation due to ease of access, which potentially leads to larger inflows. In fact, this is the mirror of what happened after the taper tantrum when expectations of higher yields in the US triggered portfolio outflows and currency depreciation in the more-liquid EMs (see Eichengreen and Gupta 2013)[7].

This leads us to an interesting conclusion: should yield remain at these historic lows in the short term, then there is a case to be made that liquid EMFX will keep on rallying, regardless of fundamentals.

Indeed, when we performed an analysis to see which factor has been more important during the recent rebound we found that financial size overshadowed both trade linkages as well as GDP forecasts.

In the end, fundamentals will matter; but we think investors should bear in mind that in this "low-yield induced rally" liquid EM currencies (like TRY and ZAR in CEEMEA) have the potential to rally further in the short-term.

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[7] See Eichengreen, B. and P. Gupta, 2013. "Tapering Talk: the impact of expectations of reduced federal security purchases on emerging markets", Policy Research Working Paper n. 6754, The World Bank.

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