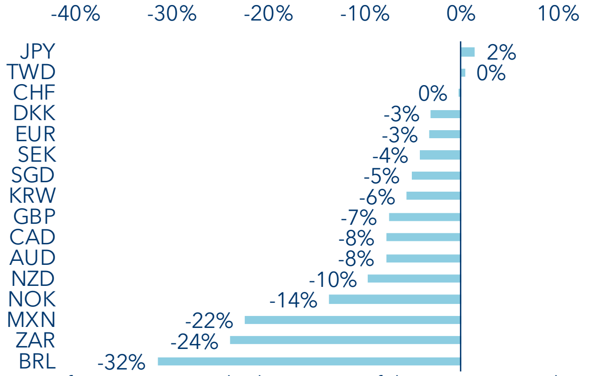
Forex markets under the spell of the corona crisis

News from the financial markets

The foreign exchange markets have also been rattled by the COVID-19 pandemic. The currencies traditionally viewed as "safe havens" are in demand, whilst the rest have been left in the dust, with some of them suffering massive losses. Investors may now be of a mind to bottom-fish. However, it is important to take a closer look before jumping into the water.

The corona crisis has stirred things up in the forex markets, and several of the less prominent currencies have taken major hits. Amongst the so-called G10 currencies (see text box at the right), the Norwegian krone has suffered severely. As to the emerging market currencies, the Brazilian real is the standout: It has lost more than 30% of its value since the beginning of the year. On the other hand, relatively little has transpired in the world's foremost currency pair, namely EUR/USD. At this point, investors may justifiably ask themselves whether it is time to take a position in one or the other laggard. In the following, we divvy up the currencies into four groups and discuss how it is not just the respective valuation aspects that are playing a role at present.

Price developments of the major currencies (vs. USD)



Performance since the beginning of the year against the US dollar in %

JPY: Japanese yen; TWD: Taiwan dollar; CHF: Swiss franc; DKK: Danish krone; EUR: euro; SEK: Swedish krona; SGD: Singapore dollar; KRW: Korean won; GBP: British pound; CAD: Canadian dollar; AUD: Australian dollar; NZD: New Zealand dollar; NOK: Norwegian krone; MXN: Mexican peso; ZAR: South African rand; BRL: Brazilian real

Sources: VP Bank, Bloomberg

Group 1: Safe havens (USD, EUR, JPY, CHF)

Due to its status as the world's No. 1 reserve currency, USD usually comes away the winner in times of crisis. Not only are economic factors in play here, but also the virtually unlimited availability of the greenback, the enormity of its reach, and its global acceptance as a medium of exchange. So when the world is faced with acute threats, it becomes essentially irrelevant that the US economy is also being battered by the coronavirus) and Treasury debt is skyrocketing. What counts is the US dollar's function as a generally accepted means of payment. It therefore should come as no surprise that demand for USD increases sharply whenever the financial markets hit the skids.

What is meant by "G10 currencies"?
Many people think of the G10 currencies as being those of the (political) G10 countries. However, the groupings are not an exact match. The G10 actually comprises eleven countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.
Belgium, France, Germany and the Netherlands all share the euro, so there is room on the G10 currency list for others such as the Australian dollar, New Zealand dollar and Norwegian krone.
All told, the G10 currencies are:

- US dollar (USD)
- Euro (EUR)
- British pound (GBP)
- Japanese yen (JPY)
- Australian dollar (AUD)
- New Zealand dollar (NZD)
- Canadian dollar (CAD)
- Swiss franc (CHF)
- Norwegian krone (NOK)
- Swedish krona (SEK)

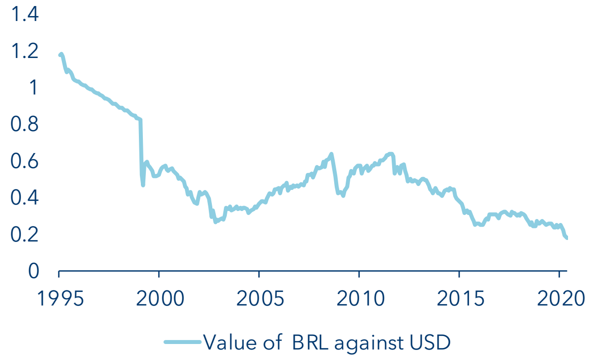
Despite the many naysayers, the euro has held up well or even gained ground against most of its G10 peers in recent months. Thus the European common currency can also be considered a safe haven, since arguments similar to those for the greenback apply here as well.
But there could be an additional factor involved: as a low-interest rate currency, the euro practically begged to be one of the pillars for so-called carry trades, in which loans are taken out in a "cheap" currency (e.g. euros) and invested in higher-yielding currencies. But because precisely those central banks that still had room for manoeuvre were the ones to ultimately cut their interest rates, these carry trades soured and were unwound. Consequently, capital flowed back into the eurozone. The same syndrome applies to the Japanese yen, which has been the only G-10 currency to appreciate against USD since the beginning of the year. While the size of the market plays a key role in US dollar and euro dealings, the Swiss franc is a safe haven in its purest form. Switzerland is an exemplar of solidity, and it is not without reason that the tiny country is also referred to as the "Alpine fortress". For many investors, Switzerland remains a refuge in times of crisis.
As the risks to the global economy are still high, safe havens should stay in demand for the foreseeable future. USD, EUR, CHF and JPY can be expected to strengthen versus the other G10 currencies in the weeks ahead. Against each other, though, the four are likely to trade in a

generally sideways fashion.
Equally spoken, we believe that the franc will fare relatively better versus the euro due to its tremendous solidity. In the medium to long term, we expect USD to tend towards weakness. From a fundamental standpoint, the greenback is overvalued. However, for that fat to be trimmed, the corona crisis and all its side effects need to be overcome first.

Group 2: Emerging Markets – the fear of defaults (BRL, ZAR, TRY)

A glance at the current exchange rates for certain emerging market currencies could spark a buying reflex in many investors. Be it the Brazilian real (BRL), South African rand (ZAR) or Turkish lira (TRY), these units are trading at levels never seen before against USD and EUR. The list could be extended: many other EM currencies have posted record lows in response to the coronavirus pandemic.
However, anyone arguing that the emerging market currencies "can hardly go any lower" has regularly been taught the opposite. Take for example the real: in 2015, after a four-year slide with losses of more than 60% against the US dollar, the Brazilian currency appeared to present a unique buying opportunity. Meanwhile, the four-year slide has turned into a nine-year cascade, with losses amounting to almost 75% versus the greenback. So it can be said that investments in emerging market currencies require a certain degree of humility.

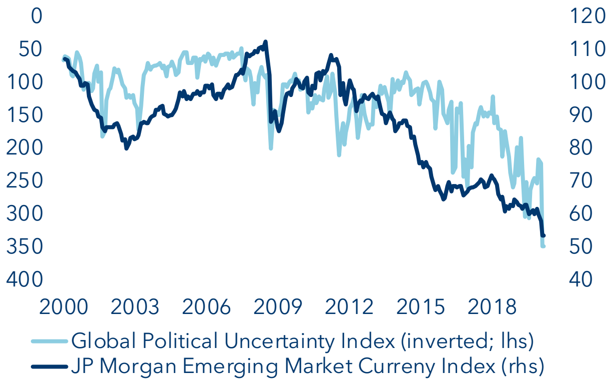
Ever-weaker: BRL's 25-year fainting spell



Sources: VP Bank, Datastream Refinitiv

Massive devaluations spawn new facts. Many emerging nations are struggling with huge debts payable in foreign currency – especially in USD, but also EUR. Expressed in the respective local currency, these liabilities are becoming ever-larger due to the exchange rate losses. On top of it all, revenue streams in foreign currency have dwindled as a result of the distressed global economic situation and concomitant weaker demand for raw materials. But if no more dollars flow into their coffers (raw materials are traded worldwide in USD), those countries will no longer be able to service their external debt. In a worst-case scenario, defaults are just a step away. South Africa and Brazil are already caught in this vicious cycle.
Although Turkey is not a significant exporter of raw materials, it is faced with a similar problem. The country is suffering under a mountain of external debt and a paucity of foreign exchange reserves. With tourism collapsing due to the coronavirus, an important source of USD and EUR income is drying up. Turkey is therefore also at risk of defaulting on its obligations.
Since investors are inclined to view the EM currencies as all being cut from the same cloth, a crisis in one country or region tend to rub off on the more solid emerging nations and their currencies. Mexico, for example, has racked up a relatively solid macroeconomic track record in recent years. However, the peso has also lost more than 50% against USD since 2011 because it got sucked into the same maelstrom as BRL – guilt by association, if you will.
Precisely because of this latent risk of defaults, we remain cautious in terms of the emerging market currencies and advise against any impulsive purchases. The fact that political uncertainties run practically in lockstep with the broad EM currency index (see chart below) is a graphic reminder of what we are talking about here.

EM currency index versus global political uncertainty index



Sources: VP Bank, Bloomberg, Datastream Refinitiv

Group 3: Global sentiment minions (NOK and SEK)

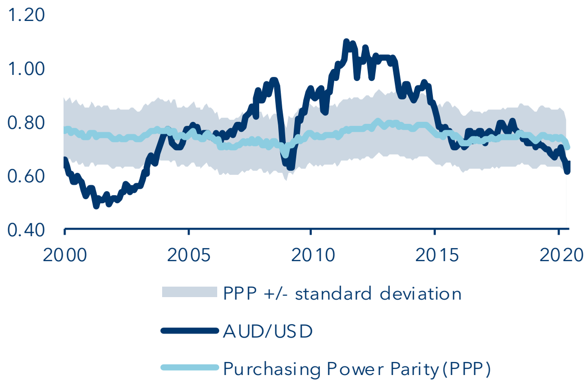
Of all the G10 currencies, the Norwegian krone (NOK) has stood out since the beginning of the year for having recorded the largest losses against both USD and EUR. The Nordic currencies (including the Swedish krona – SEK), are dependent to a large extent on overall market sentiment. That's why they are also referred to as high-beta currencies. If the financial markets are in a risk-on mode, NOK and SEK benefit; if the opposite is the case, they take a beating. Therefore, it comes as no surprise that NOK and SEK have recently recovered somewhat, thanks to the brighter mood in the equity markets of late. However, a glance in the rear-view mirror is less uplifting at least in

terms of NOK: never before has the currency traded at such abysmal levels against USD.
Even its modest upswing since mid-March has not changed this. Norway's dependence on oil is also weighing on the krone. So if the central bank (Norges Bank) had not intervened as resolutely as it did in recent months, the price decline of NOK would probably have been even steeper. As in 2014/2015, the Norges Bank reacted rapidly and decisively to the collapse in oil prices and menace of the coronavirus by introducing two rate cuts in March. Norges Bank also made it clear that they would support the krone with open market operations if necessary. In terms of relative valuation, though, the coincident swoon in SEK and NOK needs to be viewed differently. NOK is now fairly valued against the greenback based on purchasing power parity and in fact remains overvalued versus EUR. The situation is different for SEK, which, measured in the same way, is undervalued against both EUR and USD.
As high-beta currencies, NOK and SEK are likely to stay captive to mood changes in the risk markets. Ergo, further price deterioration in the two cannot be ruled out. Equally spoken, if the risk factors subside as the year progresses, both currencies could potentially gain added ground against USD and EUR.

Group 4: Asia surrogates (AUD and NZD)

Besides the Norwegian krone, the Australian dollar (AUD) and New Zealand dollar (NZD) have also been the most pressured G10 currencies since the outbreak of the coronavirus crisis. As the disease started to spread in China (the two country's most important trading partner), Australia and New Zealand felt the effect almost immediately. In recent weeks, AUD and NZD have managed to recoup some of their initial losses.
The Aussie dollar in particular is getting a boost from hopes that the domestic economy can recover quickly thanks to massive stimuli, especially since the momentum in China appears to be picking up. Moreover, AUD – and to a lesser extent NZD – should benefit from a global economic revival once today's strict lockdown measures are finally rescinded. We reckon that both currencies will strengthen against the greenback over the next six months. AUD, for example, is undervalued in terms of purchasing power parity for the first time since the financial crisis of 2008 and 2009.

AUD/USD and purchasing power parity



Sources: VP Bank, Datastream Refinitiv

Summary

At present, many currencies look cheap at first glance. But the containment measures associated with the battle against the coronavirus pandemic will continue to echo for quite some time. The consequences and implications cannot be fully quantified, despite all the economic brainpower that has been devoted to the task. For this very reason, uncertainty is likely to remain high in the months to come. There exists the latent risk of debt defaults in the emerging markets, thus a rapid recovery of the EM currencies can hardly be expected – much to the contrary: renewed setbacks cannot be ruled out. What's more, the traffic lights are not yet turning green for many of the other G10 currencies. But at least the Australian and New Zealand dollars could benefit in the coming months if only to a modest degree from the proximity of these countries to China and the discernible economic revival underway in the Middle Kingdom.

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