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Emerging Insight

EMFX in a recession: now a port in a storm

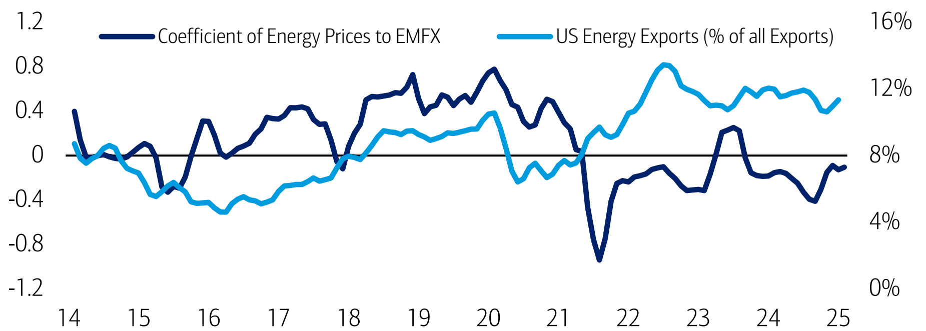
Key takeaways

- EMFX may not weaken as much in a downturn as in past years, given the now-positive correlation between USD and energy prices
- Global recession: EMFX fair value down 3%. US-led slowdown: EMFX fair value largely unchanged. EMFX is 1% undervalued now.
- Risks: a disorderly credit-driven sell-off, China's reduced appetite to stimulate. Upside: Heavy USD positioning

By R. Adlakha, M. Liluashvili, D. Hauner

Chart of the Day: EMFX is negatively correlated with energy as the US is now an energy exporter

EMFX's relationship with energy prices vs US energy exports (as % of total exports)



Source: BofA Global Research, Bloomberg, Haver

Note: 'Coefficient of energy prices to EMFX' is a series of coefficients from rolling regressions of energy prices on EMFX

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EMFX may hold up in a global recession

Our medium-term fundamental value model suggests that the fair value of EMFX should fall by only 1-3% in a global recession – a muted decline relative to previous downturns. This is largely due to the now-positive relationship between energy prices and US terms-of-trade, which is the most important determinant for EMFX. However, a major credit event may see a return to the pre-COVID regime, where lower energy prices went together with a stronger dollar. This is especially likely if China is unwilling to stimulate as forcefully as it did in previous downturns. However, light EMFX positioning limits the potential for such sharp selloffs. Thus, while the model does not capture the dynamics of a credit-risk-driven market, it helps establish an anchor for where EMFX may settle if we see a multi-quarter slowdown in growth.

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Abbreviations

EMFX is Emerging Market FX

Timestamp: 23 March 2025 05:00PM EDT

EM: Buffeted by weak growth, bolstered by cheap energy

Slowdown risks rise

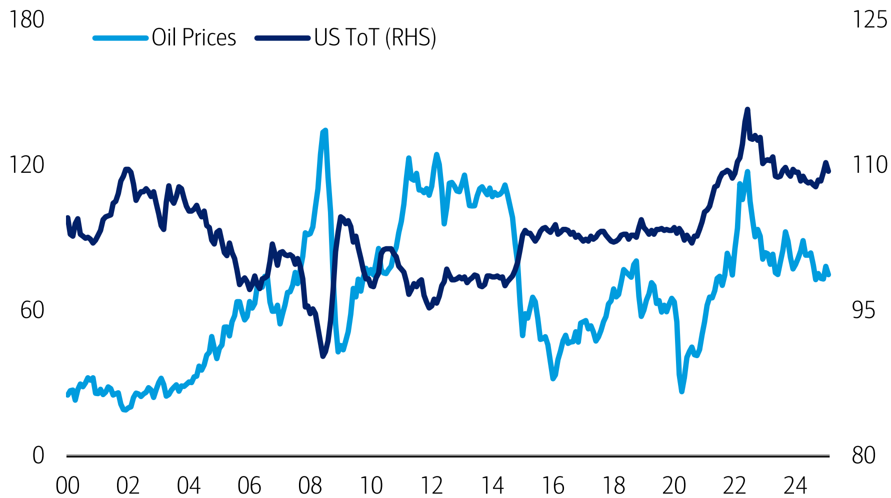
Over the past few weeks, slowdown fears have grown increasingly salient in the face of US economic policy uncertainty and the rising risks of a global trade war. This is traditionally bearish for EMFX, but will this relationship sustain?

To answer this question, we use our medium-term EMFX BEER model (see: GEMs Viewpoint: A fresh round of BEER: more fun for EMFX 03 October 2024), which identifies four fundamental drivers of EMFX: US terms of trade, the Chinese credit impulse, US 5-yr forward 5-yr break-evens, and the relative difference between the EM and US new orders to inventories ratio. While these do not capture the dynamics of a sharp credit risk-driven sell-off in EM, they establish an anchor for where EMFX may settle if we see a multi-quarter slowdown in growth.

US ToT: Most important driver of EMFX, now supported by energy prices

Now, while these fundamental drivers have been stable medium-term predictors of EMFX, their own underlying drivers have changed over time. Most importantly, energy prices are now positively correlated with US terms-of-trade (ToT), given the rising importance of energy exports to the US economy (see Exhibit 1).

Exhibit 1: Oil prices and US terms of trade since 2000
US terms of trade are increasingly positively correlated with oil prices



Source: BofA Global Research, Bloomberg

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EMFX should perform better in global recession scenarios

Given these changes, the outlook for EMFX in a recession is less clear, as the tailwinds from lower energy prices can potentially outweigh the headwinds from negative growth.

When might this be the case? To answer this, we look at how the drivers of EMFX performed during two slowdowns in the pre-COVID period:

(a) a concerted global slowdown (2015 Q2 to Q3)

(b) a slowdown in which the US underperforms RoW (2017 Q1-Q2)

Exhibit 2 describes how these variables behaved during these episodes. To assess the impact of future slowdowns on EMFX, we take the latest readings for each variable, shift them by the changes observed in 2015 and 2017, and plug them into our EMFX model.[1]

[1] We use an auxiliary model to estimate US terms of trade using energy prices, where we regress US ToT on energy prices, Chinese high frequency economic data, US commodity terms of trade, and the Baltic Dry Ice index

Exhibit 2: Performance of key drivers of EMFX in 2015 and 2017
All key drivers fell in 2015 (except Chinese credit), EM new orders ratio improved in 2017

Global downturn	2015 Q2	2015 Q3	% Change
US 5y5y	2.14	1.96	-9%
EM-US New Order to Inventory Ratio	-0.06	-0.17	-11%
China Credit Impulse	23.06	25.95	13%
Energy Prices	57.77	46.09	-20%
US underperformance	**2017 Q1**	**2017 Q2**	**% Change**
US 5y5y	2.12	1.87	-12%
EM-US New Order to Inventory Ratio	-0.02	0.06	8%
China Credit Impulse	30.04	29.33	-2%
Energy Prices	34.62	31.42	-9%

Source: BofA Global Research, Bloomberg
Note: We log transform the US 5y5y breakeven in our BEER model

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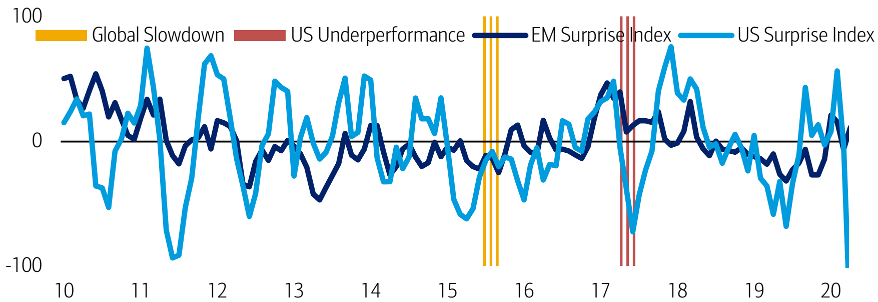
Exhibit 3: US-EM surprise index since 2010
Both US and RoW were similarly hit in 2015, the US underperformed RoW in 2017



Source: BofA Global Research, Bloomberg

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Result: Negative growth still pulls EMFX lower – but only marginally

Based on these analogues, we find that the fair value of EMFX would fall by **3% in a global slowdown** (compared to the 10% decline observed in 2015). In contrast, a US-led slowdown would see a **<1% decline in the fair value of EMFX**, compared to the 2% decline seen in 2017. Thus, while negative growth would still weigh EMFX down, the degree of weakness would be much more subdued than in previous such episodes.

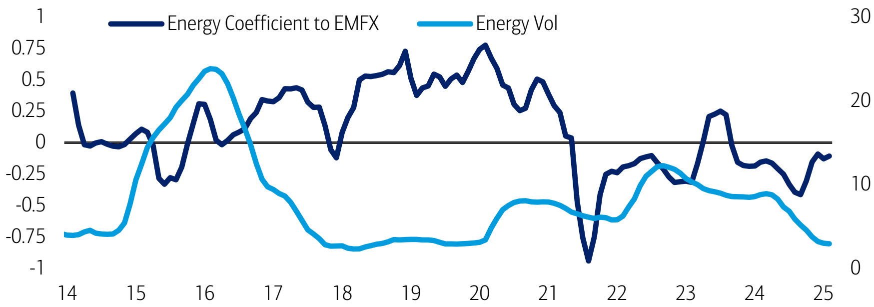
Headwind #1: A Disorderly Sell-Off

While the negative relationship between energy prices and EMFX has been sustained for the last 3 years, we have yet to see if it can persist through a disorderly market sell-off. To try to approximate this scenario, we ran 24-month rolling regressions of energy prices, energy volatility, and lagged relative US-EM positioning to assess how energy volatility mediates the relationship between energy prices and EMFX.

We find that the negative relationship between energy prices and EMFX persists even after controlling for energy price vol. Interestingly, it survives through both the relatively higher-vol period of 2020-23, and the lower-vol period of 2024, suggesting that this relationship may be robust amid different vol levels (see Exhibit 4). However, it has yet to face a period of credit-driven high volatility when such relationships can destabilize.

Exhibit 4: Energy price coefficient to EMFX vs energy price volatility

The energy price coefficient has been negative through most of the post-COVID period



Source: BofA Global Research, Bloomberg

Note: Energy volatility = Rolling standard deviation of energy prices, US-EM positioning: Relative Z-scores (per CFTC data)

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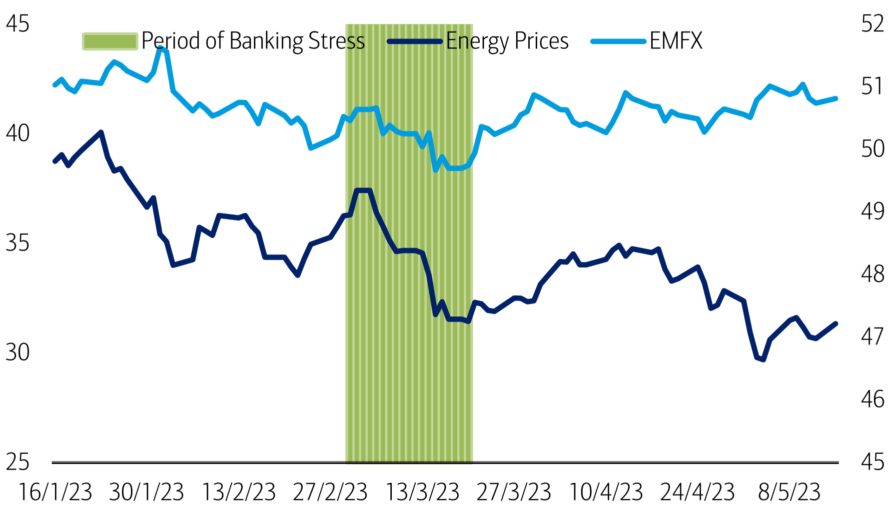
Indeed, the last period of sustained credit stress in the market – the tremors in the banking sector in the lead-up to and following the collapse of Silicon Valley Bank (SVB) in early March 2023 – saw EMFX and energy prices move in the same direction. However, even in this scenario, the reaction of EMFX to energy prices was muted. While energy prices fell by 13% between March 2 and March 20, EMFX weakened by less than 2% (see Exhibit 5).

To account for differences in underlying volatility, we normalize each asset by the standard deviation of its rolling monthly returns from Feb-May 2023 and find that while energy prices fell by ~2 SDs between 02/03 and 20/03, EMFX fell by only 1.2 SDs. This suggests that the impact on EMFX is muted even after accounting for differences in underlying volatility.

Exhibit 5: EMFX and energy prices in March 2023

EMFX and energy prices both fell during the SVB crisis – but the fall in EMFX was muted



Source: BofA Global Research

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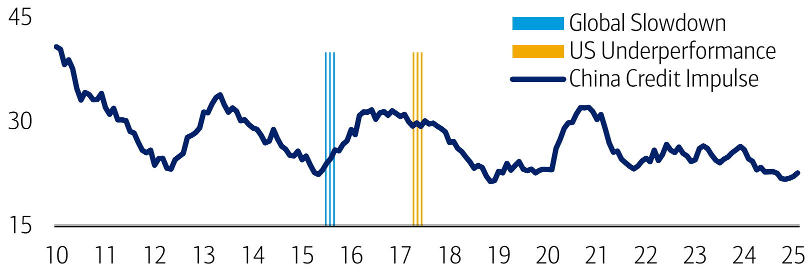
Headwind #2: China Stimulus (or lack thereof)

This relatively rosy picture may be muddied by Chinese policymakers' unwillingness to stimulate the economy as much as they did in 2015 (see Exhibit 6). However, this will not place significant strain on EMFX. Our model suggests that if the Chinese credit impulse remained at its 2022-24 average, EMFX would only weaken by a further 0.3%.

Exhibit 6: Chinese credit impulse since 2010
The Chinese credit impulse was elevated through 2015-17, but has been subdued since 2022



Source: BofA Global Research, Bloomberg

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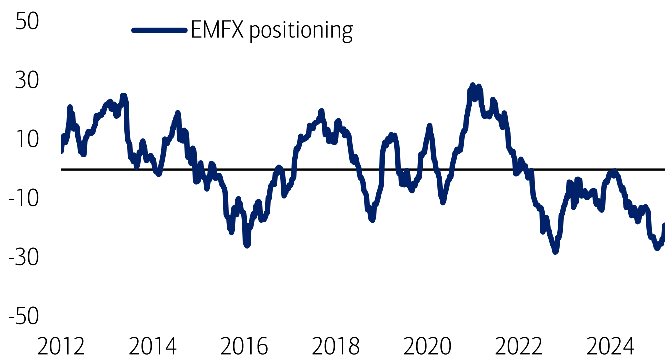
Tailwind #1: Light EMFX Positioning

Our Liquid Cross-Border Flows data (see Exhibit 7) suggests that investor positioning in EMFX is still near all-time-lows – the 7th percentile of all weeks since 2012 – which limits the potential for future selloffs in EM. Indeed, the distribution of 3m-forward returns at similar levels of EMFX positioning since suggests that risks are skewed to the upside (see Exhibit 8).

Exhibit 7: EMFX positioning
EMFX positioning is extremely light



Source: BofA Global Research
Note +50 (-50) represents max long (short) positioning

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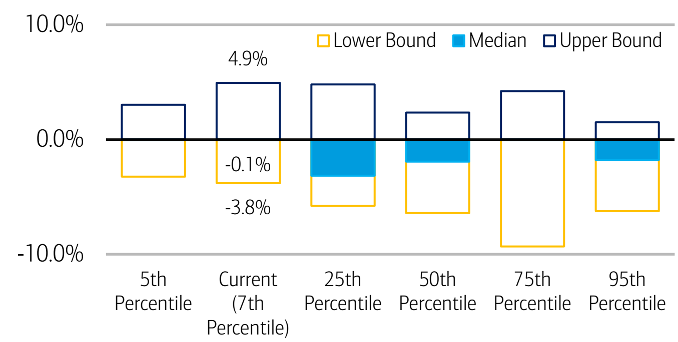
Exhibit 8: 3m-fwd return distributions across EMFX positioning levels
The forward returns distribution for current levels of EMFX positioning is skewed to the upside



Source: BofA Global Research
Note: Upper-Bound: 97.5 percentile of all 3m forward returns at a given level of positioning
Lower Bound: 2.5 percentile of all 3m forward returns at a given level of positioning

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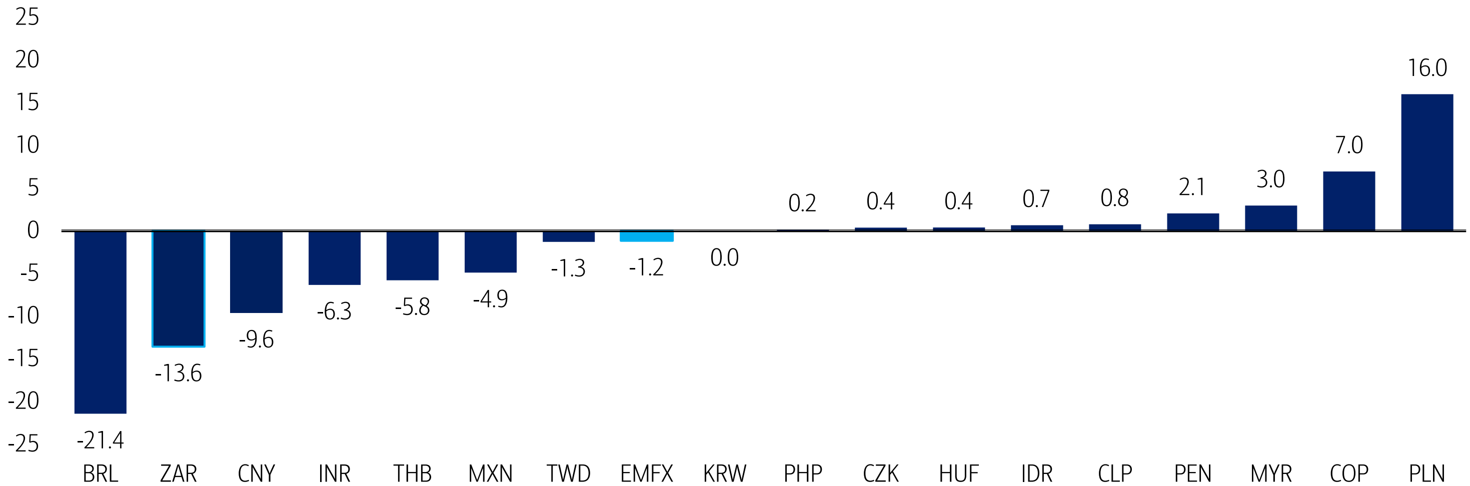
Appendix: EM BEER Model- March Update

Exhibit 9: EM BEER: Deviations from medium-term fair values
EMFX is 1.2% undervalued



Source: BofA Global Research, Bloomberg, Haver

Exhibit 10: EM BEER: Medium-term fair value forecasts
BRL, ZAR are the most undervalued, PLN, COP are the most overvalued

Currency	Ensemble Prediction	LR Prediction	Ensemble Deviation %	LR Deviation %	Regime
BRL	4.47	4.47	-21.4	-21.4	Long-Run
ZAR	15.61	15.61	-13.6	-13.6	Long-Run
CNY	6.53	6.53	-9.6	-9.6	Long-Run
INR	81.09	81.09	-6.3	-6.3	Long-Run
THB	31.63	31.63	-5.8	-5.8	Long-Run
MXN	19.08	19.08	-4.9	-4.9	Long-Run
TWD	32.58	32.19	-1.3	-2.5	Short-Run
EMFX	62.39	62.38	-1.2	-1.2	Short-Run
KRW	1453.78	1334.43	0.0	-8.2	Short-Run
PHP	57.39	57.39	0.2	0.2	Long-Run
CZK	25.15	26.83	0.4	7.1	Short-Run
HUF	398.94	437.95	0.4	10.2	Short-Run
IDR	16532.53	14760.38	0.7	-10.1	Short-Run
CLP	926.19	940.07	0.8	2.3	Short-Run
PEN	3.72	3.72	2.1	2.1	Long-Run
MYR	4.58	4.58	3.0	3.0	Long-Run
COP	4355.95	4355.95	7.0	7.0	Long-Run
PLN	4.84	4.84	16.0	16.0	Long-Run

Source: BofA Global Research, Bloomberg, Haver

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